INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D21/92

Profits tax – whether taxpayer was carrying on business in Hong Kong and whether profits arose in or were derived from Hong Kong – whether taxpayer was a financial institution and whether interest received arose through or from the carrying on by the taxpayer of its business in Hong Kong – sections 14 and 15 of the Inland Revenue Ordinance.

Panel: Robert Wei Wen nam QC (chairman), Graeme Large and Norman Ngai Wai Yiu.

Dates of hearing: 24 September 1991, 20, 21, 24, 25, 27 & 28 February and 5, 9, 12, 19, 23 & 30 March 1992.
Date of decision: 24 August 1992.

The taxpayer was incorporated outside of Hong Kong was a wholly owned subsidiary of a Hong Kong company, and was part of a larger banking group. The function of the taxpayer within the group was to serve as a vehicle for tax avoidance. The taxpayer carried on its business in a fragmented way in a number of countries. Its business was the making of loans. The Board of directors of the taxpayer made decisions outside of Hong Kong. Some loan agreements were signed in Hong Kong and some overseas. Most of the day to day management and the administration of the business of the taxpayer took place in Hong Kong. Inter-bank transfers of money took place overseas under the international clearing house system. The assessor decided that the taxpayer was carrying on business in Hong Kong and that the profits arose in or were derived from Hong Kong.

Held:

The operations from which the profits of the taxpayer in substance arose took place in Hong Kong, the taxpayer carried on its business in Hong Kong, and its profits arose from such business.

The taxpayer was a financial institution within the meaning of section 2 of the Inland Revenue Ordinance. For interest to come under section 15(1)(i) of the Inland Revenue Ordinance three conditions must be fulfilled. The interest must have been received by the taxpayer as a financial institution, the interest must have arisen through or from the carrying on of business in Hong Kong, and the business must have been carried on by the taxpayer as a financial institution. On the facts before it the Board decided that the taxpayer was only liable to tax in respect of certain of the interest which it had received and accordingly the appeal was partly successful. The Board further held that the taxpayer was not liable to tax in respect of certain fees which it had earned.

Appeal allowed in part.

> [Editor's note: Both the taxpayer and the Commissioner of Inland Revenue have filed appeals against this decision.]

Cases referred to:

> CIR v Hang Seng Bank Ltd [1991] AC 306
> Adams v Cape Industries Pic [1990] 1 CH 433
> Jabbour v Custodian of Israeli Absentee Property [1954] 1 WLR 139
> Littauer Glove Corporation v F W Millington (1920) Ltd [1928] 44 TLR 746
> Erichsen v Last [1881] 8 QBD 414
> Werle v Colquhoun [1888] 20 QBD 753
> Smidth & Co v Greenwood [1921] 3 KB 583
> Firestone Tyre Co Ltd v Lewellin [1957] 1 All ER 561
> CIR v HK-TVB International Ltd (Privy Council Appeal No. 28 of 1991)
> R v West Yorkshire Coroner [1983] QB 335
> Tomalin v S Pearson & Sons Ltd [1909] 2 KB 61

P F Feenstra for the Commissioner of Inland Revenue.
Robert G Kotewall instructed by Johnson Stokes & Master for the taxpayer.

Decision:

Subject of the Appeal

1. This is an appeal by a company incorporated in country A (the Taxpayer) against the profits tax assessments raised on it for the years of assessment 1980/81 to 1986/87 as revised by the determination of the Commissioner of Inland Revenue dated 13 July 1989.

Issues

2. By agreement the issues of this appeal are:

(1) Whether the Taxpayer was a person carrying on a business in Hong Kong; and, if so, whether the Taxpayer's profits were profits arising in or derived from Hong Kong from such business within the meaning of section 14 of the Inland Revenue Ordinance (IRO); and, if not,

(2) Whether the Taxpayer was a financial institution as defined in section 2 of the IRO; and, if so, whether interest received by or accrued to the Taxpayer arose through or from the carrying on by the Taxpayer of its business in Hong Kong within the meaning of section 15(1)(i) of the IRO.

Facts

3. The Taxpayer was incorporated as an exempt company under the laws of country A in late 70's. It changed its name 3 months later and adopted a new memorandum of association whereby its main objects were amended to include the carrying on of the business of banking and the advancing or lending of money or the grant or provision of financial accommodation with or without security. It commenced business in late 1979, having on that day obtained a category 'B' unrestricted bank licence issued by the Governor of country A which permitted it to carry on a banking business outside country A.

4. The Taxpayer was wholly owned by a company incorporated in Hong Kong (the Hong Kong company) which was in turn wholly owned by a company in place B (company B); company B was prior to mid-1981 owned by a consortium (of which a bank in country X (the head bank) was a member) and subsequently wholly owned by the head bank.

5. The Hong Kong company was at first a registered deposit-taking company (DTC) and subsequently a licensed DTC within the meaning of the Deposit-taking Companies Ordinance (DTCO) (since repealed) and the Banking Ordinance (BO) which succeeded it, and was at all times a financial institution within the meaning of section 2 of the IRO. A main purpose of the Hong Kong company was to look for business; it did this by calling on companies and state agencies directly. In the late 1970's and early 1980's, the Hong Kong company was one of the main institutions or banks which are active in syndicated loans in Hong Kong; it would on its own or in co-operation with other banks underwrite term loans and syndicate them among other banks in Asia and Europe. All those banks carried on business in Hong Kong. The banking department of the Hong Kong company undertook credit analysis, loan syndication, loan management, negotiation of new loan documentation and amendments to existing agreements and loan administration. When a syndicated loan was being put together, the lead bank or banks structured the financial package and handled the negotiations with the borrower on behalf of the lending banks. The place where the negotiations took place depended on the wishes of the borrower. The loan agreement was signed either in or outside Hong Kong. For each syndicated loan there was an agent whose role was to handle post-signing events, that is: to set interest rates, request drawdowns and collect contributions from the participating lenders, pay the proceeds to the borrower, calculate and pay commitment fees, front end fees and interest, collect repayments from the borrower and distribute them to the participants, collect from the borrower information due to be supplied under the loan agreement (annual reports, etc) and distribute it to the participants, pass on to the participants the borrower's requests for waivers and amendments to the loan agreement, and so on.

6. A commitment fee is paid to compensate a lender for loss of income during the period when any balance of a loan is undrawn, while front end fees include arrangement fee, participation fee, drawdown fee, praecipium (for finding a borrower) and pool (the unspent portion of front end fees which is divided among lead managers). A borrower knows only

the total cost of a loan; it is a matter between the lead manager and the other lenders how the fees are to be shared.

7. The Taxpayer's function within the group was to serve as a vehicle for a tax avoidance scheme whereby it borrowed money on a regular basis (in currencies other than Hong Kong dollars) from (a) the Hong Kong company until late August 1985 and (b) the branch of the head bank in country C (company C) subsequently; and on-lent (again in currencies other than Hong Kong dollars) to borrowers (recommended by the Hong Kong company and approved by the Taxpayer), thereby making a profit out of the interest differential between the borrowings and the lendings. The borrowers were in the Asia Pacific region and were in all cases outside Hong Kong. The Taxpayer's proposition was that by virtue of its offshore position and the way its business was organised and operated, the profits thus made were not subject to profits tax under the IRO. In the words of a witness who was then an associate director of the Hong Kong company, the purpose of the Taxpayer was 'to shelter certain offshore Hong Kong profits from Hong Kong profits tax'. In the words of another witness who was an officer of the head bank: 'whilst the group regards income tax as a normal operating expense, it does not regard tax mitigation as a socially unacceptable activity provided it is done within the regulations and applicable laws'.

8. To put the scheme into operation, three preliminary steps were taken:

(1) In late 1979 the Taxpayer and the Hong Kong company entered into a service agreement (hereinafter called the service agreement) which contained, inter alia, the following terms (substituting 'the Taxpayer' and 'the Hong Kong company' respectively for the parties' names):

'1. The Taxpayer shall employ the Hong Kong company and the Hong Kong company shall serve the Taxpayer to perform the following services:

(1) to provide administrative services in respect of loans and/or loan transactions which the Taxpayer may from time to time make or to which it is a party whether alone, or jointly with others, or as a member of a syndicate of banks and other institutions;

(2) to provide administrative services for such of the bank accounts and cash deposits of the Taxpayer as it shall direct under such circumstances as shall be agreed between the parties;

(3) to provide such accounting services as the Taxpayer may require.

