4/79

IN THE PRIVY COUNCIL No. 9 of 1977

ON APPEAL

FROM THE COURT OF APPEAL OF HONG KONG

BETWEEN:

COMMISSIONER OF INLAND REVENUE — Appellant

- and -

FAR EAST EXCHANGE LIMITED — Respondent

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CASE FOR THE APPELLANT

Record

1. This is an appeal from a judgment and order dated 5th October 1976 of the Court of Appeal of Hong Kong (Briggs, C.J., McMullin and Leonard, JJ.) dismissing an appeal by way of case stated from a decision dated 10th March 1975 of the Inland Revenue Board of Review annulling an additional assessment of profits tax for the year of assessment 1971/1972 made upon the Respondent by one of the Appellant's assessors. The additional assessment was in a sum of HK$732,000 and was levied on a sum of HK$4,880,000 which represented entrance fees received by the Respondent from its members during the basis period for the said year of assessment.

Pages 7-25 26-39 40.41. p.5

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2. The question for decision involves the construction and application of the Inland Revenue Ordinance, Chapter 112 (1971 edition) of the Laws of Hong Kong, and particularly sections 14 and 24 thereof. The provisions of these sections at material times were:-

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"s.14 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 the Colony in respect of his

assessable profits arising in or derived from the Colony 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.

s.24 (1) Where a person carries on a club or similar institution which receives from its members not less than half of its gross receipts on revenue account (including entrance fees and subscriptions), such person shall be deemed not to carry on a business; but where less than half of its gross receipts are received from members, the whole of the income from transactions both with members and others (including entrance fees and subscriptions) shall be deemed to be receipts from a business, and such person shall be chargeable in respect of the profits therefrom. 10 20

(2) Where a person carries on a trade association in such circumstances that more than half its receipts by way of subscriptions are from persons who claim or would be entitled to claim that such sums were allowable deductions for the purposes of section 16, such person shall be deemed to carry on a business, and the whole of the income of such association from transactions both with members and others (including entrance fees and subscriptions) shall be deemed to be receipts from business, and such person shall be chargeable in respect of the profits therefrom." 30

(3) In this section "members" means those persons entitled to vote at a general meeting of the club, or similar institution, or trade association.

3. The point raised by this appeal is whether profits tax should be charged for the year of assessment 1971/1972 on the Respondent in respect of profits arising from entrance fees paid to the Respondent by its members. 40

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4. The Respondent was incorporated on 31st October 1969 under the Companies Ordinance, Chapter 32 of the Laws of Hong Kong, as a company limited by guarantee and not having a share capital. The objects for which the Respondentwas formed are, inter alia:-

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"(a) To provide a securities market place where high standards of honour and integrity shall prevail, and to promote and maintain just and equitable principles of trade and business. 50

(b) To protect the interests of such brokers, and to promote honourable practices and to discourage and suppress malpractices.

(c) To record transactions between such brokers and to furnish reliable quotations of the price of shares and stocks, if called upon to do so.

(d) To act as arbitrator in the settlement, if desired to do so, of all disputes and differences between stock and share brokers or between stock or share brokers and their clients arising in the course of business.

(e) To establish an Exchange or place of meeting for stock and share brokers.

(f) To make rules for any of the above purposes and to make and from time to time alter (if necessary) a scale of charges for brokerage in share transactions.

(g) To purchase, take on lease, hire or otherwise acquire a suitable room or rooms, building or buildings in Hong Kong for a Stock Exchange; to fit and furnish the same as an Exchange, or to cause the same to be suitably fitted and furnished.

(h) To carry on in the premises so purchased, leased or otherwise acquired the business of a Stock Exchange."

By article 2 of the Respondent's Articles of Association the number of members of the Respondent is limited to 150. There are certain restrictions pertaining to membership which are not material for the purposes of this appeal. Upon election a member becomes liable to pay an entrance fee (articles 4(a), 5 and 11). Article 11 provides that the entrance fee shall be decided by the Committee, be deemed to be a capital receipt and in no circumstances be refundable. There is also a requirement that members pay monthly subscriptions (article 9). Articles 13 to 21 are material and provide:-

p.92
pp.93-94,95
p.95, pp.96-98

"13. All seats in the Exchange shall belong to the Exchange, but every member shall be entitled to the benefit of a seat

to be allocated by the Committee. Upon expulsion of any member, the seat and all benefits appertaining thereto shall revert to the Exchange and the expelled member shall have no claim thereon, but nevertheless, remain liable for any moneys which shall be due from him to the Exchange and Member Creditors.

