Kim Eng Securities (HK) Limited *(Taxpayer)*

and

Commissioner of Inland Revenue *(Respondent)*

Court of Appeal
(Inland Revenue Appeal No. 7 of 2004)

Hon Rogers VP, Le Pichon and Cheung JJA in Court

Date of Hearing : 28 February 2006

Date of Handing Down Judgment : 29 March 2006

Court of Final Appeal
(Final Appeal No. 11 of 2006 (Civil))

Mr. Justice Bokhary PJ, Mr. Justice Chan PJ, Mr. Justice Ribeiro PJ, Mr. Justice Mortimer NPJ and Lord Scott of Foscote NPJ

Date of Hearing : 12 March 2007

Date of Judgment : 29 March 2007

Inland Revenue Ordinance (Cap. 112) – Profits Tax

Net commission and brokerage earned for dealings on overseas stock exchanges – whether profits arose in or were derived from Hong Kong and chargeable to tax under Section 14 – Apportionment – Agency – Principle for determining source

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The Taxpayer was a company incorporated under the laws of Hong Kong. It was a member of the Hong Kong Stock Exchange ["HKSE"] and carried on the business of a stockbroker here. It was not a member of any foreign stock exchange. The Taxpayer was, however, a member of an international group of companies which included, among others, the Taxpayer and Kim Eng Securities (Private) Limited ["KES"]. KES was a company incorporated under the laws of Singapore and a member of the Singapore Stock Exchange ["SSE"].

The Taxpayer did not dispute that net commission and brokerage earned by it relating to dealings on HKSE, irrespective of whether the orders came from account executives employed by it or by an overseas company, was taxable. It, however, contended that net commission and brokerage earned by it relating to dealings in respect of stocks traded on stock exchanges in Singapore, Malaysia, the Philippines, Shanghai and Indonesia ….. was not taxable, irrespective of where the orders came from, including orders from the Taxpayer's account executives.

In a number of overseas stock exchanges, minimum commission rates for individual customers were then in force. However, in certain stock exchanges such as SSE, stock brokers were allowed to give rebates to foreign stock brokers, but not to individual customers.

In about 1990, the group of which the Taxpayer and KES were members began a system to circumvent the minimum commission rates prescribed by SSE. To participate in this circumvention scheme, a customer who did not have an account with the Taxpayer must open an account with the Taxpayer, even in cases where he had already had one or more account or accounts with any other group company. It was crucial that the account through which the customer traded was with the Taxpayer.

As the permitted rebate under the relevant SSE bye-law was one-half of the (minimum) commission, KES would get the lion share (i.e. one-half) of the (minimum) commission, leaving the rebate of one-half of the (minimum) commission to be shared between the Taxpayer and the customer (and an overseas source company in a three-company scenario).

After execution of an order on an overseas stock exchange, the Taxpayer's settlement department would be notified about the details of the executed order.

Where the account executive was not a KES account executive, the Taxpayer would send a trade confirmation to the customer. Where the account executive was a KES account executive, KES would send a trade confirmation to the customer in the name of the Taxpayer, copied to the Taxpayer.

On receipt of the trade confirmation, the Taxpayer would perform certain necessary or relevant consequential administrative functions in Hong Kong.

The second reason given by the Taxpayer to explain why accounts were opened with the Taxpayer for customers to trade on stock exchanges outside Hong Kong was to allow the provision of margin facilities to customers for 'non-marginable' securities.

SSE restricted the provision of margin facilities to securities on its prescribed list. While KES could not provide margin facilities for 'non-marginable' securities, the Taxpayer could. To provide facilities for 'non-marginable' securities, it was crucial that the facilities be provided by the Taxpayer. The provision of margin facilities by the Taxpayer enabled the customers to trade on 'non-marginable'

securities using margin facilities and enabled KES to earn its income from such trades on SSE.