2. The Hong Kong company shall in the performance of the services undertake such of the following duties as the Taxpayer shall from time to time require:

   (a) the management of the cash and deposits for the time being of the Taxpayer provided that cash belonging to the Taxpayer may during such time or times as the Hong Kong company thinks fit be retained in cash or placed on deposit with any bank or financial institution in any part of the world;

   (b) keeping under review the loan and investment portfolio for the time being of the Taxpayer;

   (c) reporting to the board of directors of the Taxpayer at quarterly intervals, or as often as the board shall reasonably require, with such information as the board may reasonably require relating to the business and affairs of the Taxpayer and the activities of the Hong Kong company hereunder;

   (d) providing or procuring the provision of such statistical and other information on the loan and investment portfolio for the time being of the Taxpayer and any changes therein, and on any projects or transactions then under consideration, as may be necessary to enable the board to report fully to he members of the Taxpayer upon the financial, investment and cash position and the potential of the Taxpayer in the annual directors' report and on such other occasions as the Board may require; and

   (e) arranging for the registration of all securities acquired by the Taxpayer in the name of the Taxpayer, or in the name of such nominee company as the Taxpayer shall direct, and for bearer securities to be deposited with such authorised bank as the Taxpayer shall direct.

4. Nothing contained herein shall under any circumstances empower or authorise the Hong Kong company to negotiate, enter or conclude any contract, loan, investment or undertake as agent any business on behalf of the Taxpayer.

5. All expenses incurred by the Hong Kong company in or about the performance of its services hereunder, including the costs of administrative services, especially personnel, secretarial, clerical and office staff and accommodation shall be reimbursed by the

Taxpayer to the Hong Kong company within thirty days of any invoice in respect thereof being rendered to the Taxpayer.

6. The Taxpayer shall pay the Hong Kong company by way of remuneration for its services hereunder a fee at the rate of 5% of the expenses payable under clause 5 hereof.

7. This agreement shall continue in force until terminated by either party on giving to the other party not less than three months written notice of termination. Either party may terminate this agreement forthwith by notice to the other in any of the following circumstances:

(i) if that other party commits a breach of this agreement, which is not remedied within thirty days after notification thereof to such party in breach; or

(ii) if an order is made or an effective resolution passed for the winding-up of that other party, otherwise than by means of a member's voluntary winding-up, or for the purpose of a reconstruction or amalgamation while solvent, the terms of which shall have been previously approved in writing by the first mentioned party; or

(iii) if a receiver or similar officer is appointed of the whole or any part of the undertaking or assets of that other party.

13. The duties of the Hong Kong company hereunder shall not preclude the Hong Kong company from providing services of a like nature to any other person, firm or corporation.

15. Nothing herein contained shall constitute or be deemed to constitute a partnership or joint venture between the parties hereto.

16. This agreement shall be governed by and construed in all respects in accordance with the laws of the Colony of Hong Kong, and the parties hereby irrevocably submit to the jurisdiction of the Hong Kong courts, but this shall not prevent either party from enforcing this agreement in any other court of competent jurisdiction.'

(2) On 9 November 1979 the Hong Kong company and a company incorporated in country A (company A) entered into an agreement which contained, inter alia, the following provisions (substituting 'the Hong Kong company', 'company A' and 'the Taxpayer' respectively for their real names):

'… AND WHEREAS each of the Hong Kong company and company A is beneficially entitled to some of the shares in the Taxpayer, whether held directly or in nominee form AND WHEREAS company A has consented to act as or otherwise provide a director and officer or either of them of the Taxpayer in [country A] upon receiving such indemnity as is hereinafter contained AND WHEREAS company A has agreed that during the period in which it performs these functions as a director and officer or either of them it shall accept the advice and recommendations of the Hong Kong company whether by word of mouth, letter, cable, or telephone and shall arrange for such advice and recommendation to be carried out with the least possible delay.

PROVIDED ALWAYS that actions or omissions based on such advice and recommendation shall comply with the laws of [country A], with the powers contained in the Memorandum and Articles of Association of the Taxpayer and in other respects shall not be ultra vires or otherwise illegal AND PROVIDED ALSO in particular that company A is satisfied either that the proposed action or omission does not infringe regulations made under [country A] Exchange Control Regulations for the time being in force or that the written permission of the Controller of Exchange has previously been obtained for such action or omission.

NOW THIS AGREEMENT WITNESSETH that in consideration of these premises:

1. The Hong Kong company hereby covenants with company A that so long as it or any officer, employee or agent of company A acts as officer or director of the Taxpayer, the Hong Kong company will at all times hereafter indemnify it and hold it harmless and keep it indemnified and held harmless from all actions, suits, proceedings, claims, demands, costs and expenses whatsoever which may be taken or made against it, its officers, employees or agents or which may be incurred or become payable by it, its officers, employees or agents, in respect of or arising out of them or any of them holding any such office or directorship in the Taxpayer.

2. The Hong Kong company agrees with company A that this indemnity shall be construed and take effect in accordance with the law of [country A] which shall be the forum for the enforcement hereof and the Hong Kong company further agrees to submit to the forum of [country A] PROVIDED

ALWAYS that company A shall not be limited to the forum of [country A] for the enforcement of this indemnity in the event that any actions or proceedings are instituted against it in another forum in relation to any act or omission to which this indemnity extends AND PROVIDED FURTHER that company A may institute proceedings in respect of this indemnity in any forum where the Hong Kong company may from time to time reside or have assets situated and the Hong Kong company hereby agrees to submit to any such forum as aforesaid in which company A may seek to enforce or have recourse to this indemnity.'

Company A was owned in equal shares by two banks, one of which was the head bank.

(3) In late 1979 the Hong Kong company and the Taxpayer entered into an agreement whereby the Hong Kong company as beneficial owner sold, assigned and transferred to the Taxpayer, and the Taxpayer thereby purchased and accepted from the Hong Kong company, all the right, title and interest of the Hong Kong company as a lender to, of and in all the loan agreements, credit agreements, participation agreements and other similar documents as set out in the schedule thereto and all guarantees, promissory notes and other securities for the obligations of the obligors thereunder (the loan documents) and its rights thereunder as a lender to the repayment and payment of all such sums as might become due or owing under the loan documents. The consideration for the loans, 27 in all, due and payable on various dates in 1979 and 1980, aggregated to US$63,846,000 plus DEM2,913,000 plus JPY279,055,000. The Taxpayer's capital of US$5,997,500 was utilised as a partial cash payment. The balance of the consideration remained as a loan from the Hong Kong company to the Taxpayer.

9. The Taxpayer had two main sources of loan assets: the assigned loans mentioned in 8(3) above, and new syndicated loans which were recommended by the Hong Kong company and approved by the Taxpayer. To fund the making or renewal of a loan or a part of a loan (that is, a drawdown or rollover), the Taxpayer would raise the required funds by taking deposits: until late August 1985 from the Hong Kong company, and subsequently from company C.

10. Before a loan was recommended to the Taxpayer, the terms would already have been negotiated with the borrower and approved at several levels within the group; the stages in the approval process were as follows:

(1) Generally speaking, all loans had to be within the country limit.

(2) The Hong Kong company would undertake a credit analysis of the borrower which had to be approved by the marketing officer, the credit officer and the managing director of the Hong Kong company.

(3) Prior to June 1981 the loan would then be placed for approval before the external loan committee composed of a representative of each of the five shareholder banks of the consortium; from June 1981 the loan would be submitted to a credit committee consisting of a senior vice president (Asia Pacific) of the head bank in Hong Kong, a member of the senior management of the company B (who were both directors of the Hong Kong company) and the managing director of the Hong Kong company.