14. No member, other than the right of disposal upon resignation, shall assign any rights, benefits or privileges of membership or create any pledge, hypothecation or lien thereon or therein, and no notice of any assignment, pledge, hypothecation or lien shall be effective as regards the Exchange for any purpose, nor shall any interest be recognised by the Exchange save as in these Articles are specifically mentioned. 10

15. Any member, unless under suspension, may give one calendar month's notice in writing of his desire to resign his membership. At the expiration of such notice, the member giving such notice shall cease to be a member and a vacancy in the membership shall occur, unless within that period he has withdrawn in writing his notice of resignation. A notice of resignation given by a member called upon to resign by the Committee shall not be withdrawn. 20

16. Any member who has given notice of resignation may from the date thereof until such notice expires nominate or cause to be nominated and put up for election as a member such person desirous of becoming a member to fill the vacancy. The nominee will be considered and ballotted for membership in the same way as any other candidate but if approved by the Committee for membership, the nominee will not be required to pay any Entrance Fee. 30

17. On the death or bankruptcy of any member his membership shall cease and a vacancy in the membership shall occur. Upon any vacancy in the membership occurring through the death or bankruptcy of any member, the personal representative or the trustee in bankruptcy of such member as the case may be may within the period of twelve calendar months, to be computed from the date of the death or adjudication of such member as the case may be nominate or cause to be nominated and put up for election such person who is desirous of becoming a member to fill the vacancy. The nominee will be considered and ballotted for membership in the same way as any other candidate 40 50

but if approved by the Committee for membership, the Nominee will not be required to pay any Entrance Fee.

18. In the event of any person being nominated by or through a resigning member, personal representative or trustee in bankruptcy of a member, as the case may be, and being put up for election and duly elected, the amount agreed to be and paid by such newly elected member shall be paid to the Exchange, and shall, subject to the deduction of any moneys owing by such resigning, deceased or bankrupt member to the Exchange or to any member creditor of his, be paid to such resigning member, personal representative or trustee in bankruptcy as the case may be.

19. If any member is expelled from membership of the Exchange, there shall become a vacancy in the membership.

20. Upon the expiration of any notice of resignation of any member or if no nomination of any candidate for election shall have been received within the stipulated time by or through the resigning member, his personal representative or trustee in bankruptcy, as the case may be, as hereinbefore provided, there shall be deemed to be a vacancy in the membership. The Committee of the Exchange may fill up such vacancy by the election of any person as a member and pay any moneys received by the Committee from such newly elected member to such resigning member, his personal representative or trustee in bankruptcy, as the case may be, subject to the deduction of any moneys owing to the Exchange or to any member creditor by such resigning, deceased or bankrupt member.

21. Subject as is hereinbefore provided, any moneys received by the Exchange from any new member be dealt with in all respects as the Committee in its discretion thinks fit."

5. On 22nd April 1971 the Respondent, through its Tax Representatives, furnished to the Appellant its profits tax returns for the years of assessment 1969/1970, 1970/1971 and 1971/1972 showing assessable profits of HK$46,352, HK$165,936 and HK$181,033 respectively. The Appellant's assessor, without any enquiry into the returns and accounts submitted in support thereof, assessed the Respondent to profits tax for the years of assessment 1969/1970, 1970/1971

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and 1971/1972 on the sums shown in the returns and issued notices of assessment accordingly. The profits declared in the returns were calculated as the profits derived from 3 main sources, viz., (i) subscriptions, (ii) listing and other fees and (iii) the sale of publications. On 11th January 1973 the Appellants' assessor, after examining the Respondent's profits tax return for the year of assessment 1972/1973 and supporting accounts, wrote to the Respondent's Tax Representatives and indicated that he would raise additional assessments on the Respondent for the years of assessment 1969/1970, 1970/1971 and 1971/1972 by including members' entrance fees and Founders' contribution as part of the Respondent's assessable profits applicable to each of those years of assessment. He also drew the Tax Representative's attention to section 24(2) of the Inland Revenue Ordinance. p.3.