The Taxpayer argued that the executing of the customers' buy and sell orders whereby it earned the income under dispute was done overseas by foreign stockbrokers acting as its agents. Such income should therefore be treated as offshore income.

The Commissioner assessed the Taxpayer to Profits Tax on the entire amount of income under dispute.

The Board of Review concluded that Hong Kong was the source of the income under dispute and therefore confirmed the assessments as increased by the Acting Commissioner.

The Taxpayer's appeal from the Board of Review proceeded, by way of a "leap-frog" order made by Cheung JA, directly to the Court of Appeal. The Court of Appeal, by a judgment issued on 29 March 2006, dismissed the Taxpayer's appeal from the Board of Review. On the source question, the Court of Appeal appeared to share the Board of Review's thinking or at least accept it as reasonable. And on the apportionment question, the Court of Appeal took the view that the Board of Review was correct not to entertain the apportionment question on the merits. The Court of Appeal further added that "the overseas elements in the transactions (appeared to have) already been catered for by reason of the commission that would be received by KES and the other brokers engaged by (the Taxpayer) to perform the various trades on the stock exchanges in Singapore and elsewhere and by the share of commission that any source brokers would be entitled to". The Taxpayer appealed to the Court of Final Appeal.

Held, dismissing the appeal, that :

(1) Although the Taxpayer's presence and activities in Hong Kong are far from conclusive against it on the question of source, that does not render such presence and activities wholly irrelevant to that question.

(2) The claim that the relevant transaction to be executed on SSE was a transaction in respect of which the instructions were given by the Taxpayer and that KES was acting for the Taxpayer did not correspond with reality.

(3) Intervention in an appeal on law only is not confined to instances in which it is apparent on the face of the record that the determination appealed against resulted from a specifically identifiable error of law. The appellate court will also correct any error of law it detects buried beneath conclusions ostensibly of fact. The Court of Final Appeal shared Lord Radcliffe's preference, indicated in Edwards (Inspector of Taxes) v. Bairstow, to put it in terms of whether "the true and only reasonable conclusion contradicts" the determination appealed against.

(4) In the circumstances of the present case, there is no justification for saying that the true and only reasonable conclusion contradicts the Board of Review's determination.

In the Court of Appeal

Mr. Stewart K M Wong (instructed by Messrs. Lee & Li) for the Taxpayer

Mr. John Bleach SC & Mr. Jin Pao (instructed by Department of Justice) for the Respondent

In the Court of Final Appeal

Mr. Robert Kotewall SC and Mr. Stewart K M Wong (instructed by Messrs. Lee & Li) for the Taxpayer

Mr. John Bleach SC and Mr. Jin Pao (instructed by the Department of Justice) for the Respondent

Cases referred to in the judgment of the Court of Final Appeal :

British Waggon Company v. Lea & Company (1880) 5 QBD 149
CIR v. Hang Seng Bank Limited [1991] 1 AC 306
CIR v. Hong Kong & Whampoa Dock Company Limited (No. 2) [1960] HKLR 166
CIR v. HK-TVB International Limited [1992] 2 AC 397
CIR v. Indosuez W I Carr Securities Limited [2002] 1 HKLRD 308
CIR v. Orion Caribbean Limited [1997] HKLRD 924
CIR v. Wardley Investment Services (Hong Kong) Limited (1992) 3 HKTC 703
Commissioner of Income-Tax, Bombay Presidency and Aden v. Chunilal B Mehta of Bombay (1938) LR 65 Ind App 332
Commissioner of Taxation v. Hillsdon Watts Limited (1937) 57 CLR 36
Commissioner of Taxation v. Kirk [1900] AC 588
Edwards (Inspector of Taxes) v. Bairstow [1956] AC 14
Kwong Mile Services Limited v. CIR (2004) 7 HKCFAR 275
Re Holt, dec'd, Holt v. IRC [1953] 1 WLR 1488
Wing Tai Development Company Limited v. CIR [1979] HKLR 642