(4) Upon approval by the credit committee, the loan would be referred to the head bank's Asia Pacific headquarters for taxation advice and counsel. If the amount of the loan was beyond the limit of that body for giving advice and counsel, they would then refer it to the head bank's head office. In practice, head office's approval was required for all the loans made by the Taxpayer because of their size, and all three levels of approval were sought simultaneously for each loan.

11. Once all approvals had been obtained, the Hong Kong company would decide which group company should be approached to take up the loan or participate in the syndicate making the loan. In arriving at this decision, the Hong Kong company would have regard to matters such as the loans taken up by the Taxpayer to date, future likely loans, the revenue and expense budget of the Hong Kong company and the prospects for the rest of the financial year.

12. Any recommendation made to the Taxpayer would be made at arm's length, that is, on the same terms as the loan would be offered to banks outside the group; for example, the same participation fee would be offered, and any pool or praecipium would be retained by the Hong Kong company, as if the Taxpayer was a third party bank.

13. On the other hand, the Hong Kong company had to earn income to cover operating expenses, so it also took up some loans and participated in syndicated loans.

14. On 3 November 1982 the Taxpayer approved only one of four loans recommended by the Hong Kong company and rejected the other three. There is no evidence to explain the reasons for the rejection. On all other occasions, the Taxpayer's board in country A approved the loans as recommended, and, in doing so, relied on the evaluations of the group committees.

15. Having approved a loan, the Taxpayer in country A would issue to a director of the Hong Kong company (and, after mid-1981, sometimes also to an officer of the head bank as an alternative) a power of attorney to execute the loan agreement on its behalf. No evidence was adduced as to where a great majority of these loan agreements were signed. In the case of fourteen of them, their places of signing are known; six of the fourteen were

signed in Hong Kong. As a matter of inference, we find that over 40% (in number) of all the loan agreements to which the Taxpayer was a party were signed in Hong Kong.

16. The Taxpayer's main bank account was a US$ account maintained with a bank in New York, as most of its loan transactions were in that currency. In addition, it maintained a Deutschemark account with a bank in Frankfurt, a Japanese Yen account with a bank in Tokyo, and another US$ account with company A in country A. The directors of the Taxpayer and persons from time to time on the Hong Kong company's list of authorised signatories were authorised to operate the Taxpayer's bank accounts. Normally the banks communicated with, and sent their statements, credit advices and debit advices to, the Taxpayer care of the Hong Kong company in Hong Kong.

17. As its paid-up capital and reserves were comparatively small, the Taxpayer had to borrow money to fund its loan commitments. The Taxpayer was not a participant in the money markets and was unknown to any bank outside its own group. The Hong Kong company had a treasury unit which raised funds on a daily basis in the international inter-bank money markets in financial centres such as New York, London, Frankfurt, Tokyo, Hong Kong and Singapore. It made loans to the Taxpayer (by placing deposits with it) with the funds raised in the money markets. With the deposits taken from the Hong Kong company, the Taxpayer was enabled to fund the drawdowns and rollovers (loan renewals). Generally, loans made by the Taxpayer would be for a number of years while deposits taken from the Hong Kong company were short-term with the same maturity date as the rollover. Thus on a rollover, the Taxpayer would repay the deposit to the Hong Kong company and take another deposit from it. On any given working day, the Hong Kong company would raise funds to make loans not only to the Taxpayer but also to other borrowers, the funds being fungible (that is, inter-mixed and indistinguishable) in the Hong Kong company's books. The Hong Kong company would not necessarily raise specific funds to on-lend to the Taxpayer but would lend it a portion of the fungible funds, the balance being otherwise deployed. Under the clearing house system, bank transfers of US dollars are made only in New York, Deutschemarks in Frankfurt, Japanese yen in Tokyo, and so on. Thus the Hong Kong company placed deposits with the Taxpayer by transferring funds from its bank account in New York, Frankfurt or Tokyo, as the case might be, to the Taxpayer's bank account in the same financial centre. Upon repayment, the amount repaid would be transferred from the Taxpayer's bank account to the Hong Kong company's bank account in the same financial centre. In addition to sending its instructions to its overseas banks to effect such transfers, the Hong Kong company also sent instructions on behalf of the Taxpayer to the Taxpayer's overseas banks.

18. The Taxpayer paid interest to the Hong Kong company, which in turn paid interest to the banks from which it borrowed.

19. During the life of a loan, the Hong Kong company would review any requests by a borrower for amendment or waiver of terms of a loan agreement. The Hong Kong company would inform the Taxpayer in country A of the request and make a recommendation; no such request would be agreed to until the Taxpayer's board in country A had confirmed its approval, which the Taxpayer's board invariably did.

20. The cash resources of the Taxpayer were invested by the Hong Kong company which: (1) placed funds through its treasury unit in the money markets or (2) used them for its own purposes or (3) funded the Taxpayer's loan portfolio. Funds placed with the Hong Kong company's treasury unit would earn interest at the market rate. The Taxpayer's capital and reserves and the funding (that is, deposits) it took from the Hong Kong company and subsequently from company C during the years in question are reflected in the following year-end figures (in US$):

Balance Sheet Date	Capital	Dividends	Retained Profit	Amount Due To Hong Kong Co	Amount Due To Head Bank
31-12-80	5,977	-	425	84,428	-
30-9-81	5,977	-	2,310	93,996	-
30-9-82	5,977	-	4,472	100,783	-
30-9-83	5,977	4,115	2,314	109,749	-
30-9-84	5,977	-	4,480	135,538	-
30-9-85	5,977	-	6,688	81,107	51,842
30-9-86	5,977	-	8,621	-	115,271

At the 1982 and 1983 year ends, the 'Amount due to Hong Kong Co' includes in each case a balance sheet item 'Current and Deposit Accounts'. As for 1983, we are satisfied on the evidence that the item consisted of short-term deposits placed with the Taxpayer by the Hong Kong company; although there was no evidence offered in respect of the figures at 30 September 1982, we are inclined to the view that the same was true of the item in the balance sheet as at that year end, and we so find.

21. There are three distinct periods in the funding transactions of the Taxpayer: (1) until mid-1983 it was funded by the Hong Kong Company's treasury unit; (2) in mid-1983 the Hong Kong company's treasury unit was absorbed by the Hong Kong branch office of the head bank, and thereafter the Hong Kong company acted as a conduit, taking funds from the head bank and on-lending them to the Taxpayer at the same rate; and (3) in mid-1985 the Hong Kong company ceased to act as a conduit, and the Taxpayer took funding directly from company C. We find that throughout the three periods, the Hong Kong company conducted all the funding transactions on behalf and in the name of the Taxpayer. The Hong Kong company went into voluntary liquidation in early 1987. The Taxpayer went into voluntary liquidation in late 1987.

22. From the records produced on behalf of the Taxpayer to illustrate the funding transactions, we find as follows:

(1) The agent of a syndicated loan would advise the Taxpayer that the borrower had given notice of a drawdown or rollover on a certain date. In three out of the seven example given, the telex which conveyed the advice could not be located. In one example, the agent communicated with both the Taxpayer in country A and the Hong Kong company in Hong Kong, while in the other three, the agent in each case notified the Taxpayer care of the Hong Kong company in Hong Kong. We find that in the majority of cases the agent communicated with the Taxpayer care of the Hong Kong company in Hong Kong. The rate of interest for the drawdown or rollover was set by the agent at a rate over a basis rate which would be LIBOR (London Inter-Bank Offered Rate) in the case of a US$ loan. The rate of interest was advised to the Taxpayer care of the Hong Kong company in Hong Kong by telex either together with the drawdown/rollover notice or separately.

(2) The loans administration unit of the Hong Kong company, acting on behalf of the Taxpayer, would give notice to the treasury unit of the Hong Kong company (by means of a takedown (that is, drawdown) ticket or a renewal of loan (that is, rollover) ticket as the case might be) that the Taxpayer would require funds to meet the drawdown or rollover, giving the particulars of the loan including the desired spread (that is, margin over, say, LIBOR).

