Case No. D79/03

Profits tax – source of profits – stock brokerage commission earned in overseas market – profits on execution of orders from Hong Kong clients versus overseas clients - section 14 of the Inland Revenue Ordinance ('IRO').

Panel: Benjamin Yu SC (chairman), Kenneth Graeme Morrison and Anthony So Chun Kung.

Date of hearing: 30 July 2003.
Date of decision: 17 November 2003.

The taxpayer, with offices in Hong Kong, was the Asia Pacific Region headquarters of an international stockbroking group.

The taxpayer derived income from brokerage commission both in respect of the Hong Kong stock market and overseas stock market. For its stock brokerage business in overseas markets, the taxpayer's claim that its profits were offshore and not taxable had been accepted for the years of assessment 1987/88 to 1991/92.

In 1993, the assessor commenced a review of the taxpayer's offshore claim and raised additional assessments on the basis that the taxpayer's profits derived from its stock brokerage business on overseas stock exchanges were profits arising in or derived from Hong Kong and taxable under section 14 of the IRO.

The additional assessments were confirmed by the Commissioner. The taxpayer appealed.

In August 2001, the Board decided that:

- Profits generated from the taxpayer's brokerage business for overseas customers in overseas market were offshore and not taxable;

- Profits derived from the taxpayer's brokerage business for Hong Kong clients in the overseas market were derived from operations carried out both within (60%) and outside (40%) Hong Kong. Yet, being bound by the decision of the Court of Appeal, the Board found itself having no power to make any order for the apportionment of profits.

The taxpayer appealed to the Court of First Instance ('the Court') by way of case stated.

The Court was called upon to decide five questions:

- Question 1 and 3 (posed by the Commissioner) centred on the question of agency of the overseas offices within the group and related to orders placed by overseas customers.

  The Court held that the Board had misapprehended the facts and the matter was remitted to the Board for reconsideration.

- Question 2 and 4 (posed by the taxpayer) centred on the execution of an order on the overseas stock exchange by overseas brokers.

  The Court accepted the taxpayer' s argument that the local brokers were the agents of the taxpayer.

- Question 5 (posed by the taxpayer) raised the legal question of whether the law permits an apportionment where the profits can be said to be derived both from within and outside the jurisdiction.

  The Court held that apportionment is permissible.

The Court remitted the taxpayer' s appeal to and ordered that the Board should reconsider its conclusion that:

1. The taxpayer engaged overseas offices as its agent;

2. The acts of execution of orders from overseas clients in the overseas markets were not the acts of the taxpayer;

3. The profits generated by the taxpayer from orders from overseas clients on overseas market arose substantially outside Hong Kong and not chargeable to tax;

4. The actual execution of the orders from Hong Kong clients in the overseas markets were the acts of the taxpayer performed through its agents as brokers;

5. The Court further ordered that it would be permissible in law and appropriate for the Board to and the Board was ordered to apportion the profits derived from orders of Hong Kong clients in the overseas markets.

Held:

1. Having considered the judgment of the Court, the Board maintained its decision that the profits generated from orders of overseas clients in overseas market were substantially offshore and that the taxpayer's activities in Hong Kong had been minor and indirect to the making of such profits in that no apportionment should be called for.

2. The Board are of the view that the profits derived from commissions generated from orders by Hong Kong clients, can truly be said to be partly onshore and partly offshore and should be apportioned 50% onshore and 50% offshore.

3. The case would be remitted to the Commissioner.

Appeal allowed in part.

