INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D17/88

Profits tax – interest – whether arising 'through or from the carrying on by [a] corporation or its business in [Hong Kong]' – relevant factors – s 15(1)(f) of the Inland Revenue Ordinance.

Panel: Henry Litton QC (chairman), Joseph M Lai and Patricia Loseby.

Date of hearing: 31 May 1988.
Date of decision: 17 June 1988.

The taxpayer company was a subsidiary of a German company. Its business consisted of buying optical goods from its parent and reselling them in Hong Kong. It lent surplus funds to its parent, and placed further funds on deposit with a bank in Hong Kong.

The IRD assessed the interest which had been earned on these loans to profits tax. The taxpayer appealed, claiming that the interest did not arise 'through or from the carrying on by the [taxpayer] of its business in [Hong Kong]'. Specifically, it claimed that the interest arose not from the business but from the loan obligations.

Held:

The interest was subject profits tax.

(a) To say that the interest arose from the loan obligations, and not the business, would result in s 15(1)(f) exempting all interest from profits tax. It could not have been intended to have that effect.

(b) Whether interest arises 'through or from the carrying on [of the taxpayer's] business' depends on the facts. For example, interest earned on trade credit given to customers is clearly taxable, whereas interest earned on funds set aside to pay dividends clearly does not. In between these extremes, it is a question of degree. The burden of proof is on the taxpayer.

(c) The bank interest was paid on deposits of the taxpayer's circulating capital and was clearly subject to profits tax.

(d) The interest earned from the parent was paid by the supplier of the taxpayer's trading goods. In the absence of evidence to the contrary, bearing in mind that the burden of proving an assessment is wrong lies on the taxpayer, the

Board would assume that the loan was made by the taxpayer as part of its normal business operations. Thus, the interest was subject to profits tax.

[Editor's note: Although s 15(1)(f) has been amended, this decision remains important for the purpose of interpreting s 15(1)(f) which deals with the assessability of interest derived by financial institutions.]

Appeal dismissed.

Cases referred to:

D15/87, IRBRD, vol 2, 373
American Leaf Blending Co Sdn Bhd v Dir Gen of IR (Malaysia) [1978] STC 561
Northend v White (1975) 50 TC 121

Agnes Sin for the Commissioner of Inland Revenue.
Stephen Tupper of Ernst & Whinney for the taxpayer.

Decision:

1. This case is concerned with the liability of the taxpayer company (the company) for profits tax in respect of interest earned by the company on two classes of loans:

(i) loans made to its parent company in West Germany and

(ii) deposits with financial institutions in Hong Kong.

2. The two years of assessment in question are 1984/85 and 1985/86. The assessor came to the view that section 15(1)(f) of the Inland Revenue Ordinance, as applicable to the period 1 April 1984 to 31 March 1986, brought the two classes of interest received by the company within the charge to profits tax, and he assessed the company accordingly. The sums which the assessor brought within the charge to tax are as follows:

Year of Assessment 1984/85 (Additional)

Interest from loan to parent company	$269,570
Interest from HK$ deposits	$ 97,211

Year of Assessment 1985/86

Interest from loan to parent company	$377,388
Interest from HK$ deposits	$ 24,056

3. These assessments were confirmed by the Commissioner.

4. On this appeal by the company against these assessments, it is agreed between the parties that, for the year of assessment 1984/85, the sum by way of interest from loans to the parent company should be reduced by the amount of $34,903. This came about as a result of a re-calculation of interest by the company's representative, which the Commissioner accepted. Accordingly, the amount in dispute, in relation to the interest from loans to the parent company in the year of assessment 1984/85, should in fact be the sum of $234,667.

5. The provisions of section 15(1)(f) of the Ordinance, at the relevant time, read as follows:

> '15(1) For the purposes of this Ordinance the sums described in the following paragraphs shall be deemed to be receipts arising in or derived from the Colony from a trade, profession or business carried on in the Colony –
>
> …
>
> (f) sums received by or accrued to a corporation by way of interest arising through or from the carrying on by the corporation of its business in the Colony, notwithstanding that the sums in respect of which the interest is received or accrues are made available outside the Colony.'