(3) The treasury unit of the Hong Kong company would find the funds in the international money markets or from the fungible funds in its account and offer to place a deposit of the required amount at, say, LIBOR with the Taxpayer, and the loans administration unit would accept the deposit on behalf of the Taxpayer. The treasury unit would raise a ‘new time deposit-placed’ ticket recording the placing of the deposit, while the loans administration unit would raise a ‘new time deposit-accepted’ ticket recording the acceptance of the deposit. If the treasury unit could find the funds at a rate lower than the deposit rate, the Hong Kong company would earn the difference, while the Taxpayer would earn any margin over the deposit rate.

(4) Then there would be an exchange of confirmations between the Hong Kong company and the Taxpayer in Hong Kong. In its confirmation the Hong Kong company would confirm ‘having placed with you the following deposit’, specifying the particulars, and would state: ‘The US dollars will be paid to your account at (naming the Taxpayer’s banker), New York. At maturity pay the US dollars to our account at (naming the Hong Kong company’s banker), New York.’ Deutschemark and Yen transactions would be similarly handled through Frankfurt and Tokyo respectively. The confirmations were addressed to the Taxpayer care of the Hong Kong company in Hong Kong. In its confirmation the Taxpayer confirmed ‘having accepted from you the following deposit’, specifying the particulars, and stated the manner of payment and

repayment in a similar way. The confirmation was prepared by the Hong Kong company and made in the name of the Taxpayer at the offices of the Hong Kong company. (After late August 1985 the Taxpayer made deposit-taking contracts with company C instead of the Hong Kong company. There was a similar exchange of confirmations between company C in country C and the Taxpayer in Hong Kong, care of the Hong Kong company. As a matter of inference, we find that the contracts were made by the Hong Kong company on behalf of and in the name of the Taxpayer.)

(5) In the case of a drawdown, the Hong Kong company would send a tested telex to its bank in New York in the case of US dollars, instructing it to pay the funds to the Taxpayer's bank account in New York. Similarly, a tested telex would be sent by the Hong Kong company on behalf of the Taxpayer to the Taxpayer's bank in New York instructing it to pay the drawdown amount to the agent's bank account.

(6) In the case of a rollover with no partial repayment, the Hong Kong company would send a tested telex to its bank instructing it to pay the new funds to the Taxpayer's bank account. A tested telex would be sent by the Hong Kong company on behalf of the Taxpayer to the Taxpayer's bank instructing it to pay the maturing funding plus interest to the Hong Kong company's bank account. The Taxpayer received interest from the agent and used it largely to meet the interest due to the Hong Kong company.

(7) Repayments and partial repayments made by the agent to the Taxpayer were paid over to the Hong Kong company with the interest due.

(8) The agent would also pay the Taxpayer the commitment fee and its share of the front end fees in respect of each loan.

(9) The Taxpayer deposited surplus cash with the Hong Kong company from time to time. In such cases, their roles were reversed, and there was a similar exchange of confirmations.

23. The Taxpayer normally had three directors, with one director resident in each of country A, Hong Kong and country D. The Taxpayer and the Hong Kong company shared common directors. The Taxpayer's directors were not remunerated or directed by the Taxpayer, but by the group company or companies which provided them and were paid by the Taxpayer for providing their services. The Taxpayer employed no staff in country A; any clerical or secretarial facilities required there were provided by company A at a fee.

24. The board of directors of the Taxpayer held its meetings in country A. Its main business was to consider and approve loan participations recommended by the Hong Kong company, and its main duty was to see that the proposal would not infringe the laws of country A. As for the merits of the loan, the board relied on the evaluations of the loan or credit committees of the group and approved all the recommended loans except on the one

occasion mentioned in 14 above. Although the loan approvals were a formality in nature, they did in our view involve a decision-making process, so that the board was not a mere rubber stamp in approving the loans. It had the power to disapprove them. Once a loan was approved and the loan agreement signed, the ensuing business of borrowing and on-lending was entrusted entirely to the Hong Kong company, which took deposits on behalf of and in the name of the Taxpayer up to late August 1985 from itself and subsequently from company C. It did this without seeking or having to seek prior approval or subsequent ratification from the Taxpayer in country A.

25. The service agreement [dated] (see 8 above) was carried out in some aspects but not in others. Clause 1 was carried out: (1) The Taxpayer's participation in the loans was administered by the Hong Kong company; the borrowers' requests for drawdowns and rollovers, the repayments and payments of interest were channelled through the agent to the Taxpayer care of the Hong Kong company in Hong Kong; there is some question as to whether the funding provided by the Hong Kong company through the placement of deposits came under the service agreement; we shall deal with the question later (see 28(d) below); (2) The Taxpayer's bank accounts in New York and other financial centres were operated by the Hong Kong company; the Taxpayer's banks communicated with the Taxpayer care of the Hong Kong company in Hong Kong. (3) All accounting facilities were provided to the Taxpayer by the Hong Kong company in Hong Kong; the Taxpayer's accounts were prepared by the Hong Kong company and audited in Hong Kong, and were then sent to country A office of the auditors for the audit to be completed in accordance with the local laws. Clause 2(a) was carried out, in particular relating to the investment of the Taxpayer's capital and reserves. So was clause 2(b). There was no performance of clause 2(c) or (d), nor did the Taxpayer's board in country A exercise their rights under those provisions by calling for any quarterly report, statistical or other information on the business and affairs of the Taxpayer, or on its loan and investment portfolios. Clause 4 will be dealt with later (see 28(d) below). Clauses 5 and 6(a) were carried out, except that the computation of the remuneration for the Hong Kong company was revised by an agreement [dated] to 0.1% of the Taxpayer's average loan portfolio during the year. Clause 7 entitled either party to terminate the service agreement by giving the required notice; the service agreement in fact remained in force throughout the years in question.

The Law And Its Application

26. Profits tax is charged for each year of assessment at the standard rate 'on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business' (section 14 of the IRO). Three conditions must be satisfied before a person can be assessed to profits tax under section 14:

(1) He must carry on a trade, profession or business in Hong Kong;

(2) The profits to be charged must be profits from such trade, profession or business; and

(3) The profits must be profits arising in or derived from Hong Kong. (CIR v Hang Seng Bank Ltd [1991] AC 306 at 318).

Conditions (1) and (2)

27. Mr Kotewall, leading counsel for the Taxpayer, cited a line of United Kingdom authorities on the question of presence or residence of an overseas corporation, culminating in Adams v Cape Industries Plc [1990] 1 Ch 433. If a corporation incorporated under the laws of one country is present or resident within the jurisdiction of the courts of another country, it is subject to the jurisdiction of those courts. The suggested relevance to this appeal of those authorities is that the word 'present' means nothing more or less than 'carrying on business', and therefore that test laid down in those authorities for 'presence' or 'residence' is an appropriate guide in deciding whether in the present case the Taxpayer, an overseas company, carried on business in Hong Kong. The Court of Appeal in the Adams case agreed with the general principle stated by Pearson J in Jabbour v Custodian of Israeli Absentee Property [1954] 1 WLR 139, 146:

> ' A corporation resides in a country if it carries on business there at a fixed place of business, and, in the case of an agency, the principal test to be applied in determining whether the corporation is carrying on business at the agency is to ascertain whether the agent has authority to enter into contracts on behalf of the corporation without submitting them to the corporation for approval …'

The court then said at 531:

> ' On the authorities, the presence or absence of such authority is clearly regarded as being of great importance one way or the other.',

Although earlier on at the same page the court stated that they would regard as too widely stated the proposition that the presence of an overseas corporation can never be established unless the representative has such authority. The authority of the Adams case is unquestionable; leave to appeal to the House of Lords has been refused. However, it does not seem to us that the principles of that case are applicable to this appeal: the test laid down in that line of authorities shows that the carrying on of business sis only one of the elements constituting presence or residence. In the words of Scott J, the judge at first instance in the Adams case at 476:

> ' But trading in a country is insufficient, by the standards of English law, to entitle the courts of the country to take in personam jurisdiction over the trader: see the Littauer Glove Corporation case, 44 TLR 746. The trading must be reinforced by some residential feature, be it a branch office or a resident agent with power to contract.'