Cases referred to:

HK – TVBI v Commissioner of Inland Revenue [1992] HKTC 468
Commissioner of Inland Revenue v Wardley Investment Services (Hong Kong) Ltd (1992) 3 HKTC 703

Clifford Smith SC and Neil Thomson Counsel instructed by Messrs Johnson Stokes & Master for the taxpayer.
Gladys Li SC instructed by Department of Justice and Francis Kwan Senior Government Counsel for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This appeal has been remitted to the Board following determinations by the Court of First Instance on various questions of law by way of Case Stated. The question raised in the appeal is one of source of profits. It is convenient to state at the outset that the parties have always been *ad idem* on the principle of law which apply in determining the source of profits, namely, that one looks to see *what* the taxpayer has done to earn the profits in question and *where* he has done it [see HK-TVBI v Commissioner of Inland Revenue [1992] HKTC 468 per Lord Jauncey of Tullichettle at page 477]. Nor is it in dispute that one must focus on what the *taxpayer* - and not what other person or entity - has done, see Commissioner of Inland Revenue v Wardley Investment Services (Hong Kong) Ltd (1992) 3 HKTC 703 at 729 per Fuad JA. The problem here is how to apply this

test on the facts. More specifically, whilst it is not in dispute that the acts of the taxpayer must include the acts of its agents, one of the questions here is whether an overseas office in the same group of companies as the taxpayer was an agent of the taxpayer such that its acts are in law the acts of the taxpayer for the purpose of determining source. The other question which arises is a no less vexed question of whether and if so how to apportion profits derived from sources both within and outside the jurisdiction.

The Background Facts

2. Company A, formerly known as Company B – Far East ('the taxpayer') is and was at the material time a member of an international stockbroking group. The holding company of the group is in Country C. The taxpayer, with its offices in Hong Kong, was the Asia Pacific Region headquarters. Every year, the taxpayer incurred substantial expenses by way of rental and staff salaries and allowances.

3. During the period from 1992 to 1995 (which is the relevant period for the purpose of this appeal), the group maintained subsidiaries and offices at various places including City D, City E, Country F, Country G, Country H, Country I and Country J.

4. The taxpayer derived income from brokerage commission both in respect of the Hong Kong stock market and overseas markets (such as Country I, Country F, Country G, Country K, Country L and Country H). For the years of assessment 1987/88 to 1991/92, the assessor accepted the taxpayer's claim that its profits from its brokerage business in respect of overseas markets were offshore and not taxable. The assessor commenced a review of the taxpayer's offshore claim in 1993 and had subsequently raised additional assessments on the taxpayer on the basis inter alia that its profits derived from commissions arising from execution of transactions on overseas stock exchanges were profits arising in or derived from Hong Kong and taxable under section 14 of the Inland Revenue Ordinance ('IRO').

5. The additional assessments were confirmed by the Commissioner of Inland Revenue ('the Commissioner'). An appeal by the taxpayer led to the first hearing before this Board. On that occasion, the taxpayer called two witnesses, Mr M, the Chief Financial Officer and Mr N, the Group Head of Sales. The Board accepted their evidence as to primary facts. Our findings on the basis of their evidence were set out in paragraph 8 of the Case Stated. It is necessary to repeat them here:

(1) The taxpayer had virtually no retail clients. Its clients were almost exclusively major financial institutions. The structure of the taxpayer's business was geared towards satisfying the needs of the institutional investors.

(2) Institutional investors demand quality in research and quality in execution. These are what the taxpayer sells and what the clients would pay for. The fees

which the taxpayer charged its clients were much higher than what a discount broker would charge by way of brokerage.

(3) In terms of business structure, there were three main business areas: research, sales and execution. The group had major offices located in City D, City E, Hong Kong, Country F and City O.

(4) The Hong Kong office was the regional head office. A number of additional functions such as management, group accounting, control, compliance, information technology and human resources were situated here. Hong Kong also had a research team and a sales team. The sales team would contact clients almost every day for marketing and for solicitation of business.

(5) Execution of the orders at the overseas market was performed either through a local broker or, in the case of Country H and Country G, through a locally incorporated subsidiary or branch to trade in the market. The quality of the execution of clients' order was very important. Execution of a substantial order placed by an institutional client required skill and judgment. This must necessarily be done at the overseas market at which the relevant shares were traded.

(6) The quality of the research was also important. Research analysts would receive a ranking for their performance, and this may often have a significant effect on the size of business generated.

