Case No. D33/90

Profits tax – savings account interest – whether interest arose in or was derived from Hong Kong.

Panel: William Turnbull (chairman), Norman Ngai Wai Yiu and Michael A Olesnicky.

Date of hearing: 3 July 1990.
Date of decision: 17 September 1990.

The taxpayer was a private limited company and carried on business which comprised the selling of equipment with customers in Hong Kong and elsewhere. Payment was made to the taxpayer by cheques and bank drafts drawn in US dollars. The taxpayer maintained a savings account denominated in US dollars with a bank carrying on business in Hong Kong. When the taxpayer received payment from its customers it would give to the bank in Hong Kong where it maintained its savings account the cheque or draft. The bank would then credit the savings account of the taxpayer with the US dollar amount less a commission charged for its services. Interest was credited to the savings account of the taxpayer on the daily balance of the savings account. It was argued, inter alia, that the funds were made available to the bank by the taxpayer in USA and that according to the provision of credit test the interest should not be taxable in Hong Kong.

Held:

On the facts of this case the interest was earned on a debt owed by the bank to the taxpayer. The debt was created and was situated in Hong Kong. Foreign currency savings accounts maintained in Hong Kong may be subject to Hong Kong interest tax.

Appeal dismissed.

Cases referred to:

Commissioner of Taxation (NSW) v Kirk [1900] AC 588
CIR v The Hong Kong and Whampoa Dock Co Ltd [1960] 1 HKTC 85
Harding v Federal Commissioner of Taxation [1917] 23 CLR 199
CIR v Hang Seng Bank Limited (CA) [1989] 2 HKTC 614
CIR v Lever Brothers & Unilever Ltd [1946] 14 SATC 1
D7/84, IRBRD, vol 2, 58
D26/88, IRBRD, vol 3, 299

CIR (NZ) v N V Philips Gloeilampenfabrieken [1954] 10 ATC 435
C H Pte Limited v Commissioner of Income Taxes [1987] 1 MSTC 7022
Nathan v Federal Commissioner of Taxation [1918] 25 CLR 183
Rhodesian Metals Ltd v Commissioner of Taxation [1940] AC 774
CG of IT v Esso O Standard Eastern Incorporated [1969] Court of Appeal for East Africa (Unreported)
BR 20/75, IRBRD, vol 1, 184
Broken Hill South Ltd v Commissioner of Taxation (NSW) [1937] 56 CLR 337
American Leaf Blending Co v Director General of IR [1978] STC 561

Chiu Kwok Kit for the Commissioner of Inland Revenue.
David Smith of Peat Marwick for the taxpayer.

Decision:

This is an appeal by a private limited company against an assessment to profits tax which included certain savings account interest which the Taxpayer claims did not arise in nor was derived from Hong Kong. The facts of the case are as follows:

1. The Taxpayer was incorporated in Hong Kong as a private company in 1987.

2. The Taxpayer commenced business in September 1987 and in its 1987/88 profits tax return the nature of its business was described as 'sale of [type of equipment named]' ('the business').

3. The Taxpayer carried on the business of selling equipment and had many transactions with customers in Hong Kong and elsewhere.

4. It was customary for the Taxpayer to receive payment from its customers both in Hong Kong and elsewhere by way of cheques and bank drafts drawn in US dollars on a banker or bank account in the United States of America.

5. The Taxpayer opened and maintained a savings account denominated in US dollars with a bank carrying on business in Hong Kong. Upon receipt of a US dollar cheque or draft, the Taxpayer would deposit or give it to the bank in Hong Kong where it maintained its savings account. The bank would take the cheque which had been endorsed by the Taxpayer and would credit to the savings account of the Taxpayer the US dollar amount of the cheque or draft less a commission charged by the bank for its services.

6. In the event of the Taxpayer wishing to make a payment in US dollars, it could and did instruct the bank to remit by telegraphic transfer the amount to the beneficiary in USA and the bank would debit the amount of the telegraphic

transfer to the Taxpayer's US dollar savings account with the bank in Hong Kong. The bank's charges for making this telegraphic transfer remittance would be debited to a current account maintained by the Taxpayer with the same bank.

7. Interest was credited by the bank to the US dollar savings account maintained by the Taxpayer computed on the daily balance and credited to the account half yearly.

8. On 25 April 1988, the Taxpayer submitted a profits tax return for the year of assessment 1987/88 showing assessable profits of $2,970,636. In the tax computation which accompanied this profits tax return, the Taxpayer excluded the sum of $12,580 stating that it was 'offshore interest'. This was the total interest (expressed in HK dollars) which had been credited to the Taxpayer's US dollar account described above.

9. The assessor did not agree with the Taxpayer regarding the exclusion of this interest and on 8 July 1988 raised a tax assessment on the Taxpayer which included the sum of $12,580 being the interest which the Taxpayer claimed was not taxable.

10. The Taxpayer objected to the assessment and claimed that the interest income was not taxable. The Deputy Commissioner by his determination dated 18 September 1989 upheld the assessment and the Taxpayer duly appealed to the Board of Review.

