

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D19/88

Profits tax – sale of shares – whether profits were trading gains or realization of capital – discussion of tests for determining whether taxpayer was engaged in trading or an adventure in the nature of trade – distinction between objective and subjective tests for determining taxpayer's original intention – s 14 of the Inland Revenue Ordinance.

Profits tax – sale of shares – whether profits were trading gains or realization of capital – numerous purchase and sales forming part of one larger transaction – s 14 of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Michael A Olesnicky and Edward Chow Kam-wah.

Dates of hearing: 12, 13 and 14 April 1988.

Date of decision: 22 June 1988.

The taxpayer company was controlled by Mr X who also controlled a listed company. Mr X wished to increase his stake in the listed company for investment purposes and to prevent possible takeover bids, but he was concerned that purchases in his name would give rise to market rumours, thereby affecting the price of the listed company's shares. He therefore acquired the taxpayer so that purchases could be made in its name.

Because the sudden acquisition of large numbers of shares would cause huge price increases, Mr X instructed an employee to acquire shares in the taxpayer's name gradually over a period which extended from October 1977 to April 1980. Funds were supplied by Mr X and additional funds were borrowed from an unrelated finance company.

In 1979, the government announced certain measures which Mr X felt would adversely affect the property market. Share prices and property prices were rising and Mr X feared they were becoming volatile. Also, interest rates were at record highs. Because the listed company was engaged in the property market, Mr X decided that shares in it were no longer attractive as an investment. He therefore instructed his employee to sell the shares which were in the taxpayer's name. Again, to avoid market rumours, these sales were made gradually in order to avoid depressing the price by a sudden sale. Sales were effected between April 1980 to November 1980.

For both the purchase and sale of the shares, another related company placed contrary orders in the market-place for lesser amounts in order to avoid unduly affecting the prices of the shares.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

The taxpayer had refrained from continually buying and selling shares, despite fluctuations in the value of the shares which it held.

As a result of these sales, the taxpayer made a profit of \$369,849,206. The IRD assessed these gains to profits tax. The taxpayer appealed.

Held:

The gains were of a capital nature and not taxable.

- (a) It was essential to look at the taxpayer's intention at the time it acquired the shares. The intention of Mr X, who controlled the taxpayer, could be imputed to it for this purpose. Normally, self-serving evidence as to the taxpayer's subjective state of mind is essential if the taxpayer is to succeed, but it is not determinative. This evidence of subjective intention should be compared with the objective evidence, based on all relevant facts, as to the taxpayer's intention. Where the subjective and objective tests give conflicting results, the real intention is to be preferred although the objective test is relevant to help determine what that real intention is.
- (b) On the facts, both subjective and objective tests pointed to an original intention to hold the shares as a long-term investment. The subsequent sale was therefore the realization of a capital asset.
- (c) In reality, there was one purchase of shares followed by one sale. These were effected by numerous purchases and sales merely in order to avoid affecting the prices of the shares.

Appeal allowed.

P F Feenstra for the Commissioner of Inland Revenue.

John Gardiner QC with John J E Swaine instructed by Woo Kwan Lee & Lo for the taxpayer.

### Decision:

This appeal is by the taxpayer company (the company) against two Profits Tax assessments for the years 1980/81 and 1981/82. The company acquired shares ('the shares') in a Hong Kong publicly listed company ('the public company') and subsequently disposed of the shares. The surplus arising from the disposal was assessed to tax as being profit arising from share trading or a venture in the nature of trade.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

An agreed statement of facts was tabled at the commencement of the hearing. It is not necessary or appropriate to set out the statement of agreed facts in full in this decision and it is sufficient for us to summarise the same. An intrinsic part of the statement of agreed facts were a number of appendices. The statement of agreed facts and the appendices thereto were accepted by the Board and accordingly form part of this decision as if the same were set out herein. The statement of agreed facts can be summarised for the purposes of this decision as follows:

1. The company was incorporated in Hong Kong in the middle of 1977. Its Memorandum and Articles of Association were in standard form for a private company in Hong Kong having wide objects and general Articles of Association.
2. The company had an initial paid up capital of \$10,000 which was increased in 1979 to \$1,000,000.
3. Shortly after its incorporation, the company started to purchase shares in the public company in Hong Kong and between October 1977 and April 1980 the company acquired a substantial shareholding therein amounting to 4.74% of the issued capital. All purchases of the shares were made on a stock exchange at prevailing market prices at the date of purchase.
4. The last purchase of shares was made on 16 April 1980 and during the period between October 1977 and April 1980 the market value of the shares steadily increased and the adjusted market price of the shares as at 16 April 1980 was many times the price at which the first shares had been purchased in October 1977.
5. The company was owned and controlled by Mr X who was the founder of the public company and at all material times had de facto control thereof.
6. The funds for the purchases made by the company were provided partly from its own relatively small capital, partly from loans made free of interest by an associated company which was also beneficially owned by Mr X, and partly from an overdraft facility with a finance company. The finance company loan was concluded on an ordinary commercial basis with interest being charged at market rates.
7. The actual dividends received on the shares of the public company exceeded the actual interest paid to the finance company on the loans made by it to the company.
8. The public company carried on business as a property company in Hong Kong and Mr X was an expert in the property market. During the period from the middle of 1978 until the later part of 1979, share and property prices in Hong

