Case No. D26/88

Profits tax – source of profits – exchange gains (and losses) derived by a financial institution – whether gains arose in or derived from Hong Kong – s 14 of the Inland Revenue Ordinance.

Profits tax – source of profits – interest – whether arising in or derived from Hong Kong – application of 'operations test' to interest income – 'provision of credit' test – s 14 of the Inland Revenue Ordinance.

Profits tax – source of profits – interest earned by financial institution – whether 'aris[ing] through or from the carrying on by the [taxpayer] of its business in Hong Kong – s 15(1)(i) of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Raphael Chan Cheuk Yuen and Albert Ho Chun Yan.

Date of hearing: 20 April 1988.
Date of decision: 22 July 1988.

The taxpayer was a registered deposit-taking company. It carried on business only in Hong Kong. All major decisions affecting its operations were made overseas by the board of directors of its parent company, a foreign bank.

The taxpayer had a paid-up capital of $10,000,000. Because of statutory liquidity requirements, this sum was kept in a bank account held by the taxpayer off-shore with its parent company. The taxpayer earned interest on the deposit. In addition, because the currency of the account was changed from time to time, the taxpayer made exchange gains and losses.

The IRD assessed the taxpayer to profits tax on such interest and exchange gains. The taxpayer appealed.

Held:

The interest and exchange gains were assessable.

(a) The interest did not have a Hong Kong source for the purposes of section 14. Prima facie, interest arises at the place where the money is made available to the borrower, although in the case of financial institutions this test must not be applied in an artificial and meaningless way. On the facts, however, there

was nothing artificial in the taxpayer depositing the funds with its parent company off-shore.

For the purposes of determining source of interest under section 14, the origin of the funds and the use to which the borrower puts the money is irrelevant. The 'operations test' is of little relevance, because that test is concerned with income from the provision of services and not with interest income.

Even if the operations test were applicable, the relevant operations here consisted of the placing of and leaving the funds off-shore. The mere fact that the taxpayer carries on business only in Hong Kong does not mean that all its profits must have a Hong Kong source.

(b) The interest arose through or from the carrying on of the taxpayer's business in Hong Kong, and was therefore assessable under section 15(1)(i). For this section to be meaningful, it must be construed widely.

In applying section 15(1)(i), one focusses not on where the funds were made available to the borrower but on how the funds were made available. The taxpayer carried on business only in Hong Kong; all of its staff, premises and activities were located in Hong Kong; it was incorporated in Hong Kong; and the money giving rise to the interest was its share capital, which exists pursuant to Hong Kong law. The fact that its board of directors and controlling shareholder were overseas was relatively insignificant. In these circumstances, the interest arose from the operation of the taxpayer's business in Hong Kong.

(c) The exchange gains were assessable under section 14. Where a financial institution carries on business only in Hong Kong, all exchange gains made by it have a Hong Kong source. This is so even though the loan funds are off-shore and the interest itself is not assessable under section 14.

Appeal dismissed.

Cases referred to:

D7/84, IRBRD, vol 2, 58
CIR v Hang Seng Bank Ltd (1972) 1 HKTC 583
CIR v The Hong Kong & Whampoa Dock Co Ltd (1960) 1 HKTC 85
Nathan v FCT (1918) 25 CLR 183

G J Laird for the Commissioner of Inland Revenue.
Peter Griffiths of Touche Ross & Co for the taxpayer.

Decision:

This appeal by the Taxpayer relates to interest income and exchange gains which arose in the years of assessment 1978/79, 1979/80, 1980/81, 1981/82 and 1982/83.

When this appeal was lodged, it was against the interest and exchange gains arising from a number of deposits and transactions. At the hearing of the appeal, the Taxpayer withdrew its appeal against all items other than one specific item which was described as 'the statutory deposit'. Accordingly this decision is limited to the amounts in dispute only and the appeal so far as it related to other sums was dismissed.

The facts of the case are as follows:

1. The Taxpayer was a private company incorporated in Hong Kong which conducted in Hong Kong the business of a registered deposit-taking company and was a financial institution as defined by section 2 of the Inland Revenue Ordinance. It did not carry on any other business in Hong Kong or overseas.

2. The Taxpayer was a wholly-owned subsidiary of a parent bank ('the parent bank') which was incorporated in country A. The parent bank did not carry on business in Hong Kong and did not have a banking licence but did maintain a representative office in Hong Kong.

3. The Taxpayer commenced business in the middle of June 1978, soon after its incorporation.

4. The Taxpayer was controlled by the parent bank and all of its directors were resident in country A. The Taxpayer had only limited authority as to the business which it could transact without first referring to the parent bank. All major decisions of the Taxpayer were made by its directors in country A or were directed by the parent bank in country A.