6. This short-lived provision of law was repealed with effect from 1 April 1986 and cannot therefore affect subsequent years of assessment.

Background facts

7. The company was incorporated as a private company in Hong Kong in May 1976. The company has been carrying on in Hong Kong the business of selling optical goods. The company purchase products from its parent company and sells them to customers in Asian countries such as Taiwan, Indonesia, Korea, Thailand and Hong Kong.

8. The company's trading profits have always been fully chargeable to Hong Kong profits tax.

9. In the year 1984, the company made advances to the parent company amounting to a total of DM2,000,000 in three instalments as follows:

Date	Amount
24 January 1984	DM1,000,000
4 April 1984	DM 500,000
2 October 1984	DM 500,000

DM2,000,000

These instalments were transferred directly from the company's bank account in Hong Kong to the parent company's bank account in Frankfurt.

10. A formal loan agreement was executed dated 1 October 1984 between the company and its parent, to the following effect: the duration of the loan was indeterminate; the loan could be cancelled by either party by giving notice of three months expiring at the end of the year; the interest rate on the loan was 7% per annum, payable quarterly.

11. The loan was outstanding for the two years of assessment in question and remained outstanding as at 31 December 1986.

12. The interest derived from the Hong Kong dollar deposits came from funds deposited with the Hong Kong branch of Citibank NA. This represented funds temporarily surplus to the company's business requirements.

The hearing

13. At the hearing before us, there was adduced in evidence certain correspondence between the company's tax representatives and the Inland Revenue Department, the financial statements of the company for the relevant years and the Memorandum and Articles of Association of the company.

14. The company's representative did not adduce any oral evidence, but relied upon the facts as enumerated in paras 7 to 12 above (which were agreed by the representative of the Inland Revenue Department) and made, in essence, two submissions:

(i) The sums received by the company by way of interest did not arise 'through or from' the carrying on by the company of its business in Hong Kong. It arose from an intervening event, namely, the placing of funds on interest. The source of the interest is not the business but the loan obligation from which the interest springs. Although Mr Stephen Tupper (the company's representative) appeared to have confined this submission to the Hong Kong dollar deposits, it is clear from the nature of this submission that, if valid, it is equally applicable to the deutschemark loans to the parent company.

(ii) As a matter of fact, the funds in deutschemarks advanced to the parent company represented accumulated profits of the company. They were surplus to the requirements of the company's business and completely divorced from the normal operations of the Hong Kong business. Accordingly, the interest cannot be said to have arisen 'through or from' the carrying on by the company of its business in Hong Kong.

Section 15(1)(f) of the Inland Revenue Ordinance: interpretation

15. For the sake of convenience, we will consider, first of all, point (i) as advanced on behalf of the company.

16. As a matter of common sense, the immediate source of any sum of interest is the loan obligation from which the interest springs. The legislature, in using the expression 'interest arising through or from the carrying on by the corporation of its business in the Colony', cannot be presumed to have lost sight of a proposition which is so fundamental.

17. Prior to the amendments of section 15(1)(f) by the Inland Revenue (Amendment) Ordinance (No 36 of 1984), section 15(1)(f) read as follows:

> '15(1) For the purposes of this Ordinance, the sums described in the following paragraphs shall be deemed to be receipts arising in or derived from the Colony from a trade, profession or business carried on in the Colony –
>
> …
>
> (f) sums received by or accrued to a corporation carrying on a trade, profession or business in the Colony by way of interest derived from the Colony.'

18. For many years, professional tax representatives in Hong Kong, and assessors in the Inland Revenue Department, have construed the words in the old section 15(1)(f) 'derived from the Colony' by asking themselves this simple question: where was the credit giving rise to the interest provided? This was the 'provision of credit' test. The words in section 15(1)(f) 'derived from the Colony' were construed as confining the charge to those instances where the credit was made available in the Colony, irrespective of the locality of the business operations of the person providing the credit.