We therefore prefer to seek guidance from the line of United Kingdom cases on the question whether the profits brought into charge were profits 'arising or accruing … from any trade exercised within the United Kingdom'. On the meaning of the word 'exercised', Jessel, MR, said in Erichsen v Last [1881] 8 QBD 414 at 415:

> ‘ Whatever the word “exercised” may mean, it certainly includes carrying on and therefore carrying on trade is within that word.’

As for the word ‘trade’, conceptually it is perhaps not as wide as the word ‘business’, but the two words have been used interchangeably in the authorities. In Werle v Colquhoun [1888] 20 QBD 753, Fry, LJ, said at 761:

> ‘ I think it is obvious that the late Master of the Rolls was correct when he said that whatever else those words (that is, “exercising a trade”) may mean, they plainly included carrying on a trade, and I also entirely agree in his observation that the question whether a trade is carried on is not a matter of law, or one in respect of which you can lay down any one distinguishing incident, but it is a compound fact made up of a variety of things. In many cases it is obvious there would be no difficulty in determining whether a trade had been carried on at a particular place. A small shopkeeper who does nothing but sell particular wares that belong to himself in a shop, receiving payment for the wares he delivers in that shop, is plainly carrying on trade in the place where that shop is situated. The question, however, becomes much more difficult when the trade is carried on, as in the present case, in a far more complicated manner – when it is carried on by the intervention of agents, and when contracts may be made in one place, the goods may be in another, the principal in another, and the goods may be delivered in some other place. We have, however, simply to take all the relevant facts, and the mode in which the business is carried on, and to ask ourselves whether or not that business be or be not carried on within the United Kingdom.’

In Smidth v Greenwood [1921] 3 KB 583, Atkin, LJ, said at 593:

> ‘ We have the guidance of the House of Lords on this subject in Grainger v Gough. Lord Herschell, after pointing out that there is a difference between trading in a country and trading with a country, says: “How does a wine merchant exercise his trade? I take it, by making or buying wine and selling it again, with a view to profit.” Similarly as manufacturer of machinery exercises his trade by making the machinery and selling it again, with a view to profit. There are indications in the case cited and other cases that it is sufficient to consider only where it is that the sale contracts are made which result in a profit. It is obviously a very important element in the inquiry, and if it is the only element the assessments are clearly bad. The contracts in this case were made abroad. But I am not prepared to hold that this test is decisive. I can imagine cases where the contract of resale is made abroad, and yet the manufacture of the goods, some negotiation of the terms, and complete execution of the contract take place here under such circumstances that the trade was in truth exercised here. I think that the question is, where do the operations take place from which the profits in substance arise?’

In Firestone Tyre Co Ltd v Lewellin [1957] 1 All ER 561, Lord Radcliffe said at 568:

> ' My Lords, no one can doubt that, in considering what are the legal consequences of the phrase "trade exercised within the United Kingdom", courts of law have ruled that the place where sales or contracts of sale are made is of great importance when it is a merchanting business that is in question. They have not gone so far as to seek to substitute this test (which, under the conditions of international business and modern facilities of communication, is capable of proving a somewhat ingenuous one) for the statutory duty to inquire whether a trade is or is not exercised within the United Kingdom. I should be doing an injustice to the arguments of counsel for the taxpayers if I said that he submitted that they had. But he rightly reminded us that more than once the place where the contract is made has been spoken of as the "crucial" test or, again, as the "most vital" element.
>
> Speaking for myself, I do not find great assistance in the use of a descriptive adjective such as "crucial" in this connection. It cannot be intended to mean that the place of contract is itself conclusive. That would be to rewrite the words of the taxing Act, and could only be justified if there was nothing more in trading than the act of sale itself. There is, of course, much more. But, if "crucial" does not mean as much as this, it cannot mean more than that the law requires that great importance should be attached to the circumstance of the place of sale. It follows, then, that the place of sale will not be the determining factor if there are other circumstances present that outweigh its importance, or unless there are no other circumstances that can. Since the courts have not attempted to lay down what those other circumstances are or may be, singly or in combination, and it would be, I believe, neither right nor possible to try to do so, I think it is true to say that, within wide limits which determine what is a permissible conclusion, the question whether a trade is exercised within the United Kingdom remains, as it began, a question of fact for the Special Commissioners.'

Lord Radcliffe then cited with approval the last part of Atkin, LJ's observations cited above. The test propounded by Atkin, LJ, is the well-known operations test. In the present case, we shall apply the operations test to determine the question whether the profits in question were profits from any trade or business carried on by the Taxpayer in Hong Kong.

28. It was suggested that the Taxpayer's business was participation in syndicated loans. But that is only half of the story. With its relatively small capital, it had to borrow money (by taking deposits) from the Hong Kong company to fund its loan participations, so in fact the Taxpayer carried on the business of borrowing and on-lending money with a view to profit. At least partly for tax reasons, that business was carried on in more places than one, as follows:

(a) The Taxpayer's board in country A approved a loan as recommended by the Hong Kong company and authorised by power of attorney a director of the Hong Kong company (sometimes also an officer of the head bank as an alternative) to sign on behalf of the Taxpayer the loan agreement to which the borrower and all the other participants would also be parties.

(b) In the case of over 40% of the loans in which the Taxpayer participated, the loan agreements were signed in Hong Kong, while the rest were signed overseas.

(c) The agent of the loan gave notice of a drawdown or rollover to the Taxpayer, normally in Hong Kong care of the Hong Kong company.

(d) A contract was then made between the loans administration unit of the Hong Kong company acting on behalf and in the name of the Taxpayer and the treasury unit of the Hong Kong company acting on behalf of and in the name of the Hong Kong company, whereby the Hong Kong company agreed to place a deposit (of an amount sufficient to meet the drawdown or rollover) in the relevant currency (usually US dollars) with the Taxpayer and the Taxpayer agreed to accept the deposit when placed. After late August 1985, the contract in each case was made between company C offering to place a deposit and the Taxpayer accepting it. Likewise, the Hong Kong company acted on behalf of and in the name of the Taxpayer in making the contracts with company C. (It was contended for the Taxpayer that clause 4 of the service agreement (see 8 above) prohibited the Hong Kong company from acting as agent of the Taxpayer, and that the prohibition extended to the borrowing of money as such agent. In our view, the true meaning of clause 4, particularly the words 'Nothing herein contained shall empower or authorise the Hong Kong company …', is that no provisions of the service agreement shall confer any power or authority on the Hong Kong company to act as agent of the Taxpayer in business transactions with third parties; that does not mean that the Taxpayer could not authorise the Hong Kong company, expressly or by implication, so to act in matters outside the scope of the service agreement. We think borrowing money was such a matter. As we have found (see 24 above), the Taxpayer left the business of borrowing and on-lending entirely to the Hong Kong company; the latter in fact acted at all times as the Taxpayer's agent in obtaining borrowings, that is, deposits (whether from itself or company C) and entering into deposit-taking contracts without seeking prior approval or subsequent ratification from the Taxpayer's board in country A. The inescapable conclusion is that the Hong Kong company had implied actual general authority to make the deposit-taking contracts; such contract-making activities were in our view outside the service agreement and did not amount to a breach of clause 4. Alternatively, if we are wrong in saying that these activities were outside the service agreement, then the Taxpayer and the Hong Kong company must have varied clause 4 by mutual abandonment to the extent of allowing the Hong Kong company to carry on the activities on behalf of the Taxpayer.

(e) The Hong Kong company then instructed its bank in, say, New York to pay the amount of the deposit to the Taxpayer's bank in New York for the Taxpayer's account. The Hong Kong company, acting on behalf of the Taxpayer, also instructed the Taxpayer's bank in New York to pay the amount of the deposit to the agent's bank in New York.

