Case No. D5/85

Board of Review:

H. F. G. Hobson, *Chairman*; Robert W. N. Wei and Patrick P. K. Wu, *Members.*

9 May 1985.

Interest Tax—section 28(1)(*a*) of Inland Revenue Ordinance—whether interest accruing upon a credit sale balance of price paid for the purchase of shares in an overseas corporation was "interest arising in or derived from" Hong Kong within the meaning of section 28(1)(*a*) and consequently subject to deduction under section 29.

A Hong Kong company (the Appellant) was set up to act as the buyer for an overseas corporation of the shares of a Taiwan Company (a wholly-owned subsidiary of the overseas corporation) in order to minimize the amount of tax payable in the U.S. The proposed terms of sale were settled upon at a meeting in June 1977. In a letter of 3 October 1977 addressed by the Taipei branch of the overseas corporation to a shareholder of the Hong Kong Company, the terms of the sale were set out in some detail. A formal agreement for the sale of the shares was executed on 1 December 1977 in Hong Kong, the price due to the vendor as well as the interest subsequently accrued were credited in the Appellant's books in Hong Kong. The question was whether the formal agreement was the key to the provision of credit.

Held:

The location of the credit was Tai Wan since that was where title to the shares was completed. The passing of title was performed in Taiwan 22 days before the formal agreement was executed. No delivery of the share certificates took place in Hong Kong. The formal agreement was as between the parties of little purpose.

Appeal allowed.

Luk Nai Man for the Commissioner of Inland Revenue.
A. L. Brown of Price Waterhouse for the Appellant.

Reasons:

Was interest accruing to a D corporation upon a credit sale balance of the price for the purchase by the Taxpayer company of the entirely of shares ("Taiwan shares") in a Taiwan corporation "interest arising in or derived from" Hong Kong within the meaning of section 28(1)(*a*) of the Inland Revenue Ordinance and consequently subject to deduction under section 29? That was the question confronting the Board in this case.

The facts corresponded closely to those in the well-known South African case of **CIR v. Lever Brothers and Unilever Ltd.,** (including a pledge over the shares concerned), except that in the Lever Brothers case neither the original agreement for sale of shares nor the subsequent revised agreement were entered into the South Africa, whereas in the instant case the formal agreement for the sale was undeniably executed in Hong Kong.

B, represented the Taxpayer company, Mr. Luk Nai-man appeared for the Inland Revenue Department.

Y, a U.S. citizen resident in Taiwan, called by B, gave evidence to the effect that prior to 1977 the Taiwan company (then a wholly-owned subsidiary of a Delaware corporation of which Y was a major shareholder and a director) was qualified as a China trade corporation under a U.S. Statute of 1922 which conferred certain tax benefits upon such companies. In 1976 the U.S. legislature cancelled such benefits, effective 1977. D corporation sought advice from a R, a U.S. tax specialist, who in November 1976 recommended that the D corporation divest itself of its Taiwan subsidiary and that a Hong Kong company, to be owned by the same shareholders as the D corporation, be established to act as buyer. It seems that under such a scheme the profit on the sale of the Taiwan shares would be treated by the U.S. IRS as a capital gain by the D corporation and therefore taxable at a lesser rate than would be the case if the D corporation were to retain ownership of the Taiwan corporation. In the event the Taxpayer company was formed (or acquired as a shelf company, it matters not which) for the express purpose of buying the Taiwan shares. Subsequent evidence was given by a C that the Taxpayer company allotted its shares to all of the shareholders in the D corporation, with some minor differences in percentages which Mr. Luk conceded were not significant in the tax issue before us: the annual return of the Taxpayer company made up the 4 May 1977 showed that 11 100 shares had been issued by that date.

Y said that all the three directors of the D corporation were U.S. citizens, two of them resided in Taiwan, the third, A (a retired Vice-President of I Trust's branch in Hong Kong) resided in Hong Kong. The Taxpayer company had five directors of whom two were resident in Hong Kong, one of whom was A, the other three being resident in Taiwan.

Save for A (who had holdings of 9.44% and 10.92% respectively) and four Hong Kong companies acting as nominees for persons resident in the Philippines, all the shareholders of the D corporation, and consequently of the Taxpayer company, were resident in Taiwan.

Y referred to a letter (and enclosure thereto headed "Terms of Sales") of the 3 October 1977 addressed by the Taipei branch of the D corporation to A in Hong Kong, in which the proposed terms of the sale to the Taxpayer company were set out with a considerable degree of particularity; including the manner in which the total purchase price of NT$102 million was arrived at and how it was to be paid by instalments over 10 years carrying interest at 7% p.a. This letter was signed by a H, who identified the letter in subsequent testimony.

It was the Taxpayer's case that this letter in reality constituted the "agreement" for the sale of the shares rather than an Agreement dated the 1 December 1977 (the "Formal Agreement") which was subsequently executed under seal in Hong Kong by the D corporation as seller and the Taxpayer company as buyer.