(7) A regional office, such as the City P office, had staff engaged in research. These researchers produced all the research on the Country G market. To obtain the necessary information for their research, the researchers made site visits to the companies which were the subject of their research, and talked to management competitors and clients. Their research product would be sent to Hong Kong where it would be edited and collated with materials from other offices for circulation to clients. Editing done at the Hong Kong office includes checking for grammatical and typographical errors, as well as ensuring that the recommendations or wordings were within the bounds of what international regulators would accept. The Hong Kong office also undertook macro-economic analysis in the region (other than Country J). The results would also be incorporated in the research materials distributed to the clients. Generally, the management role for the research function was conducted in Hong Kong.

(8) Research analysts would produce research that stimulated interest and response from clients. They would also maintain constant liaison with the

group's clients or potential clients. This involved their paying frequent visits to the clients, including visits to Hong Kong.

(9) Each client would sign a 'Client Agreement and Client Account Opening Form' with the taxpayer, although it appears that a Country Q client would also sign an agreement with the Country Q entity of Company B – Country Q. Clause 4 of the Client Agreement provides under the heading 'commission':

> ' In consideration of the Broker carrying out transactions in securities pursuant to instructions received by the Broker under this Agreement or for the Account, the Client agrees to pay the Broker commission at such rate or rates and on such basis as it may from time to time have notified the Client, whether orally or in writing, as being the rate or rates applicable to the Account...'

(10) Each country also had its own customer liaison or sales team. Some teams cover the whole region. Thus, the City E team would cover the whole of Region R. The teams contact their clients, usually on a daily basis, to draw attention to the group's research publications that may be of particular interest to that client, discuss market activity and solicit orders. The development and daily maintenance of customer relationship was not only another facet of the operations leading up to the sales contract, but in many instances was the actual point at which each sales contract was made.

(11) For Hong Kong clients, the processing of an order for execution in an overseas market typically took the following course:

(a) Hong Kong client placed order by telephone to the Hong Kong office. This order may have been generated as a result of the effort of the sales team in Hong Kong or of the research analyst maintaining his liaison with the Hong Kong client. (The Hong Kong client may also call the overseas office direct.)

(b) Hong Kong office relayed the order by telephone to the overseas office or (in cases where there was no overseas office) to an overseas stockbroker.

(c) Overseas office would manage the order by having it executed through local brokers at the overseas market.

(d) Overseas office would report back to Hong Kong office on execution.

(e) Hong Kong office prepared bargain slip to record details of the

transaction.

(f) Hong Kong office informed client of the execution of his order by telex.

(g) On the instructions of the overseas office, the overseas broker sent written confirmation of the execution of the order to the Hong Kong office by fax or telex.

(h) Hong Kong office issued a confirmation to the client.

(i) Hong Kong office issued telex instructions to the overseas independent settlement agents (mainly banks) who performed the settlement with the overseas settlement representatives of the client.

(12) For overseas clients, the processing of an order for execution in an overseas market typically took the following course:

(a) an overseas client, say in City D, placed an order to the overseas office in City D for the sale/purchase of shares (say) on the Country I market,

(b) City D office sent an order sheet to Hong Kong office to advise its receipt of a client's order and a copy of the order sheet was faxed to the Country I office for execution,

(c) After receipt of the copy order sheet, Country I office would check the market situation and place the order at the market through a Country I broker. Country I office would phone back to the Hong Kong office to report execution.

(d) Hong Kong office prepared a bargain slip to record details of the transaction.

(e) Hong Kong office informed City D office the execution of the client's order by telex.

(f) City D office would then notify client the execution of its order by phone/fax.

(g) Country I office sent written confirmation of execution of the order to Hong Kong office by fax.

(h) Hong Kong office issued a confirmation to the client.

(13) Broadly speaking, whilst the execution and settlement of the orders necessarily took place outside Hong Kong, all the back office functions such as confirmation of transaction, accounting etc were carried out in Hong Kong.

6. In our decision in August 2001, we took the view that a distinction should be drawn between commission income derived from orders placed on overseas markets placed in Hong Kong by Hong Kong customers and income derived from orders placed outside Hong Kong by overseas customers.

