

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D 20/78

*Board of Review:*

S. V. Gittins, *Chairman*, Chau Kai-yin, Roland K. C. Chow, & David B. K. Lam, *Members*.

**8 February 1979.**

Inland Revenue Ordinance – profits tax assessment – sale of property owned by appellant – whether capital assets or not – whether profits arising from sale were trading profits – distinction between operations of Insurance Company and a bank – onus of proof of appellant.

The appellant was a bank which was a public company with limited liability incorporated under the Companies Ordinance. The appellant had sold four properties (A, B, C and D) and was assessed to profits tax on the profits of sale. The appellant appealed to the Board of Review from the determination of the Commissioner of Inland Revenue on its objection against the Profits Tax Assessment on the ground:-

“That the profits on the sale of 4 properties were wrongly treated as trading profits when the properties were capital assets.”

The Board found that the banks holdings in the properties were recorded in different categories of ledger account. Property D was shown in the “Bank Premises Account”. Two properties A and B were shown in the “Investment – Property Investment” account and property C was shown in the “Foreclosed – Property Investment Account”.

The Revenue contended that there is no distinction for tax purposes between an insurance company and a bank so far as their operations are concerned and following *C.I.R. v. Sincere Insurance and Investment Co. Ltd.*<sup>(1)</sup> the Board should find that the realization of properties was a normal transaction in the Banking business and that profits from such realization should be subject to Profits Tax. The Board rejected this contention and found that:-

- (a) Property A was purchased as an investment and was therefore a capital asset.
- (b) Property B although acquired for the purpose of the appellants business and used as such was not acquired as a current asset but as a fixed or capital asset.
- (c) Properties C and D were also acquired for the purpose of the appellants business and used as such and on the balance of probability were not acquired for resale at profit and were not trading stock and were therefore capital assets.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

In reaching these findings the Board rejected the Revenue's contention that the Board must be "absolutely satisfied that the appellant has conclusively discharged" the onus of proving that the assessments appealed against are excessive. The Board held that the onus of proof is discharged on a balance of probability.

**Decision:** The appeal in respect of the four properties was allowed and the case remitted to the Commissioner for a revision of assessments.

Peter Rees Q.C. and Mrs Verina Bokhary for the appellants.

Osman Ghafur for the Commissioner of Inland Revenue.

### **Cases referred to:-**

1. Commissioner of Inland Revenue v. Sincere Insurance & Investment Co. Ltd., H.K.T.C. 602.
2. Colonial Mutual Life Assurance Society Ltd. v. Federal Commissioner of Taxes, 8 A.T.D. 137.
3. Punjab Co-operative Bank Ltd. v. Commissioner of Income Tax, (1940) A.C. 1055.
4. Union Bank of Australia v. Commissioner of Taxes, 1 Ratcliffe & McGrath 408.
5. California Copper Syndicate v. Harris, 5 T.C. 159.
6. Harvey v. Caulcott 33 T.C. 159.
7. Frasers (Glasgow) Bank, Ltd. v. Commissioner of Inland Revenue, 40 T.C. 698 HL.
8. London Australia Investment Co. Ltd. v. Federal Commissioner of Taxes, 77 A.T.C. 398.

### *Reasons:*

1. The Bank was incorporated in Hong Kong under the Companies Ordinance as a private company. By a special resolution passed in 1960, the Bank became a public company as from that date.
2. The Bank has been carrying on the business of banking in Hong Kong since the date of its incorporation.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

3. The Bank has appealed to the Board of Review from the Determination of the Commissioner of Inland Revenue on its objection against Profits Tax Assessments for the 5 years of Assessment 1970/71 to 1974/75 inclusive.

4. The Grounds of Appeal are:-

(a) That the profits on the sale of 4 properties were wrongly treated as trading profits when the properties were capital assets; and

(b) In apportioning the interest paid by the Bank in the relevant basis periods between interest notionally incurred in the production of profits arising in or derived from the Colony and that incurred in the production of profits arising or derived from outside the Colony the Commissioner has adopted a basis that is neither reasonable nor appropriate in the circumstances of the Bank's case.

5. Ground (b) was abandoned at the outset of the hearing before the Board, consequently the appeal on that ground is dismissed.