p.3. 6. The assessor raised additional assessments on the Respondent for the years of assessment 1969/1970, 1970/1971 and 1971/1972. The notices of additional assessment which were issued to the Respondent were all dated 22nd May 1973 and showed additional assessable profits of HK$2,929,649, HK$7,035,012 and HK$7,035,012 with tax payable thereon of HK$439,447, HK$1,055,251 and HK$1,055,251 for the said years of assessment 1969/1970, 1970/1971 and 1971/1972 respectively. Following the lodging of objections by the Respondent to the said additional assessments the Appellant determined that the sums upon which additional assessments for the years of assessment 1969/1970, 1970/1971 and 1971/1972 were raised should be changed to HK$5,350,000 HK$8,150,000 and HK$4,880,000 respectively with tax payable thereon of HK$802,500 HK$1,222,500 and HK$732,000 respectively. The Respondent, pursuant to section 66 of the Inland Revenue Ordinance, appealed against the Appellant's determination to the Board of Review.

7. At the hearing before the Board of Review,

p.3. (i) The additional assessments for the years of assessment 1969/1970 and 1970/1971 were annulled by consent. The reason for this is that, until the year of assessment 1970/71, Section 24(2) of the Inland Revenue Ordinance began with the words "where a person carries on a trade association in such circumstances that

more than half its receipts by way of entrance fees and subscriptions are from persons who claim or would be entitled to claim that such sums were allowable deductions for the purposes of Section 16........." As from 1st April 1971, the subsection was amended by the deletion of the words "entrance fees and" in the first place where it occurred. Unlike subscriptions, entrance fees are not deductible for tax purposes by the members paying them. Hence, until the beginning of the year of assessment 1971/72, the test of deductability was not satisfied in the present case.

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(ii) It was agreed by the Respondent that

(a) the said sum of HK$4,880,000, the subject of the additional assessment for the year of assessment 1971/1972, was composed entirely of entrance fees paid to the Respondent by its members, and

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(b) if entrance fees paid to the Respondent by its members are taxable then HK$4,880,000 was the correct figure to enter into the computation of the taxable profits of the Respondent for the year of assessment 1971/1972 such figure representing the total entrance fees received by the Respondent from its members during the basis period for such year of assessment.

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(iii) It was conceded by the Respondent that

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(a) the Respondent carried on a trade association in such circumstances as are stated in section 24(2) of the Inland Revenue Ordinance, and

(b) the whole of its income (including entrance fees and subscriptions) was therefore deemed to be receipts from business.

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(iv) It was contended on behalf of the Respondent that any entrance fee received by the Respondent was of a capital nature and could not in law be subject to any charge to profits tax.

(v) It was contended on behalf of the Appellant

that

(a) on a true construction of Part IV of the Inland Revenue Ordinance, and in particular section 24(2), the entrance fees in question amounting to HK$4,880,000 were subject to a charge for profits tax whether they were of an income or of a capital nature, and

(b) the said entrancefees were in any event of an income nature. 10

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8. The Board of Review gave its decision on 10th March 1975. The Board found that the sum of HK$4,880.000 derived from entrance fees would not be chargeable to profits tax if it consisted of receipts of a capital nature, but would be chargeable if it consisted of receipts of an income nature. The Board further found that the Respondent's accounts, audited by chartered accountants, showed the entrance fees to be capital assets and that this would appear to accord with standard accounting practice. The Board considered that the Appellant had an onus upon him to prove that the entrance fees were of an income nature and thus exigible to tax and that he had not discharged this onus. In the result the Board allowed the Respondent's appeal and annulled the additional assessment in question.

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9. On 4th April 1975 the Appellant, in accordance with section 69 of the Inland Revenue Ordinance, made an application requiring the Board of Review to state a case for the opinion of the Supreme Court (now the High Court) on the following questions of law:- 30

p.6.