## INLAND REVENUE BOARD OF REVIEW DECISIONS

Kong rose substantially. In the later part of 1979 there were indications that the Government would take steps to curb speculation in real estate business and, in November 1979, the Government decided to abandon instalment terms for the payment of premia on the sale of commercial and residential land. This had a negative effect on the property market. In December 1979 the Government announced that it proposed to extend rent controls over all residential premises and early in 1980 proceeded to do so. This also had a negative effect upon the property market.

9. A further negative factor which affected the property market at that time was that interest rates rose to record levels and in March to May 1980 the prime rate in Hong Kong was a record high of 16% per annum.
10. The effect of the foregoing negative factors was to cause the Hang Seng Index which had risen sharply in 1979 to fall from 963 in mid February to 739 in mid March with a rebound to 866 on 2k April 1980.
11. On 24 April 1980, the company commenced to sell off in the open market at prevailing market prices the shares. Having made a number of initial sales, the company then stopped selling the shares between the period of 20 May 1980 and 4 November 1980. It then continued to sell the shares and disposed of all of the shares (save for a residue having a market value of only \$3,834) by 16 June 1981. As a result of these sales, the company made a gain of \$172,236,336 in the year ended 31 December 1980 and \$197,612,870 in the year ended 31 December 1981. As at 31 December 1981, the company had effectively sold all of the shares.
12. Throughout the period up to 16 April 1980, the company only purchased shares in the public company and did not sell any of the shares. From and after 24 April 1980, the company only sold the shares and did not purchase any shares.
13. The shares were registered in the name of Mr X or in the name of the finance company as security for the loans which were made. The shares were not all registered in readily disposable board lots but were often registered in larger numbers which would require splitting if and when the company wished to sell the shares.
14. Apart from its investment in the shares, the company subscribed or acquired shareholdings in four private companies. We place on record that part of the shareholding in one of these private companies was sold but we do not consider that the acquisition by the company of any of these private company shareholdings and the disposal of part thereof are in any way material to the present case.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

15. At the hearing of the appeal, three witnesses were called by the company to give evidence. Each of the witnesses was cross-examined by Counsel for the Commissioner.
16. The first witness was Mr X who confirmed that he was the founder of the public company and the beneficial owner and person in sole control of the company. He stated that between his causing the public company to be quoted in 1972 and October 1977, his original substantial shareholding in the public company significantly decreased from over 70% down to less than 30%. He said that in October 1977 he took an optimistic view of the property market in Hong Kong following the stock market crash in 1973 and the depressed conditions which had prevailed from 1973 through to 1976. He was confident that the public company would be able to find many good business opportunities and he believed that the market capitalisation of the public company was undervalued. He spent some 80% of his time on the business of the public company. The dividend yield of the public company was good and better than many leading public companies in Hong Kong.
17. Mr X went on to say that, in October 1977, A Company (another public company group) held around 15% of the issued shares of the public company and Mr X was not happy with this situation. A Company had become involved in legal proceedings elsewhere and he feared that it would sell the 15% which it held and if it did so a potential purchaser might use this block of 15% to attempt to acquire control of the public company. From his evidence in chief and in the course of cross-examination, it was apparent that Mr X felt that, as he spent some 80% of his time on the business of the public company, he should have a much greater shareholding in the public company.
18. Mr X said that in October 1977 he decided that he would increase his shareholding in the public company to between 40% and 50%. He decided not to buy shares on the market in his own name because this might cause the share price to jump too high. He therefore decided to acquire the company, which was a shelf company incorporated by his lawyers, and to use this company to purchase the shares. Because he intended to acquire a substantial shareholding in the public company, he knew that it would take a considerable period of time and that he would have to acquire the shares very slowly to avoid making the price go very high. He instructed a senior member of his staff to purchase the shares and did not concern himself with the day to day transactions. He said that, when acquiring the shares, he did so as a long-term investment and had no intention of disposing of the shares in the short term. It was his intention to acquire the shares to increase the percentage which he held in the public company from less than 30% to nearly 50%. He said that he could not acquire more than 50% of the public company under the then stock exchange rules because it would have meant that he would have had to make a takeover bid for the entire company.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