7. We came to the view that the profits generated from commission earned by the taxpayer from orders from overseas customers for execution in overseas markets were offshore and should have been excluded from the profits tax computation. The reasons we gave were set out in the following paragraphs (the paragraph numbers are those in the Case Stated):

'26. We shall first consider the position of commission earned from execution of orders in the overseas market from clients *outside* Hong Kong. The clients may be in [City E], and the markets at which the orders were executed may have been [Country I], [Country H] or [Country F]. We ask ourselves what did the taxpayer do to earn such commission, and where did the taxpayer do it?

27. What directly brought in the commission was the execution of an order placed by a client. But this would in turn have been the result of

(1) building up and maintaining a relationship with the client,

(2) providing quality research and offering advice to the client on the market generally and any stock in particular,

(3) providing an efficient and reliable service, not only in the execution of the orders, but generally in managing the client's account, and

(4) projecting and maintaining an image of repute and reliability.

28. In seeking to answer the question posed by Atkin LJ in F L Smith v Greenwood [1921] 3 KB 583 at 593, namely: "where do the operations take place from which the profits in substance arise?" or the question formulated by Lord Jauncey in HK TVBI of what the taxpayer has done to earn the profits in question and where did he do it, we do not think it right to limit the inquiry only to the execution of the order. Indeed, neither party urged us to take such a narrow view. If the inquiry should not be confined to the

execution of the order, it seems to us that we should take into account all the matters set out in the preceding paragraph.

29. In the context of the question what *taxpayer* did, we should deal with a submission made by Mr Thomson that the overseas offices and brokers were acting as agents for the taxpayer in obtaining clients' orders and in executing clients' orders. He argued that those acts should be treated in law as the taxpayer's acts. [Mr XX] retorted that there was no evidence of such agency. This matter was argued at a very late stage and it is correct to observe that there was no direct evidence on this question. The taxpayer had not adduced any evidence as to the contractual relationship between the taxpayer and the various offices or its associated companies within the group. We should add that in his Determination, the Acting Deputy Commissioner appears to have proceeded on the basis that both the offshore offices and the local brokers were the agents of the taxpayer for the purpose of executing the orders. Thus, paragraph 3(4) of the Reasons stated:

> "From a narrower prospective, it is clear from the documents under Appendices D1, D2, D3, E1, E2 and E3 that commission was earned when customers' orders were carried out by the [taxpayer] through agents in the stock exchanges outside Hong Kong. These agents might be entities related or unrelated to the [taxpayer]...The [taxpayer] in these transactions received 1% as commission from customers and paid the overseas agents a lower percentage, ranging from 0.4% to 0.75%. The profit to the [taxpayer] was the difference between what it charged the customers and what it paid the agents to execute the orders..."

Mr Thomson had specifically relied on this paragraph in his opening submissions, with no demur from [Mr XX]. In these circumstances, the absence of direct evidence of the contractual relationship between the taxpayer and the overseas offices is explicable, and may well be the result of the absence of a procedure for exchange of pleadings or the framing of issues in such appeals.

30. It may well be that the group had organized its affairs in such a way that all the profits (other than those generated from orders brought in by [Company B – Country Q] and [Company B – Country F]) arising from trading in the Asian market would go to the taxpayer, presumably because Hong Kong has a low standard tax rate. The problem remains that we have no evidence of the arrangements between the taxpayer and the other companies or offices in the group. We are conscious, of course, that the taxpayer bears the burden of proving that the assessment appealed against is erroneous or excessive: see s. 68(4) of the Inland Revenue Ordinance.

31. Nevertheless, we are left with the fact that (apart from orders brought in by [Company B – Country Q] and [Company B – Country F]), the taxpayer was able, during the relevant years of assessment, to earn commission from its clients through orders placed by clients with overseas offices. For the reasons we gave in paragraph 29 above, we do not consider that the absence of direct evidence indicates that the taxpayer was unable to produce such evidence. In the circumstances, we consider it right to draw the inference that the taxpayer engaged the overseas offices as its agents to perform the task of liaising with clients including soliciting and handling of clients' order.