"(i) Did the Board err in law in finding that the sum of $4,880,000 derived from entrance fees would not be chargeable to profits tax if it consists of receipts of a capital nature?

(ii) Is there any or any sufficient evidence to support the Board's finding that the (Respondent's) accounts show the entrance fees to be capital assets? 40

(iii) Did the Board err in law in failing to find that the entrance fees were of an income nature?"

Both the Appellant and the Respondent desired that the case stated be heard by the Full Court (now the Court of Appeal) in the first instance and accordingly

the Honourable Chief Justice on 5th December 1975 directed, pursuant to section 28 of the Supreme Court Ordinance, Chapter 4 of the Laws of Hong Kong, that the case stated be set down for hearing before the Full Court (now the Court of Appeal).

The case stated was heard by Briggs, C.J., McMullin and Leonard, JJ. on 13th and 14th September 1976. Judgments in the Court of
10 Appeal were delivered on 5th October 1976 by Leonard and McMullin, JJ. Briggs, C.J. expressed himself as being in complete agreement with the judgments of the other Judges. pp.7-25,26-39, 40

10. Leonard, J., in his judgment, first referred to the Respondent's objects and dealt with the provisions of some of its Articles of Association. He said that the Articles 'albeit in a somewhat tortuous manner, recognise the ownership of the benefit of a
20 seat as a saleable asset which, as is common ground, is in the hands of the member, a capital asset.' the Appellant respectfully observes that it was not common ground that the ownership of the benefit of a seat is a capital asset. What was common ground was that the payment of an entrance fee by a member was, from the point of view of the member, a payment on capital account. He then contrasted the position of the
30 Respondent with that of the London Stock Exchange, citing Weinberger v. Inglis 1919 A.C. 606, and went on to state that a 'successful candidate for election to the respondent buys by the payment of his prescribed fee i.e. his "entrance fee and his subscription for the current accounts" membership of the exchange and entitlement to the benefit of a seat on the exchange.'

p.7 line 21

p.9. L.20

p.10 L.16

p.11 L.10

Leonard, J., having stated that the
40 entrance fee had the character of capital viewed from the stand-point of the member, proceeded to consider whether the entrance fee was also capital when viewed from the stand-point of the Respondent. He referred to the Inland Revenue Ordinance and noted that it was not an income tax ordinance nor a capital tax ordinance. Counsel for the Appellant had argued that section 14 of the Inland Revenue Ordinance imposed a charge on all (business)
50 profits whether they were of a capital or revenue nature. Leonard J., however, held that because profits of a capital nature could

p.11 L.39

p.11 L.41

p.12 L.33

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p.15 L.19	not in his view truly be said to arise from a trade, profession or business the Legislature did not intend to impose and did not impose a charge on profits of a capital nature by section 14 of the Inland Revenue Ordinance.

p.15 L.27 — The learned Judge then said that he was persuaded that the entrance fees were to be regarded as capital receipts and listed the factors which contributed to pursuade him that on balance the entrance fees should be regarded as capital in the hands of the Respondent. (10)
p.15 L.32 — These were that (1) the entrance fees were unquestionably capital in the hands of candidates for membership; (2) the Articles of Association "deem" them to be capital
p.15 L.37 — receipts; (3) they were treated as capital
p.16 L.6 — in the accounts of the Respondent; (4) it was
p.16 L.10 — found as a fact by the Board of Review that so to deal with the entrance fees (i.e. as capital) "accords with standard accounting practice"; (20)
p.16 L.17 — (5) they were non-recurrent. Counsel for the
p.16 L.35 — Appellant had argued that the entrance fees did possess a degree of recurrence and that in any event it or its absence was not a crucial factor.
p.16 L.41 — Leonard, J. considered the cases of Liverpool Corn Trade Association Ltd. v. Monks. 10 T.C. 442 and Commissioner for Inland Revenue v. Transvaal Bookmakers Association (Co-op) Ltd. 1953
p.16 L.42 — S.A.T.C. 14 and distinguished them from the case under appeal. (30)