5. All of the profits of the Taxpayer, which comprised interest income and exchange gains, were assessed to tax in Hong Kong on the basis that the operations of the Taxpayer were carried on in Hong Kong and that all of the profits arose in Hong Kong from such operations. The Taxpayer appealed against these assessments and claimed that some of the interest income and exchange gains did not arise in and were not derived from Hong Kong. As stated above, only the interest income and exchange gains derived from the statutory deposit are now in dispute and the Taxpayer has conceded that all other interest income and exchange gains arose in Hong Kong.

6. The original paid-up capital of the Taxpayer was $10,000,000 which was provided by the parent bank. The capital was not remitted to Hong Kong but was credited to an account in the name of the Taxpayer in the books of the parent bank. The original capital of $10,000,000 was never remitted to Hong Kong throughout the years covered by this appeal.

7. When the Taxpayer was established as a deposit-taking company, it was required by the Banking Commissioner to maintain a deposit in the sum of $10,000,000 as part of its liquidity requirements. By agreement with or with the approval of the Banking Commissioner, the Taxpayer deposited this sum of $10,000,000 with its parent bank in country A. For convenience, this deposit of $10,000,000 was referred to in the course of the hearing as 'the statutory deposit' and we will use the same description in this decision. On occasions during 1978 and 1979, the statutory deposit was designated in currencies other than Hong Kong dollars.

8. The $10,000,000 capital which was provided by the parent bank was used to create the statutory deposit. When the Taxpayer first commenced business, there was a period of approximately two weeks between the commencement of business and the close of the first financial accounting period on 30 June 1978 during which by mistake only one inter-company account was opened in the books of the parent bank and the result was that the statutory deposit was reduced slightly below the minimum requirement of $10,000,000. When this mistake was discovered, immediate steps were taken to correct it and to ensure that the statutory deposit of $10,000,000 remained in future.

9. In 1978 and 1979 the statutory deposit was not always designated in or only in Hong Kong dollars. On occasions it was designated in whole or in part in yen, United States dollars or the currency of country A, as well as Hong Kong dollars. In 1979, a decision was made that the statutory deposit should thenceforth be maintained in Hong Kong dollars only. Certain exchange gains (and losses) were taken into account in 1978 and 1979 to reflect the fact that the statutory deposit had at some time been denominated in other currencies. After 1979, the statutory deposit was maintained in Hong Kong dollars in the sum of $10,000,000.

10. In the middle of 1980, the issued share capital of the Taxpayer was increased by $8,000,000. This was likewise contributed by the parent bank and an error was again made in the book-keeping entries of the parent bank which had the apparent result of reducing the statutory deposit from $10,000,000 to $5,000,000 because the sum of $5,000,000 was wrongly deducted from the statutory deposit. When this error was discovered, it was again immediately corrected.

11. Throughout the period in question, it was a requirement of the Taxpayer as a registered deposit-taking company in Hong Kong that at all times the statutory deposit of $10,000,000 would be maintained.

12. The operations manager of the Taxpayer appeared before us to give evidence and was cross-examined. He had been working with the parent bank since May 1981 as an internal auditor until he was sent to Hong Kong in June 1986 to be the operations manager. His duties as internal auditor included the supervision or internal audit of the Taxpayer. He appeared to us to be a truthful and frank witness who was able to give full evidence either from his own knowledge of the facts or from knowledge which he had acquired from the books and records of the Taxpayer and the parent bank.

13. On the evidence given by the operations manager and from the accounts and other papers before us, we are satisfied that throughout the period in question the Taxpayer maintained a deposit with the parent bank in the sum of $10,000,000 or its equivalent in other currencies. This deposit, which has been referred to as the statutory deposit, was maintained to comply with the regulations which governed the Taxpayer as a Hong Kong registered deposit-taking company. Without this statutory deposit, the Taxpayer would not have been able to carry on business in Hong Kong as a registered deposit-taking company. On those occasions when it appeared that the amount of the statutory deposit had been reduced below the requirement of $10,000,000 or its equivalent in other currencies, it was because of genuine errors made by the parent bank and the errors were immediately corrected when they were found.

At the hearing, Mr Griffiths appeared for the Taxpayer and Mr G J Laird for the Commissioner. They addressed the Board as to the meaning and application of sections 14 and 15(1)(i) of the Inland Revenue Ordinance in relation to the facts of this appeal. In summary, the question in contention between the parties was whether or not the interest and currency gains (and losses) which the Taxpayer earned from the statutory deposit arose in Hong Kong. In the event that we might hold that the interest was not taxable because it did not arise in Hong Kong within the normal meaning of section 14, we were asked to consider whether it then fell for assessment under the provisions of section 15(1)(i).