At the hearing of the appeal, the Taxpayer was represented by its tax representative and called one witness to give evidence.

The tax representative submitted that in determining whether or not the interest in question arose in or was derived from Hong Kong, it was necessary to apply the so-called 'provision of credit test'. He said that it had long been accepted in Hong Kong that the appropriate test to determine the source of income was the provision of credit test. The tax representative went on to refer to the facts of this case and submitted that the Taxpayer had lent the bank funds which the Taxpayer had made available to the bank in America. He submitted that as all of the payments by the Taxpayer to the bank comprised US dollars in the form of cheques and bank drafts, these funds could only be made available to the bank in America, being the place where the parties on whom the cheques and bank drafts had been drawn were situated. He pointed out that no money was paid to the bank in Hong Kong. He submitted that all that the bank received in Hong Kong were cheques and drafts which had then to be sent to America for clearing and that no money was received by the bank until its clearing account in America had been credited with the proceeds. He further pointed out that the cheques and drafts received by the bank were received subject to clearance.

One witness was called to give evidence on behalf of the Taxpayer but with due respect we found her evidence to be of no assistance. She was called as an expert witness though her qualifications as an expert witness were not adduced. She was a senior officer employed by another bank in Hong Kong having nothing whatsoever to do with the bank involved in the present case. She gave evidence as to practices and procedures adopted by banks in Hong Kong but had no knowledge whatsoever of the Taxpayer or its relationships with the bank in question. She gave evidence to the effect that, if the bank had been her bank, she could have handled this transaction in one of three different ways, by 'floating' the cheques received, by purchasing the cheques received with or without recourse or by accepting the cheques for collection. She had no direct knowledge of what either the Taxpayer or the bank involved in the present case had done.

The tax representative addressed us on the law and referred us to the following cases:

Commissioner of Taxation (NSW) v Kirk [1900] AC 588

CIR v The Hong Kong and Whampoa Dock Co Ltd [1960] 1 HKTC 85

Harding v Federal Commissioner of Taxation [1917] 23 CLR 199

CIR v Hang Seng Bank Limited (CA) [1989] 2 HKTC 614

CIR v Lever Brothers & Unilever Ltd [1946] 14 SATC 1

D7/84, IRBRD, vol 2, 58

D26/88, IRBRD, vol 3, 299

CIR (NZ) v N V Philips Gloeilampenfabrieken [1954] 10 ATC 435

C H Pte Limited v Commissioner of Income Taxes [1987] 1 MSTC 7022

Nathan v Federal Commissioner of Taxation [1918] 25 CLR 183

The tax representative submitted that, on the strength of the foregoing authorities, it was necessary when ascertaining whether or not income arose in or was derived from Hong Kong to find the originating cause of the income. In the case of interest income, the originating cause was the place where the credit or funds was made available by the lender (the Taxpayer) to the borrower (the bank). On the facts of this case the tax representative submitted that the funds could only be made available in the USA which was the place where the persons on whom the cheques and drafts were drawn were situated. He said that, merely by receiving a cheque or draft in Hong Kong, no funds were received by the bank. The bank could receive funds only in its bank account in the USA after it had presented the cheque or draft for clearing through the bank clearing system in the USA.

That account would be maintained by the bank with another bank (or branch) in the USA which would clear the cheques or drafts through the US clearing system for the benefit of the bank in Hong Kong. The funds so received would then be credited to the account of the bank in Hong Kong with the US bank, so that the funds were first made available to the bank in Hong Kong at its US bank account, that is, in the USA.

The representative for the Commissioner submitted that the interest in question should be taxable in Hong Kong by application of the 'provision of credit' test because the Taxpayer, by depositing the US dollar cheques or drafts into its savings account which it maintained with the local branch of the bank, transferred to the bank the funds represented by those cheques or drafts. He submitted that therefore the credit was provided by the Taxpayer to the bank in Hong Kong. He submitted that the clearance operation was just a part of the mechanics of the banking business and did not affect the place where the credit was provided. He submitted that, after a cheque or draft was deposited by the Taxpayer, the Taxpayer was not required to perform any further activity to earn the interest income as the supply of credit had already been carried out in Hong Kong.

The tax representative submitted alternatively that one should look further than the simple 'provision of credit test' and consider all other relevant facts.

The representative for the Commissioner, in addition to the cases cited by the tax representative, cited the following cases:

Rhodesian Metals Ltd v Commissioner of Taxation [1940] AC 774

CG of IT v Esso O Standard Eastern Incorporated [1969] Court of Appeal for East Africa (Unreported)

BR 20/75, IRBRD, vol 1, 184

Broken Hill South Ltd v Commissioner of Taxation (NSW) [1937] 56 CLR 337

American Leaf Blending Co v Director General of IR [1978] STC 561

This is an interesting case which raises a number of important questions of principle. There have recently been a significant number of cases taken on appeal from various Boards of Review to courts of higher authority relating to the application of the words 'arise in or derive from Hong Kong' where they appear in the Inland Revenue Ordinance. These cases together with the much older decided cases both in Hong Kong and elsewhere make it clear that, when considering source of income, it is not appropriate to create and apply any non-statutory rules or tests for determining what is Hong Kong income and what is not Hong Kong income. It is necessary to look at all of the facts of each individual case. It may well be in many, if not most, dealing with the source of interest, cases that the place where the credit is made available to the borrower is the single most important factor and may often be the dominating factor. However, as was pointed out by

the Court of Appeal in CIR v Hang Seng Bank Ltd 2 HKTC 614, it is necessary to look at all of the relevant facts and not focus on some alone to the exclusion of others.