The learned Judge, having held the entrance fees to be capital receipts and having accepted that section 14 of the Inland Revenue Ordinance
p.20 L.20 — did not impose a charge on capital profits,
p.20 L.23 — proceeded to consider whether section 24(2) of the Inland Revenue Ordinance obliged him to treat the entrance fees as receipts from business. He did not consider that the word "income" was used
p.21 L.32 — in section 24(2) as a term of art or in contradistinction to "capital" or as having a meaning different from "receipts" (a word used earlier in section 24(2)). He did not regard (40)
p.22 L.12 — the expression in brackets "(including entrance fees and subscriptions)" as being governed by the word "income" and considered that on a true interpretation of the section the word "including" operated to extend the word "income" as in Reynolds
p.22 L.16 — v. Commissioner of Income Tax 1967 A.C.1.

p.22 L.18 — Leonard, J., nevertheless considered that by the acceptance of the entrance fees and initial subscription the Respondent secured the purchase price of the benefit of a seat on the Exchange. (50)

He said if it was the benefit of a seat that the members were "buying" it was what the Respondent was "selling". In accepting the entrance fee and the first subscription from a successful candidate for membership the Respondent was therefore in effect selling a capital asset. The learned Judge was satisfied that sections 14 and 24(2) of the Inland Revenue Ordinance read together did not clearly evince an intention to tax the subject on profits from entrance fees that were the consideration for the sale of a capital asset. p.22 L.29 p.23 L.8 p.24 L.9

Leonard, J., answered the questions posed by the case stated as follows :-

"(i) Did the Board err in law in finding that the sum of $4,880,000 derived from entrance fees would not be chargeable to profits tax if it consists of receipts of a capital nature?

A. No because they consisted not only of receipts of a capital nature but also of profits arising from the sale of capital assets. p.24 L.22

(ii) Is there any or any sufficient evidence to support the Board's finding that the (Respondent's) accounts show the entrance fees to be capital assets?

A. The accounts themselves do not show them. They do however show them to be capital items p.24. L.31

(iii) Did the Board err in law in failing to find that the entrance fees were of an income nature?

A. No. The construction of section 24(2) is such that had the profits arising from them been found not to be profits resulting from the sale of capital assets they would be taxable not because they were of an "income nature" but because they were deemed to be receipts from business and the respondent would have been chargeable in respect of the profits from them. This does not arise since I regard the profits arising from their receipt to be profits from the sale of capital assets." p.24 L.37 p.25 L.1

11. McMullin, J., in his judgment, first referred P.26 L.16

p. 29 L.23 p.29 L.25	to the Respondent's Memorandum and Articles of Association and then summarised the facts and the course of the proceedings. He thought that Counsel for the Respondent was right to say that there were but two issues before the Court, viz., (a) whether the entrance fees were of a capital nature and (b) if they were whether the relevant part of the Inland Revenue Ordinance required them to be included as receipts of the Respondent in computing the extent of the Respondent's liability to profits tax. Later,	10
p.30 L.41	McMullin, J. described the first issue as whether the entrance fees in question were to be considered part of the Respondent's capital assets as distinct from income derived from its activities as a company.	
p.33 L.30 p.32 L.21 p.36. L.12	The learned Judge, after considering the cases of <u>Liverpool Corn Trade Association Ltd. v. Monks</u> and <u>Commissioner for Inland Revenue v. Transvaal Bookmakers Association (Co-op.) Ltd.</u> (supra), was satisfied that the entrance fees were of the nature of capital and not of income both in the hands of the members and of the Respondent.	20
p.37 L.42 p.38 L.21	McMullin, J. went on to consider section 24 (2) of the Inland Revenue Ordinance and commented that the '(Respondent) is not in the business of selling seats on a stock exchange - not even on this particular Exchange. If it were, the money received from each such sale would indeed be an item of its income. Rather, it is in the business of managing premises and providing facilities on behalf of a limited number of stockbrokers whose patronage it enlists by selling its principal assets - the seats upon the exchange - plus their appurtenant benefits - to	30
p.38 L.33	those stockbrokers at a stated price.' He concluded that the entrance fees in question were to be regarded as profits of a company arising from the sale of capital assets and therefore expressly excluded from charge under section 14 and that they were correspondingly excluded from the words in brackets in section 24(2) - "(including entrance fees and subscriptions)". He said that it may be that a case would arise in which fees	40
p.38 L.40	were shown to be of the nature of capital and yet not deriving from the sale of a capital asset. In such a case it may well be that it would be right to say that the words within the brackets (in section 24(2)) operated either to extend the ordinary technical meaning of the word "income"	50
p.39 L.1	which occurs earlier in the section or else that	