19. He said that, towards the end of 1979 and into 1980, he became concerned because the stock market and property prices had risen so high. He was also very worried because of the policy of the Government with regard to cancelling instalment payment terms for premia and the Government introducing or extending rent control. Because of this, he decided that he would discontinue his policy of purchasing shares and that he would instead sell some of the shares which he had acquired. He decided that it was appropriate that the company should sell all of the shares which then comprised some 4.74% of the capital of the public company. He gave instructions to his employee to proceed to sell the shares. As when the shares were purchased, he did not wish it to be known that he personally was selling the shares and likewise could not dispose of the shares immediately. If he had attempted to sell the shares immediately it would have caused the price of the shares to collapse. It was necessary for the company to sell the shares gradually over a long period of time.
20. Mr X said that, having given instructions to sell the shares in April, he countermanded the instructions in May and told his employee to cease selling the shares for the time being until he instructed him again to start selling shares. The reason given by Mr X for this decision was that he was very busy at that time. He said that so many deals were then being done in the property market that he did not have time to attend to his own affairs and he was more busy than he had ever been before or since. Subsequently in about November 1980 he instructed his employee to again proceed with the sale of the shares. All of the shares (with the exception of the small number remaining worth \$3,834) were then sold during the period from November 1980 to June 1981.
21. We found Mr X to be a frank and truthful witness and accept all of the evidence given by him with one comparatively minor doubt. This is in relation to why he gave instructions in May 1980 to his employee to stop selling shares and gave instructions in about November 1980 to again commence selling. His reason was that he was extremely busy at that time. Whilst this was obviously true from the evidence given and was possibly the predominant reasons, it is significant that during that period the market price of the shares was steadily increasing in the market, a fact which must have been known to Mr X even if he did not closely follow the market price of the shares in his own public company. Mr X had stated and we fully accept that he made a decision in April for the company to sell the shares because of his concern regarding the high stock market and property prices. No doubt when he gave instructions to postpone further sales of shares he was knowledgeable that the stock market was increasing in price.
22. The second witness was a chartered accountant who gave formal evidence with regard to the content and meaning of the audited accounts of the company and accounting practices.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

23. The third witness was a stock broker who gave factual and expert evidence with regard to the stock market and the price of the shares of the public company during the relevant periods and at the relevant times.

Mr Gardiner appeared before us on behalf of the company and Mr Feenstra appeared before us on behalf of the Commissioner. As this case does not involve any new or complex issues of law, it is not necessary to set out their submissions.

This is a comparatively simple case and depends upon its facts and the evidence before us.

The question to be decided is whether or not the gains which the company made when it sold the shares were capital gains which are not assessable to tax or whether they were profits either arising from share trading or from a venture in the nature of trade.

### Did the Taxpayer trade in shares?

We dispose of the first part of this question very quickly and simply. The company was not engaging in share trading. As we have found in the facts, the other investments which the company had in private companies are not material to the present case. The company only acquired shares in one public company and no other. Whilst it may be possible to carry on share trading specialising in the shares of only one public company, it is axiomatic that to be a share trader or carry on the business of share trading one must trade, that is, have more than one transaction. It was submitted to us that in the present case the company had numerous purchases and numerous sales of shares. Whilst that may be strictly true on the facts, it ignores the fact that all of the purchases took place consecutively as did all of the sales and no sales took place during the period of the purchases and no purchases took place during the period of the sales. It appears to us that there was only one purchase followed by one sale, although both were conducted over protracted periods in order to avoid influencing the price of the shares to the same extent as would have occurred had all the shares been purchased and sold at once. Accordingly we find as a fact and on the evidence before us that the company was not a share trader.

### Was there an adventure in the nature of trade?

That takes us to the more important argument before us, namely, whether or not the acquisition and subsequent sale of the shares was a venture in the nature of trade.

It is well established law that, to decide whether or not a transaction or series of transactions are an adventure in the nature of trade, it is necessary to look at the intention of the taxpayer at the time when the asset or assets were acquired. Having answered this first question, it is then necessary to consider whether or not there was a change of intention at any subsequent time which would have converted the transaction from a trading transaction into a non-trading transaction or vice versa.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

To ascertain the intent of a person at the time of acquisition, it is necessary to consider two tests. The tests are used to ascertain the true intention and are mutually supportive and not exclusive of each other. The first test is to look at the subjective intention of the taxpayer and try to ascertain what was the intention. The second test is then to look at all of the facts objectively and see whether on the objective construction of the facts the answer is the same. Clearly the answer should always be the same and, as we have said, one test should support the other, but the reason for having two tests is obvious. It is difficult and sometimes impossible to establish the intention from a subjective test. Clearly self-serving statements by a taxpayer on their own are of limited value, but nevertheless they are important and often a vital part of the evidence. For example, if a taxpayer declines to give evidence but asks the Board to infer from the facts that something was or was not his intention at the time, the Board is often obliged to come to the opposite conclusion because the taxpayer has failed to come forward to state his subjective intention. Clearly the best evidence of what a person intends is to hear the evidence of that person, especially where the individual is subjected to cross-examination, even though it may be necessary to test the truth of what is said by looking at the facts objectively.