(f) Interest on the loan and fees (commitment fee and any share of front end fees) in respect of the loan were paid by the agent to the Taxpayer's bank in, say, New York. Out of the interest received, the Taxpayer paid the Hong Kong company through its bank in New York the interest due to it. Although there is no direct evidence, we think we can, and we do, infer that the Hong Kong company, acting on behalf of the Taxpayer, gave all the necessary instructions to the Taxpayer's bank for interest to be paid out of the Taxpayer's bank account to its own bank account.

(g) All the contracts for the placing of foreign currency deposits by the Taxpayer with the Hong Kong company were made in Hong Kong, with the Hong Kong company acting on behalf of the Taxpayer and on its own behalf.

(h) The Taxpayer's banks overseas communicated with and sent their statements, credit advices and debit advices to the Taxpayer care of the Hong Kong company in Hong Kong.

(i) Any proposed amendment or waiver of the terms of a loan agreement required prior approval by the Taxpayer's board in country A.

(j) The Taxpayer's books of account were kept in Hong Kong; all accounting facilities were provided to the Taxpayer by the Hong Kong company in Hong Kong.

(k) All the administrative support in the day to day running of the Taxpayer's business was provided by the Hong Kong company in Hong Kong.

(l) The Taxpayer's bank accounts were operated and its cash managed by the Hong Kong company in Hong Kong.

29. The geographical fragmentation of the carrying on by the Taxpayer of its business may be shortly stated as follows:

(a) In country A, the Taxpayer's board approved proposed new loans and amendments of existing loans.

(b) Over 40% of the loan agreements were signed in Hong Kong, while the rest were signed overseas.

(c) Short of receiving or making payments in pursuance of the deposit-taking contracts or loan agreements, the day to day management and administration of the Taxpayer's business (including but not limited to the receipt of a drawdown or rollover notice, the negotiation and making of deposit-taking contracts and the giving of instructions to the Hong Kong company's bank overseas to make payment to the Taxpayer's bank account, and to the Taxpayer's bank overseas

to make payment to the loan agent's bank account) took place in the Hong Kong company's office in Hong Kong.

(d) Inter-bank transfers of money pursuant to instructions mentioned in (c) above in performance of the deposit-taking contracts and loan agreements took place overseas. Under the international clearing house system, payments can be made only through the appropriate clearing house for the currency concerned.

30. Having considered all the facts found above and the points mentioned in 28 and 29 above, we have come to these conclusions: (1) despite the fragmented mode of carrying on business, the operations from which the Taxpayer's profits in substance arose took place in Hong Kong; (2) the Taxpayer carried on its business in Hong Kong; and (3) its profits arose from such business.

Condition (3) – the Source Question

31. A broad-guiding principle was laid down in the Hang Seng Bank case in the following terms at 322-323:

> ' The broad-guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money of dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected.'

Applying the principle to the present case, and taking it as a case of lending money, the profit which was contained in the interest receipts will have arisen in or derived from New York, Tokyo or Frankfurt as the case may be, as the place where the money was lent. The commitment and other fees earned by the Taxpayer stand or fall with the interest, because in our view the source of the fees was also the lending of money. Since the hearing of this appeal, the Privy Council delivered its judgment on 20 July 1992 in CIR v HK-TVB International Ltd (Privy Council Appeal No 28 of 1991). After quoting the above quoted passage from the judgment delivered by Lord Bridge in the Hang Seng Bank case, Lord Jauncey stated at page 8 of the judgment:

> "The case of Smidth & Co v Greenwood [1921] 3 KB 583 was cited in the Hang Seng Bank case and their Lordships do not doubt that Lord Bridge had in mind the judgment of Atkin LJ in that case and in particular the passage at page 593 when he said:
>
> > ' I think that the question is, where do the operations take place from which the profits in substance arise?'

> Thus Lord Bridge's guiding principle could properly be expanded to read 'One looks to see what the taxpayer has done to earn the profit in question and where he has done it'. Further their Lordships have no doubt that when Lord Bridge, after quoting the guiding principle, gave certain examples he was not intending thereby to lay down an exhaustive list of tests to be applied in all cases in determining whether or not profits arose in or derived from Hong Kong."

Again, at page 8, he stated:

> "Their Lordships consider that it is a mistake to try and find an analogy between the facts in this appeal and the example given by Lord Bridge in the Hang Seng Bank case … The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place."

The effect of what Lord Jauncey was saying would appear to be this: if the facts of a case do not bring it within any of the examples given by Lord Bridge in the Hang Seng Bank case, the operations test should be applied in determining the question whether the profits arose in or derived from Hong Kong. Taking the present case as one of lending money coming within the example given by Lord Bridge in the Hang Seng Bank case, we have looked to the place where the money was lent as the test. However, if we are wrong and the correct test is the operations test, then, since we have already found that the operations from which the taxpayer's profits in substance arose took place in Hong Kong (see 30 above), it would have been our conclusion that the profits in question arose in or derived from Hong Kong.

32. The judgment of the Privy Council in the Hang Seng Bank case also went on an alternative ground which was connected with the enactment in 1978 of section 15(1)(i) of the IRO. At 324 of the judgment reference was made to the principle that subsequent legislation on the same subject may be looked to in order to see what is the proper construction to be put on an earlier Act where that earlier Act is ambiguous. The judgment then continued:

> ' Here the meaning of section 14 is at least ambiguous and it follows that section 15(1)(i) is fatal to the contention that, in the absence of an applicable deeming provision, section 14 is itself effective to bring into tax the profits earned by the bank on the investment overseas of its surplus holdings of foreign currency whether those profits take the form of interest on fixed deposits or trading profits from buying and selling certificates of deposit.'

It is clear from the passage quoted above that section 14, standing alone, is insufficient to bring into charge profits earned on the investment overseas of foreign currency holdings, interest and trading profits from buying and selling being only two examples of such profits. In our view, the fees earned by the Taxpayer, being also profits on offshore loans, are another example of profits not taxable under section 14.

33. Our conclusion on section 14 is as follows:

(1) The Taxpayer carried on a business of borrowing and lending money in Hong Kong; condition (1) is satisfied;

(2) The Taxpayer's profits (interest and fees) were profits from such business; condition (2) is satisfied;

(3) The profits did not arise in or derive from Hong Kong; condition (3) is not satisfied;

(4) The profits are therefore not taxable under section 14.

Section 15(1)(i)

34.1 We now turn to the second issue (see 2 above). Section 15(1)(i) of the IRO provides 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 Hong Kong from a trade, profession or business carried on in Hong Kong:
>
> (i) sums, not otherwise chargeable to tax under this part, received by or accrued to a financial institution by way of interest which arose through or from the carrying on by the financial institution of its business in Hong Kong, notwithstanding that the moneys in respect of which the interest is received or accrues are made available outside Hong Kong …'

The definition of 'financial institution' contained in section 2 of the IRO was amended twice during the years in question, but the amendments are immaterial to this appeal. The definition, so far as it is relevant, may be paraphrased in this way:

> 'A financial institution is:
>
> (a) a licensed bank, a registered DTC, or a licensed DTC; or
>
> (b) an associated corporation of a licensed bank, a registered DTC, or a licensed DTC, which, being exempt by virtue of section 3(2)(a), (b) or (ba) of the DTCO (or section 3(2)(a), (b) or (c) of the BO as from 1 September 1986), would have been liable to be registered or licensed as a DTC under that Ordinance had it not been so exempt.'

So far as it is relevant, the above-mentioned provisions of the DTCO and section 3(2)(a) of the BO were to the effect that the DTCO or the BO, as the case might be, 'shall not apply to

the taking of any deposit from a licensed bank, a registered or licensed DTC'. In addition, as from 1 September 1986, the date of its commencement, the BO 'shall not apply to the taking of any deposit from a bank incorporated or established outside Hong Kong that is not licensed under this Ordinance' (section 3(2)(b)), or from a money lender licensed under the the Money Lenders Ordinance (section 3(2)(c)). The DTCO was in force until 1 September 1986 when it was repealed and replaced by the BO. Section 2 of the IRO defines 'associated corporation', in relation to a bank or DTC, as:

> '(a) a corporation over which the bank or DTC has control;
>
> (b) a corporation which has control over the bank or DTC; or
>
> (c) a corporation which is under the control of the same person as is the bank or DTC.'