32. As regards the actual execution of the order, we are not able to draw a similar inference. The orders were executed at the overseas market mostly by local brokers. ([Mr M's] evidence was that at the relevant time, only the [City S] office had a membership status.) These brokers would have charged their own commission, and there is no evidence or indeed any suggestion that this was in turn charged to the client as a disbursement. These local brokers were thus only engaged by the relevant office as independent contractors in carrying out the orders at the market. For this reason, we do not think that it would be right to regard the actual execution of the order at the market as the act of the taxpayer.

33. As far as research materials were concerned, we only know that the taxpayer had paid management fees to [Company B – Country G], [Company B – Country H] and [Company B – Country F] to reimburse their costs of providing research work. We do not know the actual arrangement between the taxpayer with these companies, or indeed, with the other companies or offices which had staff undertaking research, i.e. those in [Country L], [Country I], [Country T] and [Country K]. The Hong Kong office was responsible not only for editing and checking the contents of the research for consistency, but also for the macro economic analysis of the region and generally in managing the production and publication of the research materials.

34. In all the circumstances, and on the evidence we have seen and heard, we have come to the conclusion that the source of the commission generated from overseas clients was substantially offshore. In coming to this conclusion, we do not overlook the fact that some of the taxpayer's activities in Hong Kong would have contributed to the making of those profits. For example, the involvement of the Hong Kong office in the collation and publication of the research materials is one factor. The provision of other essential support functions could also be said, albeit indirectly, to have contributed to the

> success of the taxpayer in generating the profits it did during the relevant years of assessment. Nevertheless, any such contribution we regard as minor and indirect. Having regard to the other matters which the taxpayer did through its agents, which were clearly outside Hong Kong, such as the maintenance of the relationship with the client, the processing, handling and management of the orders and the provision of the primary research materials, we consider that the profits generated from orders from overseas clients arose substantially from an offshore source.'

8. As regards profits derived from commission earned from execution of *Hong Kong clients* in the overseas market, we came to the view that they can truly be said to be derived from operations carried out both within and outside Hong Kong. We took the view at the time that we were bound by the decision of the Court of Appeal in Hong Kong from ordering an apportionment of the profits, but indicated that, if we had the power to do so, we would have apportioned the profits derived from commission earned from Hong Kong clients to be 60% onshore and 40% offshore. The following is what we stated at the time:

> ' 35. As regards commission earned from execution of orders in the overseas market from clients *within* Hong Kong, these are, again, directly the result of the execution of the orders placed by the clients, which would in turn have been the result of the taxpayer's efforts in building up and maintaining the relationship with the clients, providing quality research and offering advice to the clients, providing an efficient and reliable service to the clients and in projecting and maintaining an image of repute and reliability to the clients. But here, the presence of the Hong Kong office, the efforts of the Hong Kong sales team and the visits which the research analysts from different regions calling upon the Hong Kong clients in Hong Kong would appear to us to be the substantial reason why the taxpayer was able to generate the profits it did during the relevant years of assessment. All these activities were carried out by the taxpayer in Hong Kong. At the same time, we are satisfied that there were foreign elements which contributed to the production of these profits. In particular, the order had to be managed and executed overseas, and the basic research was performed overseas. In our view, the profits earned from execution of orders from Hong Kong clients on overseas market can truly be said to be derived from operations carried out both within and outside Hong Kong. In these circumstances, we need to consider whether apportionment of the profits is possible. Mr Thomson's position before us was that if the source of profits were to be identified as both onshore and offshore, the Board would have a duty to apportion the profits. [Mr XX's] position, however, was that any apportionment could only be based on facts and figures, and that because the taxpayer had failed to produce any evidence as

to how much of the profits in question arose outside Hong Kong, the appeal ought to be dismissed...