6. As to Ground (a), the properties concerned are as follows:-

	<i>Acquisition</i>		<i>Construction</i>		<i>Disposal</i>	
	<i>Date</i>	<i>Price</i> HK\$	<i>Cost</i> HK\$	<i>Date</i>	<i>Proceeds</i> HK\$	
Property A	31.1.56	870,638.40	-	3.6.69	1,452,000.00	
Property B	10.6.63	725,000.00	3,202,694.69	1.6.71	4,675,000.00	
Property C	26.10.66	275,000.00	-	1970-1971	358,300.00	
Property D	1959	26,400.00	-	306.70	44,000.00	

7. The Deputy General Manager of the Bank gave evidence. From his evidence we find out the following facts:-

(a) From its incorporation in 1952 until 1965 a substantial portion of the shares of the Bank was held by a B company. This Company also wholly owned a C company which was engaged in general trading and warehousing.

(b) In January 1956 the Bank was offered a 40% interest in Property A by a D company. This property had been fully developed as a high class apartment building and was situated in a high class residential district. It was fully let. The Bank accepted the offer as it was considered a good investment. On the monthly rental of \$13,000 in November 1968 this represented a return of 18.8% on the purchase price. The rent for the earlier years of ownership was not disclosed and we expect the return then was lower.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

- (c) In 1956 the Bank had few banking opportunities owing to its limited clientele at that time.
- (d) The management of the property was entrusted to a Land Investment & Agency Ltd.
- (e) In 1965 the banking crisis occurred and this was followed by the civil disturbances of 1967. The property market was depressed and many mortgagors to the Bank defaulted on their mortgage payments. The Bank foreclosed on many of the mortgages rather than exercise its power of sale which would have resulted in immediate losses.
- (f) By 1969 the aggregate value of foreclosed properties together with the value of Bank's property investments exceeded the limit prescribed in section 28 of the Banking Ordinance, *Cap.* 155. This value would be below the said limit if the foreclosed properties were not included.
- (g) In 1969 the Board of Directors decided to trim down its interests in property and guide lines to this effect was handed down by the Board to Management for implementation.
- (h) On 3 June 1969 the Bank's 40% interest in Property A was sold to the D company (from whom it was bought in 1956) in implementation of the Board's decision.

### *Property B*

- (i) The Bank required reliable godown facilities for goods hypothecated to it under documentary credits. In 1963 the 2 godowns it already owned at Kennedy Town was proving insufficient. On 10 June 1963 it acquired by public auction from the Crown an undeveloped site being Property B. The conditions of sale required the site to be developed into a godown. The Bank erected a 9 storey building on the site, kept one storey for the storage of its own documents and leased the other storeys to the C company to conduct a warehouse business thereon.

In 1971 the Bank sold the whole building to the C company and leased back one floor for the storage of its own documents. This sale was also in implementation of the policy to trim down the Bank's property interests.

### *Property C*

- (j) In 1966 the Bank acquired the 9th and 10th floors of this building for the purpose of providing a hostel on the 10th floor for bachelor junior members of the staff and to rent out units on the 9th floor to married staff. The 9th floor had 13 units, but only 9 were taken up by Bank staff so that the remaining 4 were let to non-employees.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

With this lack of interest from bank staff and also to trim down the Bank's property interest, the 9th floor was sold. Most of the units were sold to bank staff.

The 10th floor was sold later.

### *Property D*

- (k) This floor was acquired for use as a staff quarter, but with the completion of the Bank's branch building in 1966 which could house all staff its requirement was ended. It was let to a C company staff member and then sold to the sitting tenant in 1970.

The flat became superfluous to the Bank's requirements and its sale fitted in with the policy to trim down the Bank's interests in property.

- (l) Foreclosed properties were required by the Banking Ordinance to be sold within 18 months unless permission was obtained to defer sale. In 1969 such permits were obtained and also permits for further extensions of time every 6 months.
- (m) Although the Bank's total investments in properties excluding the value of foreclosed properties during 1969-1971 were well within the limits prescribed by section 28 of the Banking Ordinance, so that the Bank was not compelled to sell any, we find that the decisions to sell the 4 properties under consideration, while deferring the sale of foreclosed properties, were commercially sound and were in the overall implementation of the policy laid down by the Board.