Section 2 defines 'control' in relation to a corporation as:

> 'the power of a person to secure:
>
> (a) by means of the holding of shares or the possession of voting power in or in relation to that or any other corporation; or
>
> (b) by virtue of any powers conferred by the articles of association or other document regulating that or any other corporation,
>
> that the affairs of the first-mentioned corporation are conducted in accordance with the wishes of that person.'

34.2 The preamble of the DTCO declared that it was 'an Ordinance to regulate the taking of money on deposit and to make provision for the protection of persons who deposit money', while that of the BO stated:

> 'To regulate banking business and the business of taking deposits and to make provision for the supervision of authorised institutions so as to provide a measure of protection to depositors and to promote the general stability and effective working of the banking system, and to provide for matters incidental thereto or connected therewith.'

So far as it is relevant, section 2 of the BO defined 'authorised institution' as a licensed bank, a registered DTC or a licensed DTC. So far as it is relevant, section 2 of the DTCO (and the BO) defined 'deposit' as being among other things a loan of money at interest, and provided that references to the taking of a deposit should be construed accordingly. Section 6(1) of the DTCO (corresponding to section 12(1) of the BO) provided, so far as it is relevant, that:

> 'No business of taking deposits shall be carried on except by a company which is (a) a registered DTC; or (b) a licensed DTC.'

Section 6(2) of the DTCO (corresponding to section 12(6) of the BO) provided that 'any person who contravenes subsection (1) shall be guilty of an offence' which was punishable by imprisonment and a fine. Section 6(3) of the DTCO (corresponding to section 12(8) of the BO) provided:

> ' For the purposes of any proceedings for an offence under this section if it is proved that a person took deposits on at least 5 occasions within any period of 30 days, that person shall, until the contrary is proved, be deemed to have been carrying on a business of taking deposits.'

Section 8(1) of the DTCO (corresponding to section 14(1) of the BO) provided, so far as it is relevant, as follows:

> ' (a) a registered DTC shall not take any deposit from a depositor of a sum less than the sum specified in item 1 of the first schedule;
>
> (b) a licensed DTC shall not take any deposit from a depositor of a sum less than the sum specified in item 2 of the first schedule.'

Prior to 1 April 1982, the sum specified by the first schedule was $50,000 for a registered DTC and $500,000 for a licensed DTC; subsequently it was $50,000 or an equivalent amount in any other currency for a registered DTC, and $500,000 or an equivalent amount in any other currency for a licensed DTC. Sections 9(1) and 16A(1) of the DTCO (corresponding to sections 20(1) and 24(1) of the BO) provided, so far as it is relevant, that 'every company shall, before it commences a business of taking deposits, apply for registration' as a DTC and that 'every company shall, before it commences a business of taking deposits as a licensed DTC, apply for a licence'.

35. It was conceded for the Taxpayer that it was an associated corporation of the Hong Kong company which was first a registered DTC and subsequently a licensed DTC, but it was contended that it was not a financial institution within the meaning of paragraph (b) of the definition in section 2 of the IRO. The argument is this: being exempt by virtue of section 3(2) of the DTCO (or) BO was a necessary ingredient of the definition of 'financial institution'; both Ordinances applied to the taking of a deposit in Hong Kong only; the Taxpayer took all its deposits outside Hong Kong; there was therefore no question of the Taxpayer being exempt by virtue of section 3(2) of either Ordinance; the Taxpayer was therefore not a financial institution. R v West Yorkshire Coroner [1983] QB 335, 358 was cited in support of the proposition that a statute does not have extra-territorial effect save to the extent that it expressly so provides. It was more fully stated in Maxwell on the Interpretation of Statutes eleventh edition, 199 (and cited with approval by Cozens-Hardy MR in Tomalin v S Pearson & Sons Ltd [1909] 2 KB 61) in the following terms:

> ‘In the absence of an intention clearly expressed or to be inferred either from its language, or from the object or subject-matter or history of the enactment, the presumption is that Parliament does not design its statutes to operate on its subjects beyond the territorial limits of the United Kingdom.’

36. Since our considerations are equally applicable to both Ordinances, we shall make express mention only of the provisions of the DTCO. Implicit in the Taxpayer’s argument is a construction which equates ‘taking a deposit’ with ‘accepting payment of a deposit’. On that construction, is it correct to say that the Ordinance in general and section 3(2) in particular applied only to the taking of a deposit in Hong Kong?

Section 3(1) and (2) (see 34.1 above) exempted deposit-taking of the types specified therein from the application of the Ordinance, and significantly for present purposes, from the registration and licensing provisions of sections 6, 9 and 16A(1) (see 34.2 above); the effect of section 3 was that deposit-taking of the exempted types was disregarded in considering whether a deposit-taker was carrying on a business of taking deposits or whether he was liable to be registered or licensed for carrying on or commencing a business of taking deposits.

Section 6(1) prohibited the carrying on of a business of taking deposits except by a registered or licensed DTC, while sections 9(1) and 16A(1) required registration and licensing respectively before the commencement of a business of taking deposits at all or as a licensed DTC. They were the key provisions of the Ordinance, serving as a base for the imposition of a system of prudential supervision (which gradually expanded through amendments) over deposit-takers once they were registered or licensed. Obviously, what section 6(1) prohibited was the carrying on of a deposit-taking business, not the taking of a deposit; the words ‘of taking deposits’ merely identified the nature of the business which was being prohibited; that is in our view the natural and ordinary meaning of the statutory words in question. There was no express provision to delimit the prohibition; the presumption of local application served its purpose here by limiting it to Hong Kong. However, in our view, the presumption did not localise the taking of any deposit because, as we stated earlier, the taking was not prohibited; thus section 6(1) applied to the taking of a deposit both in and outside Hong Kong, so that both classes of taking must be taken into account in determining a question whether a business of taking deposits was carried on in Hong Kong. The same construction goes for sections 9(1) and 16A(1). By the same token, the presumption of local application had no application to section 3 which should be construed as it was – without the words ‘in Hong Kong’ being read into it – so that it applied to the taking of a deposit in and outside Hong Kong, and that both classes of taking were exempted from the application of the Ordinance provided that they came within the terms of a specified exemption.

Section 6(3) provided for a rebuttable presumption of a carrying on of a business of taking deposits if at least 5 deposits were taken within a period of 30 days; but other facts were admissible in evidence to prove the contrary (see 34.2 above). The rebuttable presumption was raised to prove an offence against section 6(1); in our view therefore the presumption of local application applied to section 6(3) so that ‘took deposits’

and 'carrying on a business of taking deposits' meant respectively 'took deposits in Hong Kong' and 'carrying on a business of taking deposits in Hong Kong'. The court was entitled and bound to consider all the other facts proved in rebuttal and decide the question whether a business of taking deposits had been carried on in Hong Kong by weighing all the proven facts.

Furthermore, in cases outside the ambit of section 6(3), the question would have been decided, like any other question of fact, by weighing all the proven facts. The taking of a deposit, whether in or outside Hong Kong, would always be a factor pointing to or away from a carrying on of a business of taking deposits in Hong Kong, but no more than a factor. For example, if a deposit-taker took all his deposits outside Hong Kong, he would in our view still be carrying on business of taking deposits in Hong Kong: if all the other activities leading up to the taking (accepting payment) of the deposits (from the negotiation and conclusion or acceptance of the deposit-taking contracts to the sending of instructions overseas to effect the bank transfers) took place in Hong Kong, or if his deposit-taking business was controlled, managed and administered in Hong Kong. Otherwise, by taking deposits in foreign currencies only and by bank transfers overseas, or by taking deposits in the international money markets, he would have been excused from the registration or licensing requirements and free from all supervision and control by the Commissioner of Banking, and those who had deposited their money with him would have been deprived of the benefit of statutory protection which it was the object of the benefit of statutory protection which it was the object of the Ordinance to provide – an absurd scenario which could not have been intended by the legislature. Registered and licensed DTC were free to take foreign currency deposits outside Hong Kong; subject, as from 1 April 1982, to minimum amounts specified by section 8(1) and the first schedule (see 34.2 above); and example ready to hand was the Hong Kong company. We fall to see any reason, whether in terms of principle, policy or logic, why in considering a question of liability to be registered or licensed as a DTC, the taking of any deposit outside Hon Kong should be left out of account.