42. In respect of commission generated from orders given by Hong Kong clients, we are of the opinion that the predominant source, as well as the source where the acts more immediately responsible for the receipt of the profits, was Hong Kong. In coming to this conclusion, we have taken into account all the circumstances we consider relevant. As we have stated above, we do not overlook the fact that the research and the execution of the orders took place overseas. However, for the profits in question, the clients were in Hong Kong, the orders which immediately gave rise to the commission were placed in Hong Kong. Although the primary research was carried out offshore, the research materials had to be read and assimilated and these were presented to the clients in Hong Kong, as part of the marketing exercise to generating more orders. This was part of the efforts of the taxpayer - carried out in Hong Kong - to establish and maintain close liaison with its clients in Hong Kong. Also, Hong Kong was the place where the group's research was being monitored for its quality.

43. We should add that if the law allows an apportionment, we would have held that it would be for the Board to do the apportionment and the Board must do its best on the evidence before it. In the present case, if we were required to perform the exercise, we would, having regard to the relative importance of the activities of the taxpayer in and outside Hong Kong to the production of the profits in question, have apportioned the profits derived from commission earned from Hong Kong clients to be 60% onshore and 40% offshore. We have deliberated long and hard over this question, realising that this comes down to a matter of fact and degree. But in the event, for the reasons stated above, we consider ourselves bound to dismiss the appeal in respect of the commission profits generated from Hong Kong clients.'

The Decision of the Court of First Instance

9. The Court of First Instance was called upon to decide five questions. Questions 1 and 3 were posed at the instance of the Commissioner. These questions centred on the question of the agency of the overseas offices within the group and related to orders placed by overseas customers. In substance, what was being challenged was the Board's reasoning in paragraph 29 of the Case Stated and the way in which the Board expressed its reasoning for conclusion in paragraphs 31 and 34 of the Case Stated. The Board was wrong to have taken the reference to 'agents' in paragraph 3(4) of the Reasons in the Determination as a reference to the overseas offices. In fact, contrary to the Board's understanding at the time, this passage in the Determination was intended by the parties to be referring to the overseas local brokers who executed the orders

(see paragraph 41 of the Judgment of the Court of First Instance). The Court held that the Board had misapprehended the facts and that in so far as its conclusion was in part based on such a misapprehension, its conclusion is unsafe and the matter was therefore remitted to the Board for reconsideration. The Court did, however, point out that there was evidence which could have justified a conclusion by the Board that the overseas offices were acting as agents of the taxpayer in liaising with clients, processing, handling and managing the orders and provision of primary research materials.

10. Questions 2, 4 and 5 were posed by the taxpayer. Questions 2 and 4 centred on the Board's finding of the execution of an order on the overseas stock exchange was not the act of the taxpayer, but predominantly the act of local overseas brokers engaged by the relevant office as independent contractors. The challenge was directed at paragraph 32 of the Case Stated. The Court accepted the taxpayer's argument that the local brokers were the agents of the taxpayer (see judgment at paragraph 51).

11. Question 5 raised the legal question of whether the law permits an apportionment where the profits can be said to be derived both from within the jurisdiction and from outside. The Court held that apportionment is permissible.

12. The Order made by the Court was to the effect that:

(1) the Board should reconsider its conclusion that the taxpayer engaged overseas offices as its agent in performing various tasks such as the maintenance of the relationship with the client, processing, handling and management of the orders and the provision of primary research materials,

(2) the Board should reconsider its conclusion, in so far as overseas clients are concerned, that the acts of execution of orders of the overseas markets were not the acts of the taxpayer in the light of its reconsideration of the evidence of the relationship between the overseas clients and the taxpayer and in the light of the court's ruling in relation to Hong Kong clients that the actual execution of the orders in the overseas markets was the act of the taxpayer performed through its agents the brokers;

(3) the Board should reconsider its conclusion, in the light of (1) and (2) above, that the profits generated by the taxpayer from orders from overseas clients on overseas market arose substantially outside Hong Kong and are not chargeable to tax,

(4) the Board should reconsider its conclusion based on the opinion of the Court that it erred in law in not concluding, so far as Hong Kong clients are concerned, that the actual execution of the orders at the overseas markets were the acts of

the taxpayer performed through its agents as brokers,

(5) it is permissible in law and appropriate for the Board to apportion profits derived from commission earned from Hong Kong clients for the execution of orders in the overseas market, and in the light of its reconsideration under (4) above, to apportion the said profits.