Much time was spent by the tax representative in focusing on the affairs of the bank to demonstrate that in the view of the Taxpayer the funds were made available to the bank in USA and that this was the test to be applied. With due respect we think that in any source case it is necessary to look at the source of the income in the hands of the taxpayer and the relationship between the taxpayer and the debtor which in this case is its banker.

The two leading cases which were cited at length to us, the Lever Brothers case and the Philips case, are based on facts which are significantly different from the facts of the case before us.

The Taxpayer in this case was carrying on its business in Hong Kong and nowhere else. Its business was that of selling equipment to customers in Hong Kong and overseas. All of its profits, with the exception of the interest which is a relatively very small sum and which is the subject matter of this appeal, are accepted by the Taxpayer as arising in or derived from Hong Kong. In the course of operating its business, the Taxpayer received payments from a number of its customers, both in Hong Kong and overseas, in US dollars in the form of cheques and drafts. It could no doubt have opened and operated a bank account in the USA or elsewhere for the purpose of receiving and handling these cheques and drafts. It chose not to do so. It chose to open a US account with a bank in Hong Kong and to negotiate the cheques and drafts with that bank in Hong Kong. It gave or deposited cheques and drafts to or with the bank in Hong Kong (we note, by way of endorsing the cheque). Upon delivery of the cheque or draft to the bank in Hong Kong, the bank immediately credited the savings account of the Taxpayer with the amount of the cheque or draft less the commission charged by the bank for its services. This was a simple and routine Hong Kong banking transaction performed in Hong Kong and having nothing to do with any foreign country. The Taxpayer passed the cheques and drafts to its bankers in Hong Kong and in return received full consideration in the form of a credit to its savings account. Nothing could be simpler, more straight forward and more of a ‘Hong Kong transaction’. As a practical hard matter of fact, this was clearly a Hong Kong transaction.

It is true that the cheques and drafts were taken by the bank with the right to charge the Taxpayer if the cheques or drafts were in due course dishonoured. However that did not change the nature of the transaction. If the cheques or drafts were dishonoured in USA, the bank would have debited the savings account of the Taxpayer in Hong Kong because the Taxpayer did not have any account in USA. Once the Taxpayer had handed over to the bank the cheques and drafts there was nothing further that the Taxpayer had to do. It had fully performed its part of the bargain and received full credit for what it had done and the funds which it had transferred to the bank.

We have given careful thought to the submission that the funds were made available to the bank in the USA because that is where the bank negotiated the collection of the cheques and drafts. To accept this argument would place too much high value on what is

a technicality of the banking system. The cause of the interest in this case was a credit balance in a savings account in Hong Kong between the Taxpayer and the bank. That was the real and true cause of the interest.

We have considered whether the fact that the savings account was denominated in US dollars is a decisive factor in favour of the Taxpayer. In the course of the hearing, we put this to the parties and it was part of the submission of the Taxpayer that a US dollar debt can only arise in the USA because (leaving aside banknotes and coins) a US dollar can only have its existence through an ultimate account in the USA. This argument has some attraction and logic. A foreign currency is not legal tender in Hong Kong. However, to say that a debt designated in a foreign currency cannot earn interest in Hong Kong would be going much too far. Perhaps this is the fatal fallacy in the case for the Taxpayer. If a trader sells goods on credit or otherwise gives credit to a customer, he is entitled to charge interest on that credit. If a trader (or a banker) and its customer are both situated in Hong Kong and their entire business relationship is in Hong Kong, then the fact that the debt between the two is designated in a foreign currency does not mean that the interest arises in the country of origin of the foreign currency. In this case, we are not dealing with abstract foreign currency but a banking relationship which arose in Hong Kong between a customer and a bank in Hong Kong whereby interest was payable by the bank on a choice in action situated in Hong Kong. Interest is something which accrues on a debt owed by one person to another during the period that the money is outstanding. In this case, the bank created a debt due to it from the Taxpayer from the moment when the savings account of the Taxpayer was credited with the amount due from the bank to the Taxpayer. This took place in this case from the moment when the bank received the cheques and drafts given to it by the Taxpayer. If we were to hold that the currency of the savings account was the governing factor, then it would mean that only interest on Hong Kong dollar debts would be taxable in Hong Kong and might also lead to the suggestion that interest on any Hong Kong debt wherever it was located in the world (but outside Hong Kong) would have a Hong Kong source. This is clearly not the case and would be absurd.

For the reasons given, we find in favour of the Commissioner and dismiss this appeal.