Assessability of interest under section 14

In any case relating to the geographic source of income, it is necessary to follow a number of steps. A prerequisite of section 14 is that the Taxpayer must have carried on business in Hong Kong and in that regard there is no dispute.

Next, it is necessary to consider each item of profit because, under the wording of section 14, a business in Hong Kong can have profits arising in Hong Kong and profits

arising elsewhere. In the present appeal, two separate items of profit fall to be considered, namely, the interest and the exchange gains (or losses).

To locate the source of income, one must first decide upon the nature of the income and then locate the geographic source. As the nature of interest and exchange gains (or losses) are fundamentally different, it is appropriate to consider each separately in this decision.

If the Taxpayer had not been a financial institution, we would have no hesitation in allowing this appeal and finding that within the ordinary meaning of section 14 the interest did not arise in Hong Kong. The facts of this case are simple, concise and clear. The Taxpayer maintained a deposit of $10,000,000 or its equivalent with a recognised bank outside of Hong Kong. As we have found in the facts, the allegations that the deposit was not $10,000,000 or its equivalent are unfounded. On two occasions the amount fell below $10,000,000 or its equivalent, but this was as a result of a mistake made by the bank holding the moneys and was immediately rectified. The Taxpayer was a customer of the parent bank and it is immaterial that they may have had other relationships such as parent and subsidiary. It is likewise immaterial where the funds came from. The relevant facts are that the Taxpayer maintained a banking relationship with the parent bank in the form of maintaining a deposit of $10,000,000 or its equivalent. This deposit was required by the Banking Commissioner in Hong Kong and, without this deposit, the Taxpayer could not carry on its business and would be in breach of its obligations as a Hong Kong registered deposit-taking company. These facts make it abundantly clear that at all material times the Taxpayer was required to have and had an identifiable deposit of $10,000,000 or its equivalent. It is incidental and immaterial that the deposit was maintained with the parent of the Taxpayer.

In deciding the source of interest income on a fixed deposit with a bank, the starting point must be the place where the funds are made available. Interest is the reward which a person receives for the use of that person's money. Prima facie the place where the money is made available to the borrower is the place where the interest arises. That is where the asset is situate when it is lent and is where the borrower is situate. Obviously there can be facts and factors which affect this but it must be the prima facie starting point. In the present appeal, the funds were made available outside of Hong Kong and prima facie the interest did not arise in Hong Kong. We must now consider whether on all of the facts of this case there is any good reason to depart from this prima facie inference.

There is clear authority in the decided cases to show that the use to which the borrower puts the money is immaterial in deciding source. Likewise, the source of the funds used by the lender is not material. In the course of the hearing, the Commissioner's representative argued or suggested that because the Taxpayer was carrying on business as a deposit-taking company in Hong Kong and seeking deposits from the public in Hong Kong, its capital moneys were intermingled with all other moneys and a fortiori all income derived from those moneys must arise in Hong Kong. This is clearly incorrect. A person can obtain moneys in Hong Kong and then remit the moneys away from Hong Kong. Income which arises on those moneys outside of Hong Kong would not normally be classified as Hong

Kong sourced income. In such circumstances problems will obviously arise in deciding what interest expenses may be attributable to Hong Kong income as opposed to overseas income. Clearly, interest paid to depositors in Hong Kong cannot be claimed in full as expenses against income arising in Hong Kong if part of the moneys were used to earn income which did not arise in Hong Kong. In such cases, apportionments are necessary and well recognised. Moneys may and do intermingle but are nevertheless capable of being divided so as to reflect the fact that some interest arises in Hong Kong and some offshore.

The Commissioner in his decision and his representative in his submissions placed considerable weight on the 'operations test' and formed the view that the interest was taxable in Hong Kong because the operations of the Taxpayer took place in Hong Kong. The operations test in Hong Kong derives from the Dock Company case (CIR v The Hong Kong & Whampoa Dock Co Ltd (1960) 1 HKTC 85), but great care is necessary when considering that case. As stated above, the source of interest income is prima facie where the money is made available. The Dock Company case established the fundamental principles and then applied those principles to the services of salvaging a ship under a salvage contract. Those services were provided primarily outside of Hong Kong and accordingly the 'operations' took place outside of Hong Kong. In the present case, we are considering interest income on money and not services rendered. The application of the principles in the Dock Company case has little relevance to the case now before us. However, even on the facts of the present case, the 'operations' in so far as they are relevant to determining the source of interest income took place outside of Hong Kong. The operations which were the source of the income were the depositing of money in country A with the parent bank and the leaving of that money on deposit in country A. Very little was done in Hong Kong. The mere fact that the Taxpayer was a Hong Kong company with its business conducted in or from Hong Kong does not mean that all world-wide income which it receives is therefore Hong Kong source income. As Reece J said in the Dock Company case at page 112: 'what profits arise to any company from the mere fact of its carrying on business in a particular place? None!'