13. We have heard the parties' arguments on the remission of the case before the Board. Neither party called any additional evidence. We must therefore reconsider our conclusions based on the evidence adduced at the first hearing, but in the light of the determinations and rulings of the Court of First Instance.

The taxpayer's arguments

On overseas clients

14. Mr Smith, SC for the taxpayer emphasised that although the Court of First Instance detected an error in the manner in which the Board arrived at its conclusion that the overseas offices were engaged as agents of the taxpayer, the Court did hold that the evidence before the Board could have justified such a conclusion. He listed such evidence as the client agreement, evidence that the taxpayer was responsible for losses incurred by the client on trading and documents confirming execution of orders.

15. He argued that once it was concluded that the overseas clients were the clients of the taxpayer, then the brokers who executed the orders must have done so as agents of the taxpayer. The reasoning of the Court of First Instance in relation to the role of brokers when executing orders placed with the taxpayer by its Hong Kong clients must, he argued, apply equally as regards the brokers who executed orders placed with the taxpayer by its overseas clients.

16. He pointed out that the Board had previously concluded that the Hong Kong contribution to the generation of these profits was minor and indirect (see paragraph 34 of the Case Stated). On these basis, he invited the Board to confirm its decision that the profits generated from commissions derived from overseas customers were offshore.

Hong Kong clients

17. As regards Hong Kong clients, Mr Smith, SC relied on the ruling by the Court of First Instance that the acts of the overseas brokers are the acts of the taxpayer. He submitted that the offshore element is thereby substantially increased. He asked the Board to increase the percentage of offshore element, saying it should now predominate.

The Commissioner's submissions

Overseas clients

18. Miss Li SC, on behalf of the Commissioner, invited us to reconsider the question whether the overseas clients (other than clients from Country Q and Country F) were the clients of the taxpayer or the clients of the overseas offices. She urged the Board to look at the totality of the evidence and contended that the proper inference to draw is that these overseas clients were the clients of the group. She submitted that there was absolutely nothing in the evidence to suggest that

(1) the fostering and maintenance of relationships between the clients and the group

(2) the pushing of sales and research reports, or

(3) the processing, handling and management of clients' orders

were done at the request or to the order of the taxpayer.

Miss Li pointed out that even at this second hearing, the taxpayer has not suggested that there was any evidence put before the Board to establish that the overseas offices were acting as agents of the taxpayer.

Our conclusions

19. The starting point is *what* the *taxpayer or its agent* did to earn the profits and *where* was this done. As to what was done to bring in the profits, our findings recorded in paragraph 27 of the Case Stated have not been challenged. The question remains which of those acts, viz.

(1) the execution of an order placed by a client,

(2) building up and maintaining a relationship with the client,

(3) providing quality research and offering advice to the client on the market generally and any stock in particular,

(4) providing an efficient and reliable service, not only in the execution of the orders, but generally in managing the client's account, and

(5) projecting and maintaining an image of repute and reliability

was done by the taxpayer or its agents and where did such acts take place.

20. On the question of whether the clients are the clients of the taxpayer or of the group,

we have no hesitation in finding that the clients are, on the evidence, the clients of the taxpayer. The Client Agreement was signed with the taxpayer and the evidence shows that the taxpayer accepted responsibility for losses arising from wrongful dealing. After all, the profits which are the subject of dispute are the commission earned by the taxpayer from the execution of orders placed by clients and there is no reason to suggest that the profits were otherwise than properly booked as such.