If the objective facts support the subjective intention, then the matter is clear. Problems will only arise where the subjective and objective tests result in different answers. However, we stress that it is the true intention which matters and not a hypothetical objectively-ascertained intention which in fact is different from the true intention. The test is real, not artificial, and if there are two different answers the true intention is not replaced by an untrue artificial intention albeit in accordance with the facts when viewed objectively. In the present case we have no difficulties.

The intention of the company was the intention of the person who controlled it, namely, Mr X. We fully accept the evidence given which was that in October 1977 Mr X decided for a variety of reasons that he would acquire a substantial additional shareholding in the public company. We accept his statements that it was not then his intention to sell the shares or trade in the shares, that his intention was to acquire the shares and hold them for a long time so that he would receive greater benefits from his almost full-time work for the public company, and that he would strengthen his position against a possible take-over of the public company by a third party. Accordingly, on the subjective test, there was no intention to trade. This was a long-term investment and not a venture in the nature of trade.

Subsequently Mr X decided to sell the shares because he considered the price to be very high and he was worried that market conditions were unfavourable. This decision to sell did not change a long-term investment into a trading transaction. It was no more than a decision to realise a capital asset at the best market price which could be obtained.

This then brings us to the objective test. On the facts and evidence before us, there is little which is inconsistent with the subjective intention of the company as expressed by Mr X and as contained in the agreed facts. We have given much thought to the fact that the last purchase of shares was a few days before the first shares were sold. If this fact was in

## INLAND REVENUE BOARD OF REVIEW DECISIONS

abstract then we would agree that it suggested a trading intention. However, the fact is not in abstract and must be taken in context with all of the other facts. There were numerous earlier opportunities when the company could have sold shares at a profit. It never did so. Whilst one might have expected to see a period of time between the decision not to acquire any more shares and the decision to dispose of the shares, one must also bear in mind that Mr X did not, as was suggested by counsel for the Commissioner in the course of the hearing of the appeal, decide each day or each week whether or not to buy or sell shares. He took one decision at the beginning of the acquisition period and perpetuated that decision until the end of the acquisition period. We do not see his continuing his decision to acquire shares as being separate assessments of the market and separate decisions as to whether to buy or sell. He made his decision to acquire shares and continued with this intention.

We have taken note of the fact that, soon after Mr X had made his decision to start selling the shares, he suspended the disposal for some months. During that period of some months the stock market price of the shares rose substantially. However we have also noted that Mr X did not change his sell decision into a buy decision but simply not to sell any more of the shares for the time being. Mr X explained this in his evidence by saying that he was too busy to attend to his own affairs and decided to suspend the sales until he had more time. This is not an unreasonable explanation. However, even if he had decided to suspend sales because he thought the price would go up in the near term, this would not make the acquisition of the shares by the company into a venture in the nature of trade because it did not change the intention at the time when the shares were being acquired. It would only mean that, having decided to dispose of a capital asset, it was later decided that a postponement of the sale was beneficial. As we have accepted the evidence of Mr X as being truthful, and as this point was not argued before us, we find as a fact that Mr X postponed further sales because of his other business commitments and that the rising price played a minor if any part in his decision.

Much time during the hearing of the case was spent with regard to the facts of other companies owned by Mr X. As we have stated above we do not consider these to be material in the present case. There was no suggestion that Mr X was using a series of companies to further an overall share trading objective or venture in the nature of trade. Only one of the other companies is in any way material to the present appeal. On the evidence given before us, it appeared that it was not possible for Mr X continually to buy shares in the market without causing the price of the shares to rise substantially. As a market strategy in acquiring a substantial shareholding in a public company, it is apparently necessary to create a number of sales in the market. This was confirmed by the stock market expert witness. Mr X used another company owned by him for this purpose and that other company has apparently been taxed on the profits which it made from buying and selling shares in the public company as well as other public company shares. This was a technique, which appears from the evidence to be market practice when acquiring or disposing of large quantities of shares, to avoid unduly affecting the market value of the shares and so to enable the best possible price to be obtained. So far as taxation is concerned in this case, such procedures can have no ulterior meaning. The position might be different were it the case that the two companies contrived to manipulate market prices so as to enable net profits to

## INLAND REVENUE BOARD OF REVIEW DECISIONS

be made, in which case such activities might amount to trading or an adventure in the nature of trading. However, no such allegation was made by the Revenue and therefore we assume that there was no such ulterior motive.

On the facts and evidence before us we find that the company was neither carrying on business as a share trader nor carrying on an adventure in the nature of trade. Accordingly the appeal is successful and the assessments appealed against are annulled.