The facts of the Board of Review decision in D7/84, IRBRD, vol 2, 58 were very different from the present case. In the present case the Taxpayer did nothing except place and leave money on deposit outside of Hong Kong. The provision of credit test when applied to financial institutions must be applied with care to avoid the test becoming purely artificial and meaningless. Reece J in the Dock Company case cited with approval the famous statement of Isaacs J in Nathan v Federal Commissioner of Taxation (1918) 25 CLR 183 at page 189 where he said:

> 'The legislature in using the word "source" meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical, hard matter of fact.'

Reece J in the same case (at page 109) pointed out that it is necessary to look at all of the facts and no one test can have universal application. If one looks at all of the facts of the present case, it is clear that there was nothing artifical in the Taxpayer keeping this deposit with its parent outside of Hong Kong. Indeed, it was a most logical and practical thing for the Taxpayer to do. A practical man would regard the source of this income as arising in country A where the moneys were placed and kept on deposit.

Assessability of interest under section 15(1)(i)

For the reasons stated, if the Taxpayer were not a financial institution, we would find that under the provisions of section 14 of the Inland Revenue Ordinance the interest arising from the statutory deposit was not taxable. However, the Taxpayer was a financial institution and it is therefore necessary to look at section 15(1)(i). This paragraph was introduced into section 15 with the intention of making financial institutions taxable in respect of interest which otherwise would not be chargeable to tax. The meaning of section 15(1)(i) was considered (obiter dicta) in D7/84, IRBRD, vol 2, 58 and by Professor Willoughby in his textbook Hong Kong Revenue Law vol 2, page 2-219, para 2.01/15.20DD. Though neither of these statements is binding on us, we are of the opinion that they are fundamentally correct.

Section 15(1)(i) clearly states that it only applies in those cases where sums are not otherwise chargeable to tax under part IV of the Ordinance. As stated above, we have found that this interest income is not otherwise chargable to tax under section 14 because it did not arise from Hong Kong. Section 15(1)(i) then says that interest to be taxable must arise through or from the carrying on by the financial institution of its business in Hong Kong. We have some difficulty in understanding these words. The word ‘business’ has a very wide meaning and it seems to us that the intention is that the paragraph should apply to situations such as the present one. To try to give these words a narrow interpretation would make the paragraph meaningless.

We have already held on the facts and as a fact that this interest income did not arise in Hong Kong within the meaning of section 14, but that does not mean that it did not arise through or from the carrying on of the business in Hong Kong for the purpose of section 15(1)(i). It appears that the legislature has created a fine and indeed a very fine distinction between ‘profits arising in or derived from Hong Kong’ and ‘interest which arises through or from the carrying on of a business in Hong Kong’. It appears that under the ordinary meaning of section 14 profits can arise from a business carried on in Hong Kong some of which arise in Hong Kong and some of which arise outside of Hong Kong. If any other meaning is given to section 15(1)(i), then it would mean that, having decided that a profit does not arise from Hong Kong from such business, then it likewise does not arise from the carrying on of such business in Hong Kong. This would make section 15(1)(i) meaningless.

We appreciate that our interpretation also places a fine distinction on what Reece J said (quoted above). Perhaps the draftsman did not have in mind the words of Reece J which clearly held that no profit can arise from the mere carrying on of a business.

Taking the view which we do as to the meaning of section 15(1)(i), it means that we must now consider the source of this interest ignoring the fact that the moneys in respect of which the interest was received or accrued were made available outside of Hong Kong. As this is an artificial territorial test which applies and has applied nowhere in the world other than Hong Kong, we can find little guidance or comfort in other decided cases. As we have stated above, the decided factor in the application of section 14 in this case would be the place where the funds were made available. If that is ignored, the other subsidiary facts must be carefully studied in the light of the practical hard matter of fact test, even though in this particular case such facts are of comparatively minor importance.