that word (i.e. "income") was to be understood in a wider and non-technical sense as "all incomings" in which case entrance fees of a capital nature but not deriving from sale of a capital asset would be caught by section 24(2).

McMullin, J., held that the appeal by way of case stated must fail and he answered the questions posed by the Board of Review in the same way as Leonard, J. p.39 L.26

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12. The Appellant respectfully submits that the Board of Review erred in finding that the sum of HK$4,880,000 derived from entrance fees would not be chargeable to profits tax if it consisted of receipts of a capital nature and that it also erred in failing to find that the entrance fees were of an income nature. The Court of Appeal, it is respectfully submitted, also erred in holding that the entrance fees were of a capital and not of an income nature. More importantly, however, the Court of Appeal, in the Appellant's respectful submission, erred in holding that the profits from the entrance fees represented profits from the sale of capital assets. This point was not raised by either the Appellant or the Respondent before the Board of Review. The learned Judges, it is respectfully submitted, misunderstood what is meant by the term, "seat", and this misunderstanding led them to conclude erroneously that a "seat" is a capital asset in the hands of the Respondent. A "seat" is simply a compendious term to describe the bundle of rights associated with membership which a person acquires when he becomes a member of the Respondent. Therefore a "seat", whatever its nature vis à vis a member following his election, cannot be said to be a capital asset in the hands of the Respondent. It follows that profits from entrance fees received by the Respondent from members cannot be said to be profits from the sale of capital assets. When the nature of the interest acquired by a member upon his election is analysed it is difficult to see how the assumption of membership involves at any stage the transfer - by sale or otherwise - of a capital asset. If the profits received by the Respondent from entrance fees were not profits from the sale of capital assets but were otherwise of a capital nature they would, it is submitted, be subject to a charge for profits tax as a consequence of section 24(2) of the Inland Revenur Ordinance and this appears to have been recognised by the Court of Appeal.

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13. On 8th March 1977 the Court of Appeal of Hong Kong made an order granting the Appellant final leave to appeal to Her Majesty in Council p.45 L.13

14. The Appellant respectfully submits that the judgment of the Court of Appeal of Hong Kong was wrong and ought to be reversed and this appeal ought to be allowed with costs for the following (among other)

R E A S O N S

1. BECAUSE the profits from the entrance fees in question were of an income nature and so, on a true construction of sections 14 and 24(2) of the Inland Revenue Ordinance, the Respondent was chargeable to profits tax in respect of them. 10

2. BECAUSE even if the profits from the entrance fees were not of an income nature the Respondent was, on a true construction of section 14 and 24 (2) of the Inland Revenue Ordinance, chargeable to profits tax in respect of them.

3. BECAUSE a "seat" is not a capital asset in the hands of the Respondent.

4. BECAUSE the Respondent, when it admitted a person to membership, did not thereby sell a capital asset. 20

5. BECAUSE the profits received by the Respondent from the entrance fees were not profits from the sale of capital assets.

6. BECAUSE if the profits received by the Respondent were not profits from the sale of capital assets the Respondent was chargeable to profits tax in respect of them for the reason stated by the Court of Appeal in its answer to question (iii) posed by the case stated. 30

M. NOLAN

H. J. SOMERVILLE.

IN THE PRIVY COUNCIL No. 9 of 1977

O N A P P E A L

FROM THE COURT OF APPEAL OF HONG KONG

B E T W E E N:

COMMISSIONER OF INLAND REVENUE

Appellant

\- and -

FAR EAST EXCHANGE LIMITED

Respondent

CASE FOR THE APPELLANT

CHARLES RUSSELL & CO.,
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