It was common ground that guidance as to the meaning of the expression "interest arising in or derived from" is to be found in the Lever Brothers case in which it was held that the key to liability or otherwise depended upon the "originating cause" of the interest: the quarter from which interest is received was not the determining factor.

In the Lever Brothers case in a majority decision the Appeal Court held, as summarized in the head note, that:—

> "inasmuch as no business was carried on by the respondent company in South Africa, no contract had been made by them in South Africa, no capital had been adventured by them in South Africa, no services had been rendered by them in South Africa and no obligation resting on either party to the agreements had been performed or was to be performed in South Africa, the source of the interest received by the respondent company under the agreements was not be located in South Africa."

In the instant case the currency of account was N.T. dollars and was "paid" by crediting the D corporation's Taipei branch, in an account current between that branch and the Taxpayer company: no cash was actually remitted. The proposed terms of sale were settled upon at a meeting in June 1977 of some of the directors of the D corporation, two of whom were common to the Board of the Taxpayer company. A was not present. H at Y's request then set out the terms in the October letter (the four months' delay being due to the death of Y's father) and A agreed to them by telephoning Y in Taiwan on the 7 October 1977. The Formal Agreement was however signed in Hong Kong. The certificates relating to the Taiwan shares never left Taiwan since the D corporation, through its Taiwan branch, exercised a pledge over them as contemplated both in the October letter and the Formal Agreement. The share certificates were not endorsed to show the new holders' names as is the Taiwan practice. The Instrument of Transfer, dated 23 December 1977, was signed in Taiwan by Taiwan resident directors of the D corporation and the Taxpayer company. The Taxpayer company earned no profits in Hong Kong. The Taxpayer's directors rarely held meetings in Hong Kong.

In what way then was the origin of the interest connected with Hong Kong at all? The Taxpayer company was a Hong Kong company, the Agreement was signed in Hong Kong and the interest was credited in the Taxpayer's books in Hong Kong, (though evidently the contra revenue entries related to profits which did not arise nor were they derived from Hong Kong). It is important therefore to decide whether or not the Formal Agreement was the key to the provision of credit. The terms of the Formal Agreement different form those in the October letter but the only material variation was that dealing with the total of principal plus interest, the former combining interest with principal to achieve equal instalments throughout, the latter adopting the more convential method whereby the interest portion diminishes with each instalment of principal. No satisfactory explanation emerged for this difference, nor are we certain which method is being followed because the amount of interest disclosed in the Taxpayer's return is in Hong Kong dollars at a rate of exchange which is not readily ascertainable and relates to a period of less than a year. We believe however that there must have been prior agreement to this variation (whether or not in consequence of sighting a draft of the Formal Agreement—such a draft was referred to in the October letter—or due to suggestions by A we knew not) by those directors resident in Taiwan because we think it highly unlikely that it was agreed upon in Hong Kong at the last minute before the Formal Agreement was signed.

Y was asked why a Formal Agreement was needed, why have it drawn in Hong Kong and why sign it in Hong Kong.

His explanation for the first was that save for the need to convince the U.S. IRS no formal document was needed, and bearing in mind the close similarity in the shareholdings in the selling company and the buying company we accept the explanation since the practical, if not legal, result was that the shareholders collectively were both sellers and buyers through the medium of corporate entities. He told the Board that he had it drawn in Hong Kong by a solicitor who was well known to him whose capabilities he preferred to those of Taiwan lawyers. The final question was answered to the effect that it was one of convenience since A was then 72/73 years of age and preferred not to travel too much. It was obvious that A, who was a not insignificant shareholder of the D corporation, was viewed with respect and deference and we are inclined to accept that considerations of this sort would weight with Y.

The three witnesses for the Taxpayer were forthright and convincing, we had no reason to doubt that they were telling the truth.

Mr. Luk's case was that the provisions of credit was a consequence of the Formal Agreement: B's that it was seminal arrangements in Taiwan evidenced by the October letter.

In answering the central question we have kept in mind the oft-quoted words of **Isaacs J. in Nathan v. F.C. of Taxes** (25 CLR 183) viz:

> "Source means not a legal concept but something which the practical man would regard as a real source of income. The ascertaining of the actual source is a practical hard matter of fact."

We are inclined to the view that the location of the credit was Taiwan particularly so since that is where title to the shares was completed—in contradiction to the provision in that regard contained in the Formal Agreement. The latter contemplated a passing of title immediately the Formal Agreement was signed in Hong Kong: in fact that act, which was the sine qua non of completion of the sale, was performed in Taiwan some 22 days later. This was a deviation from the provisions of the Formal Agreement which we believe affords ready evidence that the Formal Agreement was as between the parties of little purpose and hence its only real value was to satisfy the U.S. IRS. The Acting Commissioner of Inland

Revenue put much store by the words “The Vendor hereby delivers to the Purchaser the share certificates of the said shares together with properly executed Instruments of Transfer”: Whatever the words “hereby delivers” were intended to mean, no delivery took place on the 1 December 1977 in Hong Kong.

For the above reasons we find in favour of the Taxpayer. The appeal is allowed.