21. We accept Mr Smith's submission that the reasoning of the Court of First Instance as to the status of the overseas brokers being agents of the taxpayer must apply equally to the taxpayer's relationship with the overseas customers as they do in respect of Hong Kong customers. In paragraph 55 of his judgment, Deputy Judge Longley observed:

> *'All the evidence pointed to the overseas brokers executing the transactions on behalf of the Taxpayer rather than as agent for the client or indeed any other person. The Taxpayer had contracted with its client to be responsible for the execution of the transactions. It did not pass on the commission it was obliged to pay the local overseas stockbroker as a disbursement but derived its profits from the difference between the commission it charged to the client and the commission it had to pay the local stockbroker...'*

No distinction can be drawn between execution of orders for Hong Kong clients or overseas clients. The execution of the orders by overseas brokers must therefore be considered as acts done by agents of the taxpayer in both cases.

22. We also accept that since the processing, handling and management of the orders are part of the duties of the taxpayer to its clients, the overseas offices and subsidiaries which performed these functions must have been doing the work on behalf of the taxpayer.

23. However, we are unable to find on the evidence that any work performed by overseas offices in building up and maintaining a relationship with the client or in the provision of quality research reports were done by the overseas offices as agents for the taxpayer. There is no evidence before us to suggest that the provision of these services were contracted by the taxpayer as part of its duties to clients. Nor is there any evidence of the relationship between the taxpayer and the overseas offices on these matters.

24. In the light of these findings, we have to revisit our conclusions on the source of profits generated from commission earned from overseas clients and profits generated from commission earned from Hong Kong clients.

Overseas clients

25. For overseas clients, we take into account the fact that the orders would be processed, handled and managed by the taxpayer's agents overseas. We must also take into

account the fact that the execution of the orders was carried out by the brokers overseas as agents for the taxpayer. At the same time, we have to exclude from our consideration the provision of primary research materials insofar as there is no evidence that these were done by overseas offices on behalf of the taxpayer. In paragraph 34 of the Case Stated, we have alluded to some of the taxpayer's activities in Hong Kong which contributed to the making of profits. We have also considered Annex B to Miss Li's submissions on this issue. We have previously come to the view that whilst some of the taxpayer's activities in Hong Kong would also have contributed to the making of the profits, we regard these as minor and indirect. We see no reason to alter that view. Having reconsidered the matter in the light of the judgment of the Court of First Instance, we remain of the view that the profits generated from orders from overseas clients arose substantially from an offshore source and that such contribution as there was by activities of the taxpayer in Hong Kong does not, in the circumstances of the present case, call for an apportionment of those profits.

Hong Kong clients

26. As for profits derived from commission generated from orders placed by Hong Kong clients, we have, in paragraph 35 of the Case Stated, referred to the presence of the Hong Kong office and the efforts of the Hong Kong sales team as important factors. The day to day marketing and solicitation of business, including business in the overseas market, would have been a substantial reason for bringing in the profits. These were all carried out in Hong Kong. The orders were placed and handled in Hong Kong. We must, however, bear in mind that the execution of the orders would be carried out on behalf of the taxpayer outside Hong Kong. In our earlier decision, we referred to the fact that the basic research on the overseas market was performed overseas as one of the pointers towards an offshore source. However, for the reasons given above, we are unable to find that the staff of overseas offices carried out researches in the overseas market as agent for the taxpayer; and are accordingly unable to take this matter into account as being part of the acts of the taxpayer.

27. Having reconsidered the evidence, we are of the view that the profits derived from commissions generated from orders by Hong Kong clients can truly be said to be partly onshore and partly offshore. We would therefore have to render our opinion on the apportionment of those profits. Having considered long and hard about the relative importance of the various factors and taking an overall view of the matter, we have come to the view that these profits should be apportioned 50% onshore and 50% offshore.

Disposal of the appeal

28. In the circumstances, we would remit the case to the Commissioner with our opinion that the profits generated from orders placed by clients outside Hong Kong for execution at overseas markets should not be taxable; and that the profits generated from orders placed by clients in Hong Kong on overseas markets should be apportioned on the basis of 50% onshore and 50% offshore.

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS