The Offshore Taxation Review

THE TERRITORIAL SOURCE OF INCOME: *HANG SENG BANK*, HK-TVB INTERNATIONAL AND ORION CARIBBEAN

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1 The Problem

Many states tax income profits arising within the jurisdiction, whether or not the owner of the profits is resident there. Difficulties may arise in determining whether profits arise inside or outside of the jurisdiction. This will depend on the precise wording of the statutory test and the interpretation it has been given by the courts of the jurisdiction. It is perfectly possible that different jurisdictions may give different answers to the question, especially when the question is not posed in exactly the same language. The conflict will not always be resolved by double taxation agreements or alleviated by unilateral relief from double taxation.[2]

The United Kingdom and Privy Council authorities are far from satisfactory. The main problem is the inherent vagueness of the legislative tests, often of some antiquity, which offer very little guidance as to their true construction. This is compounded by differences of wording from jurisdiction to jurisdiction.

The second problem is that the case law is not comprehensive. There is no one test which can be applied in a straightforward and consistent way to all types of income and the tests that are laid down are themselves sometimes lacking in

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2 For an example of the limits of the United Kingdom unilateral relief provisions in the context of Venezuelan tax, see the decision of Scott J in *Yates (Inspector of Taxes) v G C A International Ltd* [1991] STC 157.

precision. It is all very well to ask, as is done in the context of trading profits, "Where in substance are the profits earned?" but this in itself does not take one very far. Indeed, the courts have acknowledged that ultimately the question is a "practical hard matter of fact". Similarly, it is not very helpful simply to identify various relevant factors, as the House of Lords did in the *National Bank of Greece* case[3] in the context of the source of interest, unless there is a clear indication as to what weight each is to be given when they point in different directions. Certainty in the law can be achieved only by a great many decided cases dealing with the whole spectrum of factual situations. Yet the number of reported cases is surprisingly few and they are not always easy to reconcile.

The third problem springs from the first two. Because the taxing statutes are obscure, the basic principles are couched in language of some generality and cases are few and far between, it is very difficult to predict the result of difficult cases. In substance, the results are often inconsistent, although the apparent differences can be explained away technically. Judicial comity may make judges reluctant simply to admit that they are disagreeing with another decision, especially where it is a recent one.

2 The Trio of Cases

In this article, I shall comment on a trio of Privy Council cases, all decided on appeal from Hong Kong on the same statutory provisions, and use them to illustrate some of the difficulties. *Commissioner of Inland Revenue v Hang Seng Bank Ltd*[4] concerned profits made by a Hong Kong resident bank by investing surplus funds in short term certificates of deposit, bonds and gilt-edged securities and selling them before maturity. The decisions to buy and sell were taken in Hong Kong, but the sales and purchases were effected by agents on the Singapore and London markets. The Privy Council held that the profits were not "profits arising in or derived from Hong Kong".

Commissioner of Inland Revenue v HK-TVB International Ltd [1992] STC 723 concerned the exploitation of foreign copyrights in video films by sub-licensing their copying and showing in foreign jurisdictions. The Privy Council held that the profits were "profits arising in or derived from Hong Kong".

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3 46 TC 472.

4 [1990] STC 733.

In *Commissioner of Inland Revenue v Orion Caribbean Ltd (in voluntary liquidation)* [1997] STC 923 a tax avoidance vehicle borrowed and on-lent money. Although the lending was outside Hong Kong, most of its operations were conducted in Hong Kong. The Privy Council held that its profits were "profits arising in or derived from Hong Kong".

In my view, *Hang Seng* was simply wrong. *HK-TVB*, although technically distinguishable, is difficult to reconcile with it. While the actual decision was the correct one, its reasoning is not entirely satisfactory. In *Orion*, a Judicial Committee presided over by Lord Nolan has not only given a decision which is impeccable on its application of the law to the facts, but has done much to cast doubt on *Hang Seng* and restore orthodoxy. The Board did not, however, disapprove all the erroneous dicta in *Hang Seng* and *HK-TVB,* as it was not necessary to do so.

3 Statutory Tests

3.1 Hong Kong

The Hong Kong Inland Revenue Ordinance section 14 provided:

> "Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part."

As Lord Bridge said, delivering the Opinion of the Judicial Committee in *Hang Seng*:

> "Three conditions must be satisfied before a charge to tax can arise under s.14:
>
> (1) the taxpayer must carry on a trade, profession or business in Hong Kong;
>
> (2) the profits to be charged must be 'from such trade, profession or business', which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong; and

(3) the profits must be 'profits arising in or derived from Hong Kong'.

"Thus the structure of the section presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located within Hong Kong, others overseas. The former are taxable, the latter are not.

"...

"It follows that a distinction must fall to be made between profits arising in or derived from Hong Kong (Hong Kong profits) and profits arising in or derived from a place outside Hong Kong (offshore profits) according to the nature of the different transactions by which the profits are generated."

3.2 The United Kingdom

The corresponding United Kingdom statute is rather differently worded. Tax is chargeable under Schedule D:[5]

"in respect of ... (a) the annual profits or gains arising or accruing-

(i) to any person residing in the United Kingdom from any kind of property whatever, whether situated in the United Kingdom or elsewhere, and

(ii) to any person residing in the United Kingdom from any trade, profession or vocation, whether carried on in the United Kingdom or elsewhere, and

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5 While Schedule D is by far the most important schedule and the one which give rise to the greatest problems of interpretation, the other surviving schedules also contain territorial tests. Schedule A applies to the annual profits or gains arising from any business carried on for the exploitation, as a source of rents or other receipts, of any estate, interest or rights in or over any land *in the United Kingdom*. Schedule E applies to emoluments from an office or employment in respect of duties performed *in the United Kingdom* (Case II) or, if the person holding the office or employment is resident and ordinarily resident in the United Kingdom, in respect of duties performed anywhere but subject to a deduction in certain cases where the duties of the office or employment are performed wholly or partly *outside the United Kingdom* (Case I). Schedule F applies to dividends and other distributions of a company *resident in the United Kingdom.*

(iii) to any person ... although not resident in the United Kingdom from any property whatever in the United Kingdom or from any trade, profession or vocation exercised within the United Kingdom ..."[6]

3.3 Other Jurisdictions

Two cases which were cited in the trio of cases I am discussing illustrate the variety of wording one can find. In *Commissioner of Income Tax, Bombay Presidency and Aden v Chunilal B Mehta of Bombay*[7] the Indian Income Tax Act taxed "all income, profits or gains ... from whatever source derived, accruing, or arising, or received in British India". In *Rhodesia Metals Ltd v Commissioner of Taxes*[8] "gross income" was defined by the Southern Rhodesian Ordinance to mean "the total amount other than receipts or accruals proved by the taxpayer to be of a capital nature, received by or accrued to or in favour of any person ... from any source within the Territory or deemed to be within the Territory".

4 Trade or Investment Income?

4.1 The Distinction

Although there is no express acknowledgment of the fact,[9] one finds in the authorities two fundamentally different tests. One is applicable to investment income, the other to trading income. While the line between trade and investment can be notoriously difficult to draw, especially when the alleged trade consists of buying and selling assets which can be held as investments, the distinction is so fundamental to the United Kingdom tax system that one should not be too surprised to see it reflected in tests to determine the territorial source of income or gains.

It is in my view no accident that the territorial scope of Schedule D in the United Kingdom is contained in wording which embodies this dichotomy. It covers the income of non-UK residents "from any property whatever in the United Kingdom or from any trade, profession or vocation exercised within the United Kingdom".

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6 Taxes Act 1988 section 18.

7 (1938) LR 65 IA 332.

8 [1940] AC 774.

9 Even *Orion Caribbean* contains only hints.

For "property", read "investment". In the case of "property" one is concentrating on the asset and where the income comes from, whereas in the case of a trade one is looking to what the proprietor of the income does to earn the income and where he does it. In the case of a passive investment, the latter test would be quite inappropriate.

4.2 Investment Income

In the case of investment income, broadly speaking, the test is "Where does the income in fact come from?"[10]

This is simple enough in the case of payment for the use of land or chattels: one simply sees where they are situate.

In the case of dividends from a company, United Kingdom law has long-since adopted the test of the country of residence of the payer company. On the whole, this test is clear, workable and usually fair, although it does not deal with all cases, such as those of dual resident companies, and may give rise to anomalies or tax planning opportunities where a company is resident in one jurisdiction but earns the profits out of which the dividends are paid in another.

The source of interest is rather more difficult. Does one simply look at where the debtor is resident? In many cases, the country of residence of the debtor will no doubt also be the source of the interest, but it is not in my view conclusive. The United Kingdom Revenue used to take this view that it was, but have, wisely, hedged their bets in RI 58 of November 1993.[11] In my view, the most important factor is the situs of the funds from which the interest is to be paid, but the matter is complicated and further discussion outside the scope of this article. Other annual payments give rise to similar difficulties.

To what extent does the proper law of the obligation to pay the income matter? On a casual reading of the House of Lords decision in *Westminster Bank Executor and Trustee Company (Channel Islands) Ltd v National Bank of Greece SA*[12] one might think not at all. In my view, that is true if one is concerned only with obligations which are truly international in that they would be recognised and

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10 This is not a test which has been laid down judicially in terms but is in my view the only test which enables one to reconcile (most of) the authorities. A complete analysis of the authorities is beyond the scope of this article.

11 The Revenue Interpretation is set out in the Appendix to this article.

12 46 TC 472.

enforced in virtually every civilised jurisdiction, no matter what the proper law. A prime example is that of a debtor or guarantor to pay interest on a loan. When, however, the payment is in respect of a right which is created by and exists only under the law of one jurisdiction, then there is much to be said for the view that the source of the income is that jurisdiction. I have in mind in particular intellectual property rights, such as patents and copyrights. If, for example, a French company enters into a licence agreement with a German company under which it agrees to pay royalties for a licence to commit what would otherwise be an infringement of a USA patent owned by the German company as an investment, a fair case could be made out that the source of the royalties is not France but the USA. If the French company were paying the German company rent for a lease of real or tangible personal property situate in the USA, there would, I apprehend, be no argument.[13]

4.3 Trading Income

In the United Kingdom, after some false starts, the law settled down in 1920 in the Court of Appeal decision in *Smidth (FL) & Co v Greenwood.*[14] Although it was approved by the House of Lords in 1957 in *Firestone Tyre & Rubber Co Ltd v Lewellin*,[15] it is interesting that it was *Smidth* and not *Firestone* which was cited in the trio of Hong Kong cases.[16] The test is now "Where do the operations take place from which the profits in substance arise?" On this view, where the trade takes the form of buying and selling assets, the place where the assets are situate, the place where the contracts of purchase and sale are concluded and the place of receipt of the sale proceeds will be less important than the place where the key decisions to buy and sell are taken.

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13 In so far as the *HK-TVB* decision contains dicta which are inconsistent with my view, I respectfully submit below that they are wrong.

14 8 TC 193.

15 37 TC 111.

16 One might well wonder whether the decision in *Hang Seng* would have been different if *Firestone* had been cited, especially the speech of Lord Radcliffe at page 142. Given the rejection by the Privy Council of other sound arguments advanced on behalf of the Commissioner, I rather doubt it would.

5 *Hang Seng Bank*

5.1 The Facts[17]

The question in the appeal was whether the respondent (the bank) was liable to profits tax under Part IV of the Inland Revenue Ordinance (Hong Kong) (the Ordinance) on profits accruing from the purchase and resale outside Hong Kong of certificates of deposit, bonds and gilt-edged securities in the years 1978 to 1980. The bank was a 'financial institution' as defined in section 2 of the Ordinance. It carried on business in Hong Kong where it had many branches. In the course of that business it acquired substantial amounts of foreign currencies, in particular United States dollars. The amount of any particular currency which the bank required to meet its obligations varied from day to day. But at any one time it would have held a substantial surplus available for investment. Before 1978 the bank normally invested its surplus holdings in foreign currencies on fixed deposit with overseas financial institutions. It was never assessed to profits tax on the interest earned by such deposits since the Revenue accepted that the interest could not be regarded as profits 'arising in or derived from Hong Kong'.

In 1978 an amendment of the Ordinance changed the law. Section 15(1) opens with the words:

> "For the purposes of this Ordinance, the sums described in the following paragraphs shall be deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong."

The 1978 amendment added a new paragraph (i) in the following terms:

> "(i) sums, not otherwise chargeable to tax under this Part, received by or accrued to a financial institution by way of interest which arises through or from the carrying on by the financial institution of its business in Hong Kong, notwithstanding that the moneys in respect of which the interest is received or accrues are made available outside Hong Kong."

It was no doubt partly in order to minimise its tax liability in view of this change in the law, but it was also, as the Board of Review had found, for good commercial reasons that in 1978 the bank changed its practice. From then on its holdings of foreign currencies were mainly invested in certificates of deposit, and to a lesser extent in bonds and gilt-edged securities.

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17 The account is taken from the speech of Lord Bridge.

As, for the purpose of determining the issues in the appeal nothing turned on any distinction between these different forms of security, Lord Bridge found it convenient to confine his attention to certificates of deposit, which, as he explained, are issued by prime banks agreeing to repay a fixed sum of money on a fixed date at a fixed rate of interest but which, unlike fixed deposits, are readily marketable at any time before maturity at a price which will fully reflect the anticipation of the interest element accrued up to the date of sale. At the material time there were markets for certificates of deposit in Singapore and London but not in Hong Kong. The bank's practice was for its foreign exchange department continually to monitor its foreign currency holdings and its future foreign currency requirements and to invest the relevant surpluses in certificates of deposit on the Singapore and London markets at the best rate obtainable and with a view to their resale shortly before maturity to meet obligations which would then arise.[18]

Instructions for purchase and sale were given through correspondent banks in Singapore and London. Sales were invariably effected before maturity. The funds used and accruing from these transactions were debited and credited to accounts of the respondent bank with other banks overseas. It was the profits arising from these transactions which were the subject of the appeal.

5.2 The Issue

The sole issue on which the appeal turned was whether the profits earned by the bank through the buying and selling of certificates of deposit in overseas markets were profits 'arising in or derived from Hong Kong' on the true construction of that phrase in section 14.[19]

Looking at the matter in the light of the decided cases, especially *Firestone*, it was in my view clear that those profits were earned in Hong Kong. The bank was not simply an investor of its own money in receipt of passive income. It was a financial trader. It borrowed money at one rate of interest and sought to make a

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18 Thus avoiding receiving any interest, which would have been taxable under section 15 of the Ordinance.

19 Before the Board of Review and the Court of Appeal one of the contentions unsuccessfully advanced by the commissioner was that the profit on resale of certificates of deposit before maturity represented interest on the original purchase price and thus was deemed to be a receipt 'arising in or derived from Hong Kong' by virtue of section 15(1)(i), but this contention was not pursued before this Privy Council. In 1990 I would respectfully have agreed with Andrew Park QC, who represented the Commissioner, that the contention was an impossible one. After reading what Lords Steyn and Cooke of Thorndon had to say in *IRC v McGuckian* [1997] STC 908 about the sale of the right to a dividend being income, the argument must now be worth a shot.

profit by on-lending it at a higher rate of interest.[20] Its profits were in substance earned in Hong Kong where all its management and administration was carried on and where were taken the crucial decisions as to how to invest its surplus cash and when to realise such investments. While the actual purchases and sales were effected abroad, they were purely ministerial acts. If the source of its income derived from the relevant transactions were indeed the jurisdiction where the certificates of deposit were bought and sold, the most extraordinary consequences would follow which no one has ever suggested. For example, a dealer in securities based in Switzerland who gave instructions to a broker in London as to what to buy or sell on the London markets would find that the profits of his dealing had a United Kingdom source, as would a Jersey company trading in United Kingdom real property which gave a power of attorney to a solicitor to enter on its behalf into contracts and conveyances which had been decided on by the directors in Jersey.

5.3 The Submissions for the Commissioner

In my view, the approach taken by of Andrew Park QC on behalf of the Commissioner, was entirely orthodox. His submissions are to be found only in the report of the case in [1991] AC 306, at pages 308-312 and 316:

> "The ... overseas profits were so embedded in the Hong Kong business of the bank that they cannot be separated from it... Those profits are contributed to by all the transactions which formed integral parts of it. The amalgam of all the results, profitable or otherwise, of all those transactions, including individual transactions which might have been implemented outside Hong Kong but were integral parts of the entire business conducted in and from Hong Kong, constitutes the profits of the business... in determining the source of a profit it is necessary to decide where the operations take place from which the profit in substance is derived."

In his reply he shortly emphasised the crucial points:

> "The critical decisions with regard to the buying and selling of the certificates of deposit were taken in Hong Kong ... The concept of income from property is different from business income. It is necessary to look at the essence of the particular business."

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20 And, no doubt, by buying cheaply and selling at a profit financial commodities.

5.4 The Decision

5.4.1 The Commissioner's First Submission

Lord Bridge of Harwich gave the judgment of the Board:

> "The primary submission made on behalf of the commissioner is that the business of the bank is one and indivisible. It is carried on in Hong Kong and all the relevant operations which resulted in the profits in question being earned were directed from Hong Kong and owed their success to the expertise of officers of the bank employed in Hong Kong. No overseas branch of the bank was involved and the funds used in the purchase of certificates of deposit were part of the assets of the bank arising from the carrying on of the bank's business in Hong Kong. For these reasons, it is submitted, the profits accruing from overseas trading in certificates of deposit cannot be looked at in isolation; they are mere components of the profits of an entire business and those profits, as a whole, arise in and derive from Hong Kong.
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> Their Lordships cannot accept this submission. Three conditions must be satisfied before a charge to tax can arise under s.14:
>
> (1) the taxpayer must carry on a trade, profession or business in Hong Kong;
>
> (2) the profits to be charged must be 'from such trade, profession or business', which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong; and
>
> (3) the profits must be 'profits arising in or derived from Hong Kong'.
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> Thus the structure of the section presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located within Hong Kong, others overseas. The former are taxable, the latter are not. On the commissioner's submission the requirement of condition (3) would be otiose, since it would be sufficient to show that profits were earned by a business carried on in Hong Kong to make them taxable. Counsel for the commissioner sought to escape this conclusion by submitting that condition (3) if effective, and is only effective, to exclude from liability to tax the profit earned by what he called a 'fully fledged' overseas branch of a Hong Kong bank 'which takes in its own deposits,

> makes its own loans and investments and generally runs its own banking business subject to the overall direction of head office in Hong Kong'. Their Lordships cannot accept that the only effect of restricting the scope of profits tax to 'profits arising in or derived from Hong Kong' is to exempt a Hong Kong profits taxpayer from liability to tax on the profits of an independent business carried on by him overseas. The Hong Kong taxpayer could in any event secure such exemption for himself, without statutory assistance, by ensuring that the separate business of his overseas branch establishment was carried on by a different company or subsidiary company. To accept the construction which underlies the commissioner's primary submission would reduce the effect of condition (3) to negligible significance.
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> It follows that a distinction must fall to be made between profits arising in or derived from Hong Kong (Hong Kong profits) and profits arising in or derived from a place outside Hong Kong (offshore profits) according to the nature of the different transactions by which the profits are generated."

With respect, the reasoning is fallacious and the description of the argument of Andrew Park QC unfair. The third condition covers the case where a business is carried on both in Hong Kong and elsewhere. It ensures that only those profits attributable to the business carried on in Hong Kong activities are taxable in Hong Kong. Otherwise, profits of another part of the business carried on outside Hong Kong would have been taxable in Hong Kong. Andrew Park's illustration of a separate branch was no more than that, as was made crystal-clear in his reply, at page 316B-D.

5.4.2 The Commissioner's Second Submission

Lord Bridge disposed of the secondary submission of the Commissioner in the same, equally unacceptable, way:

> "The secondary submission for the commissioner was and is that, even if the offshore trading transactions must be considered in isolation, the profits they yield arise in or derive from Hong Kong both because the relevant investment decisions are taken in Hong Kong and because the funds used by the bank enabling them to invest overseas in the certificates of deposit derived from their Hong Kong depositors.
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> "...
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> "Since appeal from the Board of Review's decision lies on a point of law only, the first question is whether this reasoning betrays any error of law.

The Court of Appeal held that it did. The Court of Appeal's reasoning may be summarised in the following propositions:

> (1) The assessable profits to which s 14 relates are net profits and it is the source of these net profits which requires to be identified as a Hong Kong source or an offshore source.
>
> (2) The Board of Review erred in law in disregarding the funds acquired in Hong Kong, which the bank itself had brought into account in its apportionment under r.2A(1), as one source of the net profits made by the offshore trading. This was, therefore, a 'multi-source' case...
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> "...
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> "The difficulty their Lordships find in the Court of Appeal's first two propositions is that, like the primary submission made on behalf of the commissioner, they lead to the conclusion that all the profits of a business which is carried on in Hong Kong (unless derived from a substantially independent branch establishment carrying on a separate business outside Hong Kong) must be regarded as derived in part from sources within Hong Kong."

5.4.3 The Commissioner's Third Submission

5.4.3.1 Lord Bridge

Lord Bridge then dealt with the argument that the profits in dispute had a Hong Kong source because it was in Hong Kong that the investment decisions were taken on a day to day basis in the exercise of the skill and judgment of officers in the bank's foreign exchange department:

> "Their Lordships think that this argument is authoritatively refuted by the Board's decision in *Commissioner of Income Tax, Bombay Presidency and Aden v Chunilal B Mehta of Bombay* ... The respondent in that case was a commodity broker carrying on business in Bombay who traded in commodity futures on exchanges in Liverpool, London and New York, giving instructions to buy and sell to brokers operating on those exchanges. The question at issue was whether the profits of the trade were profits 'accruing or arising in British India'. Beaumont CJ, in the High Court of Bombay, (1935) ILR 59 B 727 posed the question:

> 'Does the fact that profits arising under contracts made abroad depend upon the exercise in Bombay of knowledge, skill and judgment on the part of the assessee, and upon instructions emanating from Bombay, involve that the profits accrued or arose in British India?'

The High Court answered this question in the negative and the answer was duly affirmed by the Board on appeal to His Majesty in Council. This authority can only be distinguished from the instant case if the words in section 14 'derived from' are given a much wider meaning that the words 'arising in'. Whilst it may be that there is some marginal difference in the shades of meaning conveyed by the two phrases, their Lordships do not accept that it can possibly be sufficient to bear the weight sought to be put on it in distinguishing *Mehta's* case."

5.4.3.2 *Mehta*

This is at least more promising ground. Lord Bridge was relying on earlier Privy Council authority. The difficulty is firstly that the crucial point was not argued in *Mehta* and it is in any event no longer good law (if it ever was). The principal difficulty was that the Commissioner pitched his argument too highly. He contended that business profits are always earned in the place where the business is carried on in the sense of where the general control and direction of the business is situate. Yet the test was not: "Where is the trade exercised?", as it is, for example, in the United Kingdom. It is abundantly clear that a business of can be controlled and directed in London but the profits be earned in the USA. See, for example, *American Thread Co v Joyce*, (1913) 6 TC 163 (HL), where the company owned a large number of mills and real estate in the United States of America and its business consisted of spinning cotton thread in the United States of America and selling it there and elsewhere outside the United Kingdom.

What the Commissioner should have contended was that, in accordance with *Smidth*, which was not cited by either side or referred to by the Board, one looked to see where the profits were in substance earned; and that where one has a trade of dealing by playing the futures markets, the profits are made by the expertise of the person who decides what to buy and sell and when and not by brokers at the other end of the telegraph who simply carry out instructions. The Privy Council not surprisingly rejected the argument of the Commissioner and thus found for the taxpayer. The real point was never argued. The decision is therefore hardly an authority at all.

Whatever the authority of *Mehta* might have been when it was decided sixty years ago, it was swept away by *Firestone* twenty years later. *Firestone* was not, of

course, even cited by counsel in *Hang Seng* and *Smidth*, although cited, was ignored by the Privy Council. So far as United Kingdom law is concerned, it was established as long ago as 1908 in *Ogilvie v Kitton*[21] by the Court of Exchequer (Scotland) Second Division that, had Mr Mehta been resident in the United Kingdom and giving instructions to brokers to buy and sell on the New York exchange, he would have been carrying on a trade at least partly within the United Kingdom and would thus have been assessable to United Kingdom income tax on all the profits. The facts of *Ogilvie* were even stronger, in that it was held that the fact that Mr Ogilvie, who was resident in Scotland, was the sole proprietor of a business of woollen warehousing carried on in Toronto was enough to make the trade carried on in Scotland. He was "the head and brain of the trading adventure" even though he never attempted to exercise control or to give directions to the Toronto staff about even the smallest detail.

5.4.4 Lord Bridge's Dicta

5.4.4.1 The Dicta

Lord Bridge then made some general comments which have given rise to confusion:

> "But the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis a question of fact depending on the nature of the transaction. It is impossible to lay down precise rules of law by which the answer to that question is to be determined. The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected... But the present case was a straightforward one where, in their Lordships' judgment, the decision of the Board of Review was fully justified by the primary facts and betrayed no error of law."

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21 5 TC 338.

5.4.4.2 Critique

It is the penultimate sentence which is highly questionable. Lord Bridge has ignored the vital distinction between investment income and trading income. It is only in the latter case that it is relevant to ask what the taxpayer has *done* to earn the profit in question.

If *investment* income is derived from letting property then the profit arises in the place where the property is situate. Lord Bridge's remark is ambiguous. It is just possible that that is what was saying. That is the way in which he was benevolently interpreted in *HK-TVB*. See below. More likely, he was referring to the place where the letting took place. Can it really be the case that the source of rent payable under a lease of English land depends on where the lease was executed?

Likewise, Lord Bridge's statement that when money is lent the source of the profit is where the money was lent is contrary to all United Kingdom authority. The *National Bank of Greece* case is the latest and most authoritative House of Lords decision on the territorial source of interest. Although the loan was raised in London in sterling,[22] the House of Lords held that payments of interest had a foreign source. So insignificant was the place where the money was lent that they did not even refer to it! Lord Bridge could never have made the statement had he been aware of the decision (which was not cited to the Board).

If one is concerned with *trading* income, then the test is the same as that mentioned in the previous sentence in relation to rendering services or engaging in an activity. Profits from the letting of property by way of trade will be situate where the business is carried on. Thus, if I, an English resident, own chattels situate in Ireland and lease them as an investment, the source of my income is Ireland, no matter where I make the contract of letting. If I am not a United Kingdom domiciliary, I will thus be taxed only on the remittance basis. Conversely, if, say, a Jersey resident were to lease by way of investment chattels situate in England, the United Kingdom Revenue would be the first to claim that the income had a UK source. If, however, I carry on the trade of leasing from London, then the source of the profits will be within the United Kingdom notwithstanding that the chattels are physically situate outside the UK. Similarly, if the Jersey resident were to carry on a trade of leasing, the source of the profits of the trade would be situate in Jersey.

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22 See per Karminski LJ at 489C-D.

The same is true of the lending of money. If I carrying on a banking or other financial *trade*, the source of my profits is the place where I conduct the activities which earn my profits.

The position is complicated by the fact that, under UK tax law, the Revenue sometimes have the choice of taxing receipts of a trade as investment income. For example, interest derived by an insurance company can be taxed either as interest or as an element in computing trading profits: see *The Liverpool and London and Globe Insurance Company v Bennett*.[23] Thus, if a Jersey resident company carried on a banking business only in Jersey, its profits would *prima facie* have a Jersey source and would be outside the charge to UK tax. If, however, its trading receipts included interest with a UK source, the UK Revenue could in principle levy tax under Schedule D Case III on the interest. The rule which allows it to do so presupposes that in determining the source of the income one ignores for one moment the fact that the company is carrying on a trade.[24]

What if the income was earned by buying and reselling at a profit? Is it the case that the income will have arisen in or derived from the place where the contracts of purchase and sale were effected? Buying and reselling at a profit constitutes the trade of dealing. The true test is that applicable to other trades. If a French domiciliary resident in England were to deal from London in foreign real property, could he really escape liability to UK income tax on his profits on an arising (as opposed to a remittance) basis simply by taking care that the contracts of purchase and sale were technically entered into abroad by his attorneys?

I would respectfully agree with Lord Bridge that the *Hang Seng* case was straightforward, but equally respectfully disagree with him as to what the result should have been.

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23 (1913) 6 TC 327.

24 The position is even more complicated still in that, in the case of a Jersey enterprise, the UK Revenue would normally not even have that option on account of article 3(2) of the Jersey-UK double taxation arrangement: see *Hughes (Inspector of Taxes) v Bank of New Zealand* (1936) 21 TC 472.

6 *HK-TVB International*

6.1 The Facts[25]

The taxpayer company was a subsidiary of another Hong Kong company, HK-TVB Ltd (TVB), which made or acquired films in various Chinese dialects. TVB had the copyright in these films in a number of countries where Chinese is spoken and owned films which were either telecast or home videos. By clause 6 of an agreement dated 1st June 1981 (the agreement) TVB granted certain rights to the taxpayer company in the following terms:

> 'TVB hereby grants to [the taxpayer company], which accepts, the sole and exclusive right outside Hong Kong and the non-exclusive right in Hong Kong throughout the life of this Agreement and upon the terms and conditions of parts 2 and 3 hereof:
>
> (a) to copy, adapt, and cause to be seen and heard in public (otherwise than by means of wireless or cable TV transmissions in Hong Kong) all TVB Films,
>
> (b) to exploit all derivative rights in TVB Films (excluding the hotchpot programmes) and
>
> (c) to grant sub-licences to others to do the acts set out in paragraphs (a) and (b) above for periods not exceeding 5 years unless TVB's prior written consent ...'

It was provided in clause 10 of the agreement that the taxpayer company would pay to TVB a licence fee equivalent to 40% of the aggregate revenues received and receivable by it from the grant of the sub-licences. Thereafter the taxpayer company exercised their contractual rights under clause 6(c) but not those under (a) or (b) of that clause.

A very considerable number of sub-licences which were normally for a period of six to twelve months were granted during the relevant years of assessment and the aggregate profit therefrom during these years amounted to some $HK57m. The precise circumstances surrounding the granting of individual sub-licences necessarily varied but in general the taxpayer company sent representatives abroad to solicit business and to negotiate with potential customers. The price to be paid for the sub-licences was either agreed at that time or subsequently by letter or telex

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25 This account is taken from the judgment of Lord Jauncey of Tullichettle.

and the sub-licence was then prepared in Hong Kong and sent to the customer for signature. On occasions the sub-licence was signed by both parties in the foreign country, and on other occasions the whole negotiations were concluded by telex with no representative of the taxpayer company visiting the foreign customer. The sub-licensee paid a fixed fee, unrelated to profits earned by him, which was either payable as a lump sum or by instalments. Payment was made in Hong Kong. In addition to granting sub-licences the taxpayer company from time to time provided facilities for the duplication of films from the master film onto video cassettes and for dubbing which was carried out by sub-contractors. All the work in connection with these facilities was carried out in Hong Kong and the cost thereof was included in the sub-licence fee unless a customer asked specifically for a separate invoice. On receipt of the executed sub-licence from the customer the film was dispatched to him from Hong Kong.

6.2 The Court of Appeal Decision

In the light of the Privy Council's decision in *Hang Seng* and Lord Bridge's wider-ranging dicta, the Court of Appeal of Hong Kong not surprisingly found in favour of the taxpayer:

> "The taxpayer here has carried on marketing activities outside Hong Kong resulting in agreements for the sale or sub-licensing of intellectual property rights also exercisable only outside the Colony. The consideration is paid because the purchasers and sub-licensees are entitled to exercise these rights. Essentially the profit making activity was carried on and the services, being the provision of the rights, were rendered outside Hong Kong. Alternatively, the profit was earned by the exploitation of property assets and arose in or was derived from the places where those assets were when sold or licensed and remain; all outside Hong Kong."

6.3 The Privy Council Decision

6.3.1 Overview

The Privy Council reversed the decision of the Court of Appeal. In reality, they were disagreeing with Lord Bridge and the whole approach of the Privy Council in *Hang Seng* but did so politely by "expanding" what he had said, by emphasising that he had only given examples and not laid down a rule and by distinguishing *Hang Seng* (rather unconvincingly) on its facts.[26] Lord Jauncey said:

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[26] It is noteworthy that it fell to Lord Jauncey, the only Privy Counsellor who was a member of both Boards, to deliver the judgment.

> "The case of *F L Smidth & Co v Greenwood (Surveyor of Taxes)* ... was cited in the *Hang Seng Bank* case and their Lordships do not doubt that Lord Bridge had in mind the judgment of Atkin LJ in that case and in particular the passage ([1921] 3 KB 583 at 593, 8 TC 193 at 204) when he said: 'I think that the question is, "Where do the operations take place from which the profits in substance arise?"' Thus Lord Bridge's guiding principle could properly be expanded to read 'One looks to see what the taxpayer has done to earn the profit in question and where he has done it.' Further their Lordships have no doubt that when Lord Bridge, after quoting the guiding principle, gave certain examples he was not intending thereby to lay down an exhaustive list of tests to be applied in all cases in determining whether or not profits arose in or derived from Hong Kong. In the *Hang Seng Bank* case the two transactions which threw up the profit, namely the purchase and resale of the certificates of deposit, both took place outside Hong Kong and this Board held that the profits did not arise in or derive from Hong Kong, notwithstanding the fact that all the instructions to buy and sell originated in Hong Kong and that there was no independent branch office interposed between the head office in Hong Kong and the following transactions."

6.3.2 The Rival Contentions

Lord Jauncey, having stated the correct test, then went on to consider the rival contentions as to how it should be applied:

> "Applying Lord Bridge's guiding principle it is clear that the first question to be determined in this appeal is what were the transactions which produced the profit to the taxpayer company. Those transactions were two-fold, namely, the acquisition of the exclusive rights of granting sub-licences together with the relevant films and the grant of those sub-licences together with provision of the film by contracts with individual customers. Mr Kentridge, for the commissioner, referred to seven factors which, he submitted, demonstrated that the taxpayer company's business and its profits were carried on in and were derived from Hong Kong. These factors were: (1) its organisation which acquired the films and the exclusive overseas rights therein was in Hong Kong; (2) its sales organisation was in Hong Kong; (3) the representatives who were sent abroad were part of the Hong Kong sales organisation; (4) the sub-licences were drawn up in Hong Kong, according to Hong Kong law, and were dispatched from Hong Kong; (5) the films were either delivered in or dispatched from Hong Kong; (6) the films at the expiry of the sub-licence period had to be returned to Hong Kong or were destroyed; and (7) payments for the grant of the sub-licences were received in Hong

> Kong. He further submitted that the owner of an incorporeal right did not derive his profits from the place where a sub-licensee, who was neither an agent nor a joint adventurer, of these rights exploited them itself.
>
> Mr Park QC for the taxpayer company argued that there were two alternative approaches to the problem: (1) the taxpayer company provided a service in an overseas territory, say Vancouver, by sub-licensing in Vancouver, or (2) the taxpayer company exploited property assets by sub-licensing rights which were only capable of use in Vancouver. The service, Mr Park argued, could either consist in the grant of a sub-licence which enabled the operator to do in Vancouver what he could not otherwise lawfully do or could consist in the refraining by the taxpayer company from stopping the grantee doing what he could otherwise be stopped from doing. The place where that service was performed was the place where the sub-licensee did what the grant enabled him to do without being stopped by the taxpayer company. In arguing for the provision of a service Mr Park was seeking to bring the taxpayer company's operations within Lord Bridge's example in the *Hang Seng Bank* case of rendering a service (see [1990] STC 733 at 740, [1991] 1 AC 306 at 323)."

6.3.3 Who was Right?

Pausing there, which argument was right? I have little doubt that, the *Hang Seng* case apart, it was the Commissioner's. HK-TVB was doing more than deriving passive income from an investment. It was carrying on the trade of exploiting its master licence. This is a well-established type of trade. See, for example, *Noddy Subsidiary Rights Co Ltd v IRC.*[27] By far the most important part of its profit-making activities were conducted in Hong Kong. That was the place where in substance the profits were earned. HK-TVB's argument only became plausible if *Hang Seng* was right. *Hang Seng* was wrong, so the Privy Council distinguished and ignored it.

What of the alternative argument of Andrew Park QC that the taxpayer company exploited property assets by sub-licensing rights which were only capable of use outside Hong Kong? Only if this had been a case of investment income rather than of trading income, would this have been correct.

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27 43 TC 458.

6.3.4 The Rendering of Services

What was unfortunate is that the Privy Council then reached the right decision for not altogether the right reasons. Lord Jauncey, after stating that their Lordships rejected Mr Park's arguments, continued:

> "Where a resident in country A grants in that country the right in country B to exercise intellectual property rights which he has therein acquired by registration or application he does not render a service in country B by the grant. Nor does he render a service in country B or anywhere else by refraining in consequence of the grant from taking preventive action against the grantee. Rendering a service connotes some positive action on the part of the renderer and not a state of passivity. When Lord Bridge referred to the rendering of a service he no doubt had in mind the sort of service rendered by the salvage company in *Comr of Inland Revenue v Hong Kong and Whampoa Dock Co Ltd* (1960) 1 HKTC 85 which was held to have been registered outside Hong Kong. Another example of rendering a service outside Hong Kong could be the oversight by a Hong Kong-based engineer of a civil engineering project in another country."

Readers familiar with value added tax will perhaps be surprised to see that the grant of an intellectual property licence for a consideration is not regarded as the rendering of a service. On one view the licensor of a copyright does indeed render a service. What can be said in defence of Lord Jauncey is that even where there is an undoubted service rendered, when it comes to taxing the profits of the person supplying it, the question is not where the benefit of the service is enjoyed by the recipient but where the person providing it earns the reward for the service. If I write an opinion in London for a New York law firm and fax it to them there, they enjoy - if that is the correct word - my services there but there is no doubt that I have earned my fee in London. The place where the supply is *enjoyed* might be highly relevant to a tax on consumption such as value added tax, but not to a tax on business profits.

6.3.5 The Letting of Intellectual Property Rights

6.3.5.1 Lord Jauncey

Lord Jauncey then considered Mr Park's second argument:

> "In developing his argument that the taxpayer company was exploiting property assets which were only capable of use abroad Mr Park sought to draw an analogy between letting a property which was referred to by Lord Bridge in the *Hang Seng Bank* case ... and licensing of intellectual

> property rights. In the former case the profits arose where the property was situated and in the latter case where the rights were exercisable. Their Lordships consider this to be a false analogy, since it presupposes that intellectual property rights have a situs similar to immovable property. In the latter case profits accruing to a resident taxpayer from the sale of foreign immovable property are likely to arise in the country where that property is situated although both the contracts of purchase and sale thereof are made in the country of residence of the taxpayer (see *Rhodesia Metals Ltd (in liquidation) v Comr of Taxes* [1940] AC 774). It by no means follows, however, that intellectual property rights exercisable only in one country are to be equiparated to immovable property in that country. The *Rhodesia Metals* case was referred to in the *Hang Seng Bank* case and it follows that when Lord Bridge used the words 'place where the property was let' he must have been referring to the place where the property let was situated and not to the place or places where the lease happened to have been signed."

6.3.5.2 Critique

Instead of simply stating that Lord Bridge's dictum was inapplicable as soon as one was concerned with trading profits, Lord Jauncey denied that intellectual property rights have a situs similar to immovable property! I find this frankly incomprehensible. An intellectual property right is always the creature of the law of a jurisdiction. The reason a video could not be shown without licence in, say, Canada, was because a Canadian statute made it a tort to do so. The reason that no licence was needed in the People's Republic of China was that China had no such law.

6.3.5.3 *Rhodesia Metals*

The *Rhodesia Metals* case was no bar to the Commissioner succeeding. The Southern Rhodesia statute was couched in very different language: was income "received by ... any person ... from any source within the Territory"? Lord Atkin was at pains to point out, in delivering the judgment of the Board, that none of the English, Australian, New Zealand and South African authorities were in point and that the "English" statute was differently worded. He also pointed out that income could be derived from more than one source even where the source is a business and that different states might each claim the source of the same profits to arise within their own jurisdiction. Even if, therefore, if it could be said that the profits in *HK-TVB* had a source in, say, Canada, that did not prevent them also having a source in Hong Kong.

In any case, the *Rhodesia Metals* case was very different from *HK-TVB*. An English company managed in England had bought Rhodesian mining concessions as trading stock and had actually developed them there before going into liquidation and selling the whole enterprise. Under the Southern Rhodesia Ordinance section 5, an amount was deemed to be derived from a source within the territory if it accrued to any person whose business was wholly or partly managed therein. There was ample material upon which the courts could find that, in the special circumstances of the case and in view of the statutory language, the profit on sale did arise from an actual or deemed source within Rhodesia. The fact that the company appears to have been brought into existence only as an inserted step in a predestined raid on the exchequer probably did little to improve its chances of success on appeal.

6.3.6 What was Productive of Profit?

Lord Jauncey's reasoning was less than perfect in dealing with Mr Park's next argument:

> "Mr Park went on to argue that there were three phases in the operations carried out by the taxpayer company, namely: (1) the pre-control phase where business was solicited abroad; (2) the making of the contracts; and (3) the performance of the contract throughout the stipulated period of duration in the overseas country by refraining from taking action there against the sub-licensee. This approach ignores the fact that the taxpayer company first had to acquire the right to grant sub-licences. It also assumes that the taxpayer company's forbearance from taking action in the overseas country was productive of profit to the taxpayer company in that country - an assumption which their Lordships are not prepared to make. If a company hires out equipment for a given time on payment of a fixed fee, its profit derives from the contract of hire and not from its continued forbearance from seeking to recover that equipment during the contract period. Forbearance in the overseas country would be equally relevant to a grant to another Hong Kong company of rights to exhibit in that country - a situation which could hardly escape the operation of s 14 of the Ordinance."

It is alarming that the Privy Council could have thought that if a company hires out equipment for a given time on payment of a fixed fee, its profit derives from the contract of hire and not from its continued forbearance from seeking to recover that equipment during the contract period. The contract of hire is mere machinery and not the source, even if the owner of the goods is a trader. One might as well argue that when an author writes a book, the source of his royalties is his contract with his publisher rather than his profession. That is precisely the argument the

House of Lords rejected in *Carson v Cheyney's Executors*.[28] If the goods are hired by way of investment, it is the goods which are the source of the rentals. The hire agreement is mere machinery to enable the owner to exploit his ownership of the goods. If the owner does not continue to make the goods available, then he is no longer entitled to any rental under the agreement.

6.3.7 The Operations Test

Lord Jauncey then got back onto firmer ground:

> "Their Lordships consider that it is a mistake to try and find an analogy between the facts in this appeal and the example given by Lord Bridge in the *Hang Seng Bank* case. The circumstances in that case involving, as they did, buying and selling in well defined foreign markets were very different from those in the present and the examples were never intended to be exhaustive of all situations in which s.14 of the Ordinance might have to be considered. The proper approach is to ascertain what were the operations which produced the relevant profits and where those operations took place. Adopting this approach what emerges is that the taxpayer company, a Hong Kong-based company, carrying on business in Hong Kong, having acquired films and rights of exhibition thereof, exploited those rights by granting sub-licences to overseas customers. The relevant business of the taxpayer company was the exploitation of film rights exercisable overseas and it was a business carried on in Hong Kong. The fact that the rights which they exploited were only exercisable overseas was irrelevant in the absence of any financial interest in the subsequent exercise of the rights by the sub-licensee. Their Lordships therefore consider that the profits accruing to the taxpayer company on the grant of sub-licences during the relevant years of assessment arose in or derived from Hong Kong and as such were subject to profits tax under section 14."

My only comment is that in the circumstances of the case it is difficult to see how the fact that the rights which HK-TVB exploited were only exercisable overseas would have been relevant if HK-TVB had had a financial interest in the subsequent exercise of the rights by the sub-licensees.

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28 (1958) 38 TC 240.

6.3.8 Apparent Exceptions to the Operations Test

Lord Jauncey then concluded by re-asserting the basic principle and by indicating that the exceptions to it were rare:

> "In the view of their Lordships it can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax under s 14 of the Ordinance. Counsel for the commissioner was able to refer to three cases only in which the source of profits had been held not to be in the principal place of business of the taxpayer. In *Comr of Income Tax, Bombay Presidency and Aden v Chunilal B Mehta of Bombay (trading as Chunilal Mehta and Co)* ... a broker in Bombay entered into future delivery contracts for the purchase and sale of commodities in various foreign markets with parties outside British India, in which no delivery was even given or taken, and the profits flowing from such contract were not received in British India. This Board held that in the particular circumstances - the contracts having been neither framed nor carried out in British India - the profits derived from the contracts did not there accrue or arise. The circumstances were thus very similar to those obtaining in the *Hang Seng Bank* case. In *Comr of Inland Revenue v Hong Kong & Whampoa Dock Co Ltd* (1960) 1 HKTC 85 the appellants, in response to a request from the owners, sent a tug to salvage a vessel stranded on a foreign island. The tug refloated the vessel, towed her to a sheltered anchorage where she was made fit for the tow to Hong Kong, and thereafter towed her for four days to docks in Hong Kong. The Supreme Court (Appellate Jurisdiction) held that the profits from the salvage operation were not 'profits arising in or derived from the Colony' within the meaning of s 14(1) of the Ordinance. Reece J said (at 116):
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> > 'Here the contract of salvage was entered into in the Paracels and all the work of refloating and putting the vessel into a condition to be towed to Hong Kong and nearly all the tow, except for the last three miles, were completely beyond the territorial limits of Hong Kong and consequently I take the view that the profits must be said to arise outside of Hong Kong rather than inside.'
>
> The third case is that of the *Hang Seng Bank*."

In my respectful opinion, neither *Mehta* nor *Hang Seng* is good law, while *Whampoa Dock* merely proves the rule, as it was indeed a case where the profits were in substance earned out of Hong Kong.

7 Orion Caribbean Ltd

7.1 The Facts[29]

Orion Caribbean Ltd (OCL) was a Cayman Islands company, wholly owned by Orion Royal Pacific Ltd (ORPL), a company incorporated in Hong Kong. ORPL in turn was wholly owned by Orion Royal Bank Ltd (ORBL). Until June 1981, ORPL was owned by a consortium which included the Royal Bank of Canada (RBC). After June 1981 RBC wholly owned ORBL and hence, indirectly, ORPL and OCL.

ORPL was at first a registered deposit-taking company and subsequently a licensed deposit-taking company within the meaning of the Deposit-taking Companies Ordinance (since repealed) and the Banking Ordinance which succeeded it. In the late 1970s and early 1980s, ORPL was one of the main institutions or banks active in syndicated loans in Hong Kong. It would on its own, or in co-operation with other banks, underwrite term loans and syndicate them among other banks in Asia and Europe. The banking department of ORPL undertook credit analysis, loan syndication, loan management, negotiation of new loan documentation and amendments to existing agreements and loan administration.

OCL was formed in 1979. It had three directors (whom it did not pay) and no staff. Its function within the group, as found by the Board of Review in para 4.5 of the stated case 'was to serve as a vehicle for a tax avoidance scheme whereby it borrowed money on a regular basis (in currencies other than Hong Kong dollars) from (a) ORPL until late August 1985, and (b) the Singapore branch of RBC subsequently; and on-lent (again in currencies other than Hong Kong dollars) to borrowers (recommended by ORPL and approved by OCL), thereby making a profit out of the interest differential between the borrowings and the lendings'. It was evidently intended that the profits thus realised by OCL, and the attendant fees arising from participation in syndicates, would be protected from the risk of a claim for tax under s.14, and that the interest component would be protected from liability under s.15(1)(i) which was added to the Ordinance in 1978.

OCL was formed with what the Board of Review describe as a comparatively small capital: it appears to have been just under $US 6m. On 18th October 1979 ORPL entered into a service agreement with OCL whereby ORPL agreed, for stated remuneration, to provide OCL with management, administrative and accounting services with respect to syndicated loans in which OCL intended to participate as a lender. In November 1979 ORPL sold and assigned to OCL a portfolio of 27

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29 These are taken from the judgment of Lord Nolan.

syndicated loans. In addition, ORPL thereafter recommended new syndicated loan business to OCL. Before recommending new syndicated loan business to OCL, ORPL assessed the potential borrowers' credit worthiness, sought RBC group credit committee approvals in relation thereto, negotiated the terms of approved loans, and liaised with the banks which formed the syndicates of lenders. Once loans and their terms were approved ORPL would then approach OCL (or other institutions within the RBC group) offering participation as a lender in the syndicated loans. Participation by OCL in these loans was always on an arm's length basis as to fees and other arrangements, that is to say on the same terms as would be offered to banks outside the group.

On 3rd November 1982 OCL approved only one of four loans recommended by ORPL and rejected the other three. There is no evidence to explain the reasons for the rejection. On all other occasions, OCL's board in the Cayman Islands approved the loans as recommended, and, in doing so, relied on the evaluations of the group committees.

Having approved a loan, OCL would issue to a director of ORPL (and, after June 1981, sometimes also to an officer of RBC as an alternative) a power of attorney to execute the loan agreement on its behalf. No evidence was adduced as to where the great majority of these loan agreements were signed. In the case of 14 of them their places of signing were unknown; 6 of the 14 were signed in Hong Kong. The Board of Review found, as a matter of inference, that over 40% of all the loan agreements to which OCL was a party were signed in Hong Kong.

OCL's main bank account was a US dollar account maintained with a bank in New York, as most of its loan transactions were in that currency. In addition, it maintained a deutschmark account with a bank in Frankfurt, a Japanese yen account with a bank in Tokyo, and another US dollar account with a bank in the Cayman Islands. OCL used its New York, Frankfurt and Tokyo bank accounts in the course of its participation as a lender in the syndicated loans.

The Board of Review made the following findings:

> "The board of directors of OCL held its meetings in the Cayman Islands. Its main business was to consider and approve loan participations recommended by ORPL, and its main duty was to see that the proposals would not infringe the laws of the Cayman Islands. As for the merits of the loan, the board relied on the evaluations of the loan or credit committees of the group and approved all the recommended loans except on the one occasion mentioned ... above. Although the loan approvals were a formality in nature, they did in our view involve a decision making process, so that the board was not a mere rubber stamp in approving the

> loans. It had the power to disapprove them. Once a loan was approved and the loan agreement signed, the ensuing business of borrowing and on-lending was entrusted entirely to ORPL, which took deposits on behalf of and in the name of OCL up to late August 1985 from itself and subsequently from the Singapore branch of RBC. It did this without seeking or having to seek prior approval or subsequent ratification from OCL in the Cayman Islands.
>
> "...
>
> "It was suggested that OCL's business was participation in syndicated loans. But that is only half the story. With its relatively small capital, it had to borrow money (by taking deposits) from ORPL to fund its loan participations, so in fact OCL carried on the business of borrowing and on-lending money with a view to profit."
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> "As we have found ..., OCL left the business of borrowing and on-lending entirely to ORPL; the latter in fact acted at all times as OCL's agent in obtaining borrowings, that is, deposits (whether from itself or the Singapore branch of RBC) and entering into deposit-taking contracts without seeking prior approval or subsequent ratification from OCL's board in the Cayman Islands. The inescapable conclusion is that ORPL had implied actual general authority to make the deposit-taking contracts; such contract making activities were in our view outside the service agreement and did not amount to a breach of clause 4. Alternatively, if we are wrong in saying that these activities were outside the service agreement, then OCL and ORPL must have varied clause 4 by mutual abandonment to the extent of allowing ORPL to carry on the activities on behalf of OCL."

The Board went on to find in further sub-paragraphs of para 10.3 that in, for example, the case of US dollar loans ORPL instructed its bank in New York to pay the amount of the deposit to OCL's bank in New York for OCL's account. ORPL, acting on behalf of OCL, also instructed OCL's bank in New York to pay the amount of the deposit to the loan agent's bank in New York.

Interest on the loan and the various fees in respect of the participation were paid by the loan agent to OCL's bank in New York. Out of the interest received, OCL paid ORPL through its bank in New York the interest due to it. Although there was no direct evidence, the Board heard that ORPL, acting on behalf of OCL, gave all the necessary instructions to OCL's bank for interest to be paid out of OCL's bank account to its own bank account. All the contracts for the placing of foreign currency deposits by OCL with ORPL were made in Hong Kong, with

ORPL acting on behalf of OCL and on its own behalf. OCL's banks overseas communicated with and sent their statements, credit advices and debit advices to OCL care of ORPL in Hong Kong. OCL's books of account were kept in Hong Kong; all accounting facilities were provided to OCL by ORPL in Hong Kong. All the administrative support in the day to day running of OCL's business was provided by ORPL in Hong Kong, and OCL's bank accounts were operated and its cash managed by ORPL in Hong Kong.

Not all of OCL's relevant activities were carried out in Hong Kong. Reverting to this point in para 10.4 of the stated case the Board of Review repeated that the approval of proposed new loans by OCL's Board took place in the Cayman Islands. So did OCL's approval to proposed amendments of existing loans. While over 40% of the loan agreements were believed to have been signed in Hong Kong, the rest were signed overseas. Finally, the actual transfers of money into a bank which took place pursuant to the instructions given by ORPL, on OCL's behalf, in performance of the deposit-taking contracts and loan agreements took place outside Hong Kong. Under the international clearing house system, payments could only be made through the appropriate clearing house for the currency concerned.

7.2 The Board of Review and Court of Appeal

The Board concluded, however, at para 10.5 of the stated case:

> "Having considered all the facts found above and the points mentioned in 10.3 and 10.4 above, we have come to these conclusions: (1) despite the fragmented mode of carrying on business, the operations from which OCL's profits in substance arose took place in Hong Kong; (2) OCL carried on its business in Hong Kong; and (3) its profits arose from such business."

If the Board had then concluded that the profits had a Hong Kong source, its decision would have been impeccable. The difficulty was that it naturally turned for guidance to *Hang Seng Bank* and *HK-TVB* and that is when it started to go wrong.[30] The Board concluded:

> "The effect of what Lord Jauncey was saying [in *HK-TVB*] would appear to be this: if the facts of a case do not bring it within any of the examples given by Lord Bridge in the *Hang Seng Bank* case, the operations test

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30 I imply no criticism of the Board. Both it and the Hong Kong Court of Appeal simply gave effect to what the Privy Council had apparently told them was the law.

> should be applied in determining the question whether the profits arose in or derived from Hong Kong. Taking the present case as one of lending money coming within the example given by Lord Bridge in the *Hang Seng Bank* case, we have looked to the place where the money was lent as the test. However, if we are wrong and the correct test is the operations test, then, since we have already found that the operations from which OCL's profits in substance arose took place in Hong Kong ... [it] would have been our conclusion that the profits in question arose in or derived from Hong Kong."

Similarly, the Court of Appeal followed the dicta in *Hang Seng Bank*.

7.3 The Argument for the Taxpayer

On behalf of OCL, Mr Christopher Clarke QC invited their Lordships to uphold the decision of the Board of Review and the Court of Appeal on the simple basis that where the gross income in question is interest on a loan the source of the income is located, as a matter of law, in the place where the money is advanced. For this proposition he relied upon the example given by Lord Bridge. He submitted that if ORPL had itself made money available by way of loan to borrowers in New York, Frankfurt or Tokyo the resulting interest would not have been taxable under s.14, and that there was no reason why OCL should be in a worse position than ORPL.

I had at first wondered why a commercial Silk, no matter how distinguished, with no apparent knowledge of tax law, should have been instructed to appear in such an important case. As soon as I read his argument I realised that his ignorance of tax law was a tremendous asset. No Revenue Silk could, consistently with his duty to the Court and his professional ethics, have stood up before their Lordships and have relied on Lord Bridge's dictum without pointing out that it was plumb against House of Lords authority. Unfortunately for the taxpayer, the Board was presided over by a former Revenue Silk who did know his tax law.

7.4 Lord Nolan's Answer

Lord Nolan dealt with the argument as follows:

> "There are three difficulties inherent in this proposition. The first is that it attributes to Lord Bridge's words, even if they are taken in isolation, a rather broader meaning than that which they naturally bear. Lord Bridge speaks of profit earned 'by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities'. The reference to 'property assets' in relation to the letting of property or the

> lending of money may have been intended to refer simply to the exploitation of property or money owned by the taxpayer. If ORPL lent its own money to a borrower in, say, New York, then other things being equal there might be little difficulty in saying that the location of the source of the interest on the loan was New York. If, on the other hand, Lord Bridge was intending to cover, by his examples, a case such as that of OCL where the money has to be borrowed before it can be lent - like the commodities which have to be bought before they can be resold - it would be surprising if he were suggesting that regard should be had solely to the place of lending, to the exclusion of the place of borrowing."

Here, Lord Nolan is making the crucial distinction between lending as an investment and lending in the course of a trade. In the example he gives, the source of the interest will normally be New York if the borrower is resident there and is going to pay the interest out of funds which arise there, but not because the money is lent there. That is why he expresses himself in such guarded language. It was not, of course, necessary for him to go further in expressing disagreement with Lord Bridge.

Lord Nolan continued:

> "Secondly, and more generally, the proposition that Lord Bridge was laying down a rule of law to the effect that, in the case of a loan of money, the source of income was always located in the place where the money was lent, is one that cannot stand with the opening words of Lord Bridge quoted above, nor with the explanation of his remarks by Lord Jauncey in the *HK-TVB* case, nor with the whole range of authority starting from the judgment of Atkin LJ in *F L Smidth & Co v Greenwood (Surveyor of Taxes)* onwards, to the effect that the ascertaining of the actual source of income is a 'practical hard matter of fact', to use words employed, again by Lord Atkin, in *Rhodesia Metals (in liq) Ltd v Comr of Taxes* [1940] AC 774 at 789. No simple, single, legal test can be employed."

This is again correct in principle. My only comment is that while it is perfectly true that no simple, single, legal test can be employed, that does not mean that there are not some legal tests which will usually help to determine the question of the territorial source of income. Lord Nolan was, of course, delivering a judgment and not writing a text-book.

Lord Nolan then continued:

> "Thirdly, even if the activities of ORPL, before the involvement of OCL, could be regarded as simple loans of money of the kind which Lord Bridge intended to exemplify, it by no means follows that the profit-making activities of OCL can be seen in the same light. The suggestion that OCL's business was participation in syndicated loans was expressly rejected by the Board of Review at para 10.3 of the stated case. Its business in fact, as found, was borrowing and on-lending money with a view to profit. The borrowing and on-lending, on the findings of the Board, were carried on for OCL by ORPL, acting for OCL on each side of the transaction. If one asks what OCL did to earn the profits in question, and where OCL did it, the answer is that OCL allowed itself to be interposed between ORPL and the ultimate borrowers. It did so by allowing itself to be used as a channel for loans of funds raised or provided by ORPL in Hong Kong and passed through OCL to the ultimate borrowers under loan agreements negotiated, approved and serviced by ORPL. The present case is far removed from the simple type of loan transaction contemplated by Lord Bridge in *Hang Seng Bank*."

I am in complete and respectful agreement.

8 Conclusion

The authority of *Hang Seng Bank* has been seriously undermined. While the Privy Council in *HK-TVB* were content to regard it as an exceptional case, the Board as constituted in *Orion* would very likely have decided the actual case the other way.

While some of Lord Bridge's wilder statements have already been explained away, there remain dicta in both *Hang Seng* and *HK-TVB* which are contrary to principle. They could be used just as much against a Revenue authority as in favour of one.

Even in *Orion,* the distinction between investment and business income, which is in my view fundamental to determining the source of income, has not been fully articulated.

APPENDIX

RI 58 (November 1993) Interest - location of source of income
Schedule D Case III - meaning of "source".

The availability of relief under TA 1988 s.353 for interest paid and the right (or obligation) to deduct tax from that interest under TA 1988 s.349 may depend on whether interest is annual interest chargeable to tax under Schedule D Case III. Chargeability in turn depends on there being a UK source. The current Revenue view on the location of the source for interest is based on the case of *Westminster Bank Executor and Trustee Company (Channel Islands) Ltd v National Bank of Greece SA* [46 TC 472] - the Greek Bank case. The factors considered relevant in that case (leading to the conclusion that the income involved did not have a UK source) were:

- there was an obligation undertaken by a principal debtor which was a foreign corporation;

- the obligation was guaranteed by another foreign corporation with no place of business in the UK;

- the obligation was secured on lands and public revenues outside the UK;

- funds for payments by the principal debtor of principal or interest to residents outside Greece would have been provided either by a remittance from Greece or funds remitted by debtors from abroad (even though a cheque might be drawn in London).

Although the Greek Bank case was concerned with income which turned out not to have a UK source, inferences can be drawn from that case about the factors which would support the existence of a UK source and [the Revenue] regard the most important as:

- the residence of the debtor, that is the place in which the debt will be enforced;

- the source from which interest is paid;

- where the interest is paid; and

- the nature and location of the security for the debt.

If all of these are located in the UK then it is likely that the interest will have a UK source.

It is not possible for [the Revenue] to comment individually in advance on the many cases in which the location of the source of interest may be relevant since the precise tax treatment depends on all the factors and on exactly how the transactions are in fact carried out. [The Revenue] hope that this summary of [their] views will assist practitioners and their clients in determining for themselves where the source of interest with which they may be concerned is located.