On the facts before us, it appears that, if the interest did not arise from where the money were made available, then it arose from how the money was made available, that is, the activities of the Taxpayer some of which took place in country A and some of which took place in Hong Kong. In country A the Board of Directors of the Taxpayer made the fundamental decisions but, on the other hand, the Taxpayer maintained its only place of business in Hong Kong and all of its staff and activities other than its Board of Directors appear to have been physically located in Hong Kong where it had its office premises, equipment and services. We think that a practical man viewing these facts would come to the conclusion that the interest arose through or from the carrying on of the taxpayer's business in Hong Kong, if he had to decide upon one place or the other. To decide that the location of the Board of Directors and its decisions was the fundamental fact would be to give undue weight to the concept of 'mind and management' or the concept of residence for taxation purposes, which are concepts which were developed in other tax jurisdictions but up to the present date have had little relevance in Hong Kong.

It appears to us that the intention of section 15(1)(i) was not to abolish the concept of territorial taxation as we know it and replace it by other concepts which are totally foreign to our territorial tax system, but somehow to invoke an 'operations test'. If these moneys had been kept in Hong Kong, it is clear that the interest would have been taxable in Hong Kong. Even if one ignores the place where they were made available and if, as is the case here, (i) the only place of business was Hong Kong, (ii) the Taxpayer was a Hong Kong incorporated company with all of its assets derived from Hong Kong (which includes its share capital which exists only under Hong Kong company law) and (iii) the only foreign element was a Board of Directors and a controlling shareholder outside of Hong Kong, it is clear to us that the practical man would form the view that the interest arose through or from 'the operation' of the taxpayer's business in Hong Kong. Accordingly, that is the view which we take and we decide that this interest is caught under the provision of section 15(1)(i).

<u>Exchange gains and losses</u>

We now come to the question with regard to whether the exchange gains (and losses) made or incurred when the statutory deposit was converted in whole or in part from one currency to another constitute profits (or losses) arising in Hong Kong.

In the course of the hearing, we were referred to the decision of Huggins J in CIR v Hang Seng Bank Ltd (1972) 1 HKTC 583. With some misgiving, it appears to us that the Hang Seng Bank case applies to the present facts and is binding upon us. We have some misgiving because Huggins J so frequently in the course of giving his judgment refers to and accepts the way in which one counsel or the other submitted or conceded their case before him without apparently making positive decisions or findings as to whether such submissions or concessions were necessarily correct in law. We also have some misgiving because Huggins J did not appear to understand currency transactions. He made reference to a painting being sent abroad for exhibition and its value increasing whilst it is overseas. He seems to have overlooked the fact that money is not sent overseas and then returned. Money is sent overseas, sold to purchase another currency and then remitted back. We wonder whether his example would be so clear if the art dealer who sent his stock of pictures to Japan had sold the pictures in Japan at a profit, purchased other pictures in Japan, and brought the new pictures back to Hong Kong. As stated, the decision of Huggins J is binding on us and it is therefore not for us to speculate further.

The Hang Seng Bank case decided that a bank carrying on business in Hong Kong with no branches or other business outside of Hong Kong was subject to assessment to tax upon any currency gains that might be made notwithstanding the fact that the moneys from which the currency gains arose were situate outside of Hong Kong and were earning interest not taxable in Hong Kong. The facts of the present case are identical in all material respects. The Taxpayer in this case is a deposit-taking company and not a bank but there is no material distinction between a deposit-taking company and a bank in this regard. Huggins J clearly held or accepted that moneys on deposit overseas consitute stock-in-trade and held that any currency gains or losses arising from such stock-in-trade are taxable as arising in Hong Kong.

The representative for the Taxpayer argued that the moneys which were used in this case were the original capital of the company and were never remitted to Hong Kong. In our opinion, the source of the funds is immaterial. The moneys when received by the Taxpayer became part of the funds available to the Taxpayer to operate its business. The moneys were freely available to the Taxpayer without any restriction. It is true that the moneys were required by the Taxpayer to maintain its statutory liquidity ratio, but this does not mean that the moneys ceased to be or were not part of its stock-in-trade.

We have taken due note of the fact that the Board of Directors of the Taxpayer were situate in country A. However, this would not appear to us to be a material difference from the Hang Seng Bank case. The Taxpayer had one business only which it carried on in Hong Kong. That being the case, its stock-in-trade was the stock-in-trade of the Hong Kong business and could have been nothing else and we are bound by the Hang Sang Bank

decision to find that any profits (or losses) which arose on the stock-in-trade which included the statutory deposit arose in Hong Kong and are accordingly taxable.

For the reasons stated, we dismiss this appeal both as to the interest and the exchange gains (and losses) relating to the statutory deposit. As the Taxpayer withdrew the other parts of its appeal, we confirm the assessments appealed against and dismiss the appeal in its entirety.