19. As the Financial Secretary stated in the Legislative Council in the course of his Budget speech in 1984, whilst the 'provision of credit' test might well determine the liability of private depositors to interest tax, it really begged the question where the moneys were loaned as part and parcel of the operations of a business carried on in Hong Kong. He went on to say:

> 'As long ago as 1976 the Third Inland Revenue Ordinance Review Committee expressed doubts as to the validity of this approach, pointing out the opportunities for manipulation which it presents; and the present Commissioner of Inland Revenue – and his predecessor – have long held the view that the provision of credit test is both artificial and inappropriate in determing the true territorial source of interest income accruing to businesses. I share their view, particularly as in the technological age in which we live the placing of a deposit in a bank account in London or New York is only a quick telephone call or a telex message away. All in all, I believe that a more realistic approach is to look at the locality of the business carried on, rather than the

physical location of the moneys loaned, in order to determine the source of the resultant interest income.'

20. This was the context in which the amendment to section 15(1)(f) came to be made, by Ordinance No 36 of 1984. The expression 'sums received by or accrued to a corporation by way of interest arising through or from the carrying on by the corporation of its business in the Colony' is the same as that used in section 15(1)(i) in respect of financial institutions. The addition of section 15(1)(i) to the 'deeming' provisions in section 15 had been made some years back, in 1978, and was plainly intended to catch within the tax-net interest on funds made available offshore to financial institutions carrying on business in Hong Kong.

21. The argument for the company on point (i) above boils down to this: the amendment to section 15(1)(f) made in 1984 did not have the effect of widening the scope of profits tax liability at all, in respect of interest income; it had the opposite effect. This argument appears to us to be very odd. It would be an astonishing thing if, by using the expression 'arising through or from the carrying on by the corporation of its business in the Colony', the legislature had meant to exclude from the tax-net altogether all interest received upon the basis that, conceptually, the source of interest is never the business of the corporation but the loan obligation from which the interest springs. This is to construe the words 'arising through or from the carrying on by the corporation of its business in the Colony' as if the sole function of those words were to act as a screen, exempting from the charge to profits tax under section 14 interest of every description. This is to turn statutory interpretation on its head, construing the function of the 'deeming' provisions in section 15(1) as if they were exempting provisions.

22. The company's representative relies upon certain dicta in Templeman J's judgement in Northend v White (1975) 50 TC 121 at 129-130 for the proposition that 'the source of interest is not the trade but the loan obligations from which the interest springs', and argues that this is a general proposition applicable to all cases, including the present case. We derive no assistance from Northend v White in our task of construing section 15(1)(f) of the Hong Kong Ordinance. That case was concerned with earned income relief claimable by individuals, and Templeman J was there construing section 525(1)(c) of the Income Tax Act 1952 where earned income was defined as: 'any income which is charged under Schedule D and is immediately derived by the individual from the carring on ... by him of his trade, profession or vocation'. Like the Board of Review in Case No D15/87 to which decision we were referred, we do not regard it as appropriate to pluck a simple statement out of the ratio decidendi and attempt to apply it against an entirely different background.

23. We accordingly reject the company's argument on this point.

24. Having said that, we do find the words 'arising through or from the carrying on by the corporation of its business in the Colony' difficult to construe. There is no built-in lexicon in the tax statute by which assistance to interpretation can be sought. However,

these words, like other words in the ordinance, are used by the legislature within the framework of general principles as evolved in decided cases under the common law system. As was stated by Lord Diplock in American Leaf Blending Co Sdn Bhd v Director General of Inland Revenue (Malaysia) [1978] STC 561, 565, 'business' is a wide concept and 'in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business'.

But words, however wide, have their limits and where a company has, for example, put aside a sum of money in anticipation of declaring a dividend in the future, and in the meanwhile is receiving interest on the sum thus put aside, it would be difficult to argue that the interest was received 'through or from' the carrying on by the company of its business. On the other hand if, in the course of its business, say that of selling optical goods (as in the present case), the company gave credit to its customers and earned interest thereon, it would be impossible to argue that such interest did not arise 'through or from' the carrying on by the company of its business. Between these two extremities, it is a question of degree, depending upon the facts as they emerge from the case, as to whether the interest arises through or from the carrying on of the company's business.

The Hong Kong dollar deposits

25. On the facts before us, it appears quite clearly that the funds were initially put into a seven-day call deposit account and a savings account. They were transferred to a current account later on from which no interest was generated.

26. Such sums as were placed on deposit were on call at short notice, and there was a period, from October 1984 to August 1985, when there were no sums on call deposit at all.

27. In these circumstances, not only has the company failed to discharge its burden of showing that the assessment in relation to the Hong Kong dollar deposits was erroneous, the material before us positively proved that the assessment was correct. The funds deposited from time to time with Citibank NA were part of the circulating capital of the company, employed in its business, and the interest clearly arose through and from the carrying on by the company of its business in Hong Kong.

Deutschemark loans to parent company

28. The submission as put to us by Mr Tupper, the company's representative at the hearing, was that the funds advanced to the parent company 'represented accumulated profits of the company which, but for German tax considerations, would otherwise have been distributed by way of dividend to the parent'. However, no evidence was adduced before us to substantiate this point, nor were we told what the German tax considerations might have been.

29. The argument as put to us on the company's behalf was that the funds were permanently removed from the normal operations of the company and were outstanding for over three years. However, this is not the full picture. We cannot lose sight of the fact that the parent company was the supplier of the goods sold by the company in its business of selling optical goods, and there were other dealings between the parent and the company apart from the placing of the deutschemark loans with the parent company. Thus, in the financial statements for the calendar year (which was also the company's financial year) in which the funds were advanced, one sees the following: under the heading 'Other Assets', there is the sum of HK$5,006,000 representing the value of the deutschemark loans; but under 'Current Liabilities' one sees 'amounts due to parent company' of HK$2,802,535. Whilst the amount of the deutschmark loan remained constant in the following year (although its Hong Kong dollar value had increased), the amount owing the parent company went up considerably, to $6,855,458.

30. The argument for the company is that the deutschemark funds could effectively be treated as profits distributed to the parent company. There seems to us two objections to this argument. First, a loan brings with it an obligation to repay, and is therefore quite different from dividends which, once declared, become the property of the shareholder. Secondly, the financial statements of the company for the years ending 31 December 1983 and 1984 do not suggest that the company had the means readily at hand to pay out dividends amounting to over $5,000,000. The increase of current assets from 1983 to 1984 was very slight, from $14,353,445 to $14,911,321, but current liabilities increased for the same period from $1,881,231 to $4,531,398.

31. Eventually, the deutschemark funds were repaid to the company in September 1987.

32. The burden of proof is on the company to satisfy us that the assessment is erroneous. No oral evidence was adduced before us, from any director or manager of the company, to explain the operations of the company, in particular as regards the figures in the financial statements representing 'amounts due to parent company'. These, as we have said above, increased from $2,802,535 in 1984 to $6,855,458 in 1985 and we can only assume, in the absence of evidence to the contrary, that these represented obligations incurred in the normal operations of the company's business of selling optical frames and lenses. Seen in this context, the advances totalling DM2,000,000 are not really divorced from the carrying on of the company's business. In the conduct of that business, there are inter-company financial transactions: the company owes money to the parent company (which is also the supplier of the products sold by the company) and the company is owed certain sums by the parent. No evidence has been adduced as to whether, in relation to the amounts due to the parent company, the company incurred liability for interest. Assuming that such interest was paid to the parent, the parent would presumably have received the interest 'through or from' the carrying on by the parent of its business. We cannot see why the reverse of this situation should not also prevail when, in relation to the deutschemark loans, it was the company which received interest from the parent.

33. The onus of satisfying us that the interest on the deutschemark loans was not received through or from the carrying on by the company of its business in Hong Kong is upon the appellant company to discharge. This burden the company has failed to discharge and accordingly the appeal must be dismissed.

34. To give effect to what we have stated in paragraph 4 above, the assessment for the year of assessment 1984/85 must be reduced to reflect the reduction in the interest received which should, in fact, be the sum of $234,667. The appeal is otherwise dismissed.