### *Depositors Funds*

- (n) We find from the analyses (produced as Exhibits C2 and C3) of the published accounts of the Bank for the years 1966 to 1974 (Exhibit D) that –
  - (i) The liquidity ratio for those years was always greater than 45%.
  - (ii) The loan ratio was within 5% of 50%.
  - (iii) Depositors funds were adequately covered by current assets which did not include the properties in dispute. On the other hand, depositors funds could be regarded as being adequately covered by fixed assets. Further, shareholders funds could be regarded as being represented by current assets or fixed assets.
- (o) From the published accounts and their analyses it was not possible to identify the funds used to acquire the 4 properties under consideration, or indeed any properties, although the Deputy General Manager in his evidence maintained that the properties were acquired with shareholders funds and not depositors funds.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

However, from the evidence of a sub-manager of the Bank responsible for internal accounting and the ledger sheets he produced (Exhibit F) we find that the Bank's holdings in property were recorded in the following categories of ledger account:

- (i) "Bank Premises" in respect of buildings wholly used for banking purposes (Exhibit F1 – in respect of Property D).
- (ii) "INVESTMENT—Property Investment" which included the Bank's building in Tsuen Wan, the ground floor being for the Bank's office and the upper floors let out (Exhibit F2).

The ledger sheets for Property B (Exhibit 4 to 9) and Property A (Exhibit F10) were so entitled.

- (iii) "FORECLOSED – Property Investment" (Exhibit F11) which dealt with properties acquired on foreclosure, the opening entry of which is a transfer from "mortgage Loan Foreclosure account".

The Ledger account of Property C is contained in 2 sheets forming part of Exhibit G and it is also entitled "Investment – Property Investment".

8. The issue before the Board is whether the 4 properties were trading assets so that the profits on their sale were assessable to profits tax or whether they were capital assets.

9. The case for the Revenue as presented to us hinged on the proposition that there is no distinction for tax purposes between an insurance company and a bank so far as their operations are concerned, and the application of the Hong Kong case of **Commissioner of Inland Revenue v. Sincere Insurance & Investment Co. Ltd.**<sup>1</sup> which held that the realization of properties of the taxpayer insurance company was a normal step in carrying on its insurance business and that on the facts of the case the profits on realization were trading profits and assessable for Profits Tax.

10. For the proposition that there is no distinction between an insurance company and a bank so far as their operations are concerned the following authorities were cited to us: -

- (a) A passage from the judgment of Starke, J. in **Colonial Mutual Life Assurance Society Ltd. v. Federal Commissioner of Taxes**<sup>2</sup> at 145:

"In Konstam, 'The Law of Income Tax,' 8th Edn, p. 126, it is stated that 'The buying and selling of investments is a necessity of insurance business; and where an insurance company in the course of its trade realises an investment at a larger price than was paid for it, the difference is to be reckoned among its profits; conversely any loss is to be deducted.' This view is in line with that of the Privy

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<sup>1</sup> H.K.T.C. 602.

<sup>2</sup> 8 A.T.D. 137.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

Council in the case of a bank in *Punjab Co-operative Bank Ltd. v. Income Tax Commissioner*. In our opinion there is no substantial distinction between the business of an insurance company and that of a bank in this respect.’

- (b) A passage from the judgment of the Privy Council delivered by Lord Maugham in ***Punjab Co-operative Bank Ltd. v. Commissioner of Income-Tax***<sup>3</sup> at 1072:

“In the ordinary case of a bank, the business consists in its essence of dealing with money and credit. Numerous depositors place their money with the bank, often receiving a small rate of interest on it. A number of borrowers receive loans of a large part of these deposited funds, at somewhat higher rates of interest.”

- (c) A passage from the judgment of Sim, **J.** in ***Union Bank of Australia v. Commissioner of Taxes***<sup>4</sup> at 409:

“It was contended ... that the loss here was one of capital and not one incurred in carrying on the business of banking. But this argument is based, we think, on too narrow a view of what constitutes the business of banking. In order to carry on such a business properly it is necessary to have a large reserve fund. This fund is created out of profits and is invested so as to be available immediately for meeting demands on the bank as they may arise. It is not treated as part of the capital of the bank, and the investments cannot be regarded as investments of capital. They are a use of profits for the purposes of the business of banking when conducted in the recognized and proper manner. The realization from time to time of these investments appears to be part of the ordinary business of a banker, just as much as the realization of a security given by a customer in connection with an advance.’

11. It is only in an insurance case, 10(a) above, that there is a statement of the similarity between operations of bank and insurance companies and the words used are “there is no substantial distinction”. In the ***Punjab Bank*** case, 10(b) above, the securities which were sold were “mainly held in Indian Government securities which, being readily saleable, could, if necessary, be promptly realized in order to pay claims” (at p. 1070). In other words they were acquired as trading assets with depositors’ funds to meet depositors’ claims. This was the same position in the ***Union Bank*** case, 10(c) above, where the fund “is invested so as to be available immediately for meeting demands on the bank as they may arise”.