For all these reasons, we are satisfied that subject to section 3 exemptions, the taking of a deposit, whether in or outside Hong Kong, was a relevant factor to be taken into consideration in determining whether there was a carrying on of a business of taking deposits in Hong Kong or whether a deposit-taker was liable to registration or licensing. That leads necessarily to our view that a section 3 exemption embraced both classes of taking, for otherwise capricious results would have followed. Take the exemption in section 3(2)(ba) – the taking of a deposit from a licensed DTC; irrespective of the place where it took place, the taking would be excluded from consideration in determining a section 6(1), 9(1) or 16A(1) question. Suppose that two deposits of US$100,000 each were taken from a licensed DTC, one in US dollar bank notes paid in Hong Kong and the other paid by the depositor's bank in New York to the deposit-taker's bank in New York; both the local and New York takings would in our view be within the terms of section 3(2)(ba) and therefore excluded form consideration in determining a section 6(1), 9(1) or 16A(1) question. Had section 3(2) only been intended to apply to the taking of deposits locally, then only the local taking of the US$100,000 deposit would have been so excluded, while the New York taking, albeit in the same currency, of the same amount and from the same

licensed DTC, would not have ranked as a section 3(2)(ba) exemption, and would have been taken into account as a relevant factor for sections 6(1), 9(1) and 16A(1) purposes.

We do not believe that the legislature could have intended such an unreasonable result. The above considerations have led us to the conclusion that a contrary intention was clearly indicated in the Ordinance and that the presumption of local application did not apply to the taking of a deposit in relation to the Ordinance in general or section 3(2) in particular.

37.1 The taking of deposits by the Taxpayer from the Hong Kong company which was first a registered DTC and subsequently a licensed DTC, was within section 3(2)(b) and (ba); the Taxpayer was consequently exempt by virtue of : first, section 3(2)(b), and then, (ba) of the DTCO, within the meaning of the definition of 'financial institution' in section 2 of the IRO. Its position under the BO will be dealt with later. The question is: supposing it had not been so exempt, so that the DTCO would have applied to the taking of the deposits, would the Taxpayer have been liable to be registered or licensed as a DTC under the DTCO? We think the answer must be yes. All activities related and leading to the taking of deposits – from the negotiation and conclusion or acceptance of the deposit-taking contracts to the sending of instructions to the banks overseas to effect the transfer – took place in Hong Kong, and the deposit-taking business was controller, managed and administered in Hong Kong (see 24 and 29(c) above). So the Taxpayer would have carried on a business of taking deposits in Hong Kong and would have been liable to be registered or licensed under sections 9(1) or 16A(1) of the DTCO. It was said that the Taxpayer could not have carried on a business of taking deposits because there was only one counter-party to the deposit-taking transactions, that is, the Hong Kong company, which was its parent company. We disagree. The list of exemptions contained in section 3 of the DTCO and the BO did not include one in respect of the taking of a deposit from a holding company or a member company within the same group. Furthermore, both sides asked us to treat the Taxpayer and the Hong Kong company as two independent third parties dealing with each other at arm's length; in fact they compared the Hong Kong company to a bank totally unconnected with the group, such as a subsidiary of Barclays Bank. On that footing, the parent/subsidiary relationship has no significance in relation to the question whether the Taxpayer would have been carrying on a business of taking deposits; nor has the fact that the Hong Kong company was the only lender. From the commencement of the accounting period to late August 1985, the Taxpayer took deposits from the Hong Kong company. Our conclusion is therefore that during that period the Taxpayer was a financial institution within the meaning of section 2 of the IRO.

37.2 From late August 1985 up to 30 September 1986, the last day of the accounting period, the Taxpayer took deposits from company C which was the branch in country C of the head bank. From the column headed 'Amount due to Head Bank' set out in 20 above, the deposits taken from company C were clearly substantial; as a matter of inference, we find that the Taxpayer took deposits on a regular basis from company C throughout that period.

37.3 During the period from late August 1985 until 1 September 1986, the DTCO continued in force. From the fact that company C was the branch in country C of the head bank, we infer that company C was neither a licensed bank (that is, a bank licensed under the BO) nor a registered or licensed DTC (that is, a DTC registered or licensed under the DTCO) within the meaning of section 2 of the IRO, and we so find. Consequently during that period the Taxpayer was not exempt by virtue of section 3(2)(a), (b) or (ba) of the DTCO and was not a financial institution as defined in paragraph (b) of the definition.

37.4 The BO came into force on 1 September 1986 governed the last month of the accounting period. Company C being the branch in country C of the head bank, we infer from that fact that the company C was a 'bank incorporated or established outside Hong Kong that is not licensed under this Ordinance' within the meaning of section 3(2)(b) of the BO, and we so find. The Taxpayer was consequently exempt by virtue of that provision. Had it not been so exempt, then the reasons stated in 37.1 above would have applied mutatis mutandis; the Taxpayer would have carried on a business of taking deposits in Hong Kong and would have been liable to be registered or licensed under section 20(1) or 24(1) of the BO. The Taxpayer was therefore a financial institution within the meaning of the definition from 1 September 1986.

38. The next question is whether the interest earned on the loan participations is taxable under section 15(1)(i) of the IRO. It seems to us that taxability is subject to the following conditions:

(a) The interest must have been received by or accrued to the Taxpayer as a financial institution;

(b) The interest must have arisen through or from the carrying on by the Taxpayer of its business in Hong Kong; and

(c) The business through or from the carrying on of which the interest arose must have been carried on by the Taxpayer as a financial institution.

39. Dealing with condition (b) first, we do not find much difference in import between the phrase 'through or from the carrying on of its business in Hong Kong' in section 15(1)(i) and the phrase 'from the business carried on in Hong Kong' in section 14; if anything, the former is wider in scope. We have already found as a fact in relation to section 14 that the gross receipts were from the business carried on by the Taxpayer in Hong Kong (see 30 above). For the same reasons, we find that the interest received by or accrued to the Taxpayer throughout the accounting period arose through or from the carrying on by the Taxpayer of its business in Hong Kong and therefore that condition (a) was satisfied.

40. During the period from the commencement of the accounting period to late August 1985, during which the Taxpayer took deposits from the Hong Kong company, both conditions (a) and (c) were satisfied. As for the period from late August 1985 until 1 September 1986, condition (a) was not satisfied, while condition (c) may or may not have been satisfied. From 1 September 1986 to 30 September 1986, condition (a) was satisfied in

respect of any interest received by or accrued to the Taxpayer during that period, while condition (c) may or may not have been satisfied depending on the base period during which the loan or loans were made or renewed in respect of which the interest in question was received or accrued.

41. Our conclusions are:

(1) That the Taxpayer is liable to tax under section 15(1)(i) of the IRO in respect of interest received by or accrued to it during the period from the commencement of the accounting period to late August 1985 during which the Taxpayer took deposits from the Hong Kong company;

(2) That the Taxpayer is not liable to tax in respect of interest received by or accrued to it during the period from late August 1985 to 1 September 1986 during which it took deposits from company C;

(3) That the Taxpayer is liable to tax in respect of any interest (a) which was received by or accrued to it during the period from 1 September 1986 to 30 September 1986 during which it was a financial institution, and (b) which arose through or from the carrying on of its business by the Taxpayer as a financial institution; and

(4) That the Taxpayer is not liable to tax in respect of any of the fees.

DECISION

42. The case is hereby remitted to the Commissioner for the assessments in question to be revised in accordance with our conclusions stated in 41 above, with liberty to apply: (1) for the Board to reconvene and to take evidence for the purpose of quantifying the interest or any part thereof in respect of which the Taxpayer is liable to tax as above stated; and/or (2) for such further or other directions as may be necessary.