12. We respectfully adopt the following passage in the ***Punjab Bank*** case at 1070:

“Their Lordships note that the High Court ... examined and considered a number of cases, most of which related to insurance companies and banks. Their Lordships do not propose to attempt to reconcile all these decisions and the various dicta which are to be found in the reports of them, which might indeed prove to be an impossible task; and they will add that the cases relating to insurance companies largely turn on the

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<sup>3</sup> (1940) A.C. 1055.

<sup>4</sup> 1 Ratchiffe & McGrath 408.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

nature of the insurance business actually carried on and the way in which reserve funds have been set aside and dealt with.”

On the authority of this passage and of those passages set out in subparagraphs (d) and (e) in paragraph 14 below, we reject the Revenue’s contention that there is no distinction between the operations of insurance companies and banks for tax purposes.

13. This sufficiently distinguishes the **Bank’s case**<sup>3</sup> from **Commissioner of Inland Revenue v. Sincere Insurance & Investment Co. Ltd.**<sup>1</sup> But even in that case the learned judge in arriving at his decision balanced the factors advanced on behalf of the taxpayer in favour of non-trading against the taxpayer’s admission that it had turned over between 10 to 15 properties and that the turnover of investments which included landed properties is part of the normal function of an insurance company.

14. The Bank’s representative referred us *inter alia* to the following authorities: -

(a) **California Copper Syndicate v. Harris**<sup>5</sup>, at 166 where Lord Justice Clerk stated:

“But it is equally well established that enhanced values obtained from realization or conversion of securities may be so assessable where what is done is not merely a realization or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business. The simplest case is that of a person or association of persons buying and selling lands or securities speculatively, in order to make gain, dealing in such investments as a business, and thereby seeking to make profits. There are many companies which in their very inception are formed for such a purpose, and in these cases it is not doubtful that, where they make a gain by a realization, the gain they make is liable to be assessed for Income Tax.

What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being – Is the sum of gain that has been made a mere enhancement of value by realizing a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?”

(b) **Harvey v. Caulcott**<sup>6</sup>, where there was a presumption that the houses built by a builder were trading stock, the presumption was rebutted by evidence that three of his houses were retained as investments and the profits on their sale were not assessable to Income Tax.

(c) The **Punjab Bank** case 1070 at paragraph 12 above and at 1072, where the passage set out in subparagraph (a) above was cited with approval.

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<sup>1</sup> H.K.T.C. 602.

<sup>3</sup> (1940) A.C. 1055.

<sup>5</sup> 5 T.C. 159.

<sup>6</sup> 33 T.C. 159.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

- (d) **Frasers (Glasgow) Bank, Ltd. v. Commissioner of Inland Revenue**<sup>7</sup>, at 711, where Lord Reid held that the taxpayer used its trading facilities with its bankers to finance its purchases of stock of a company in the same group to maintain the market price of the stock and that the sale of the stock was made in order to put its trading bank account in better shape. Lord Reid concluded as follows –

“The question whether particular operations were acts done in carrying on the taxpayer’s trade is not one that can be answered by applying any definite rule or criterion. The answer must depend on a consideration and evaluation of all the relevant facts. Here it appears to me that all the facts point in the same direction. When the stock was bought the Company had no funds to invest. The object of the purchase was to support its chief customer in its trade. And the stock was sold because of the requirements of its trade.”

- (e) A passage from the judgment of Jacobs, J. in **London Australia Investment Co. Ltd. v. Federal Commissioner of Taxes**<sup>8</sup> in the High Court (Full Court) of Australia at 4,410:

“The cases referred to are some of what may be described as the ‘banking’ and ‘insurance’ cases, upon which naturally the Commissioner relies quite strongly on this appeal. But there is a significant difference between a banking or insurance business which involves investment activity and the course of investment activity in the instance case. The nature of a banking or insurance business, as part of its putting of money as circulating capital to use, involves not only occasional acquisition of property in satisfaction of advances, as in the situation to which Kitto J. was referring, but also and more commonly the purchase and sale of various kinds of property whereby moneys which are obtained as part of the business but which form no part of the original capital structure of the bank or insurance company, or of that structure enhanced by accumulated net profits, are put to use short term or long term. All profits arising from that activity are profits of the business of banking or insurance. At any time and from time to time the property acquired may need to be sold, in whole or in part, to meet the requirements of the banking or insurance business and the hope and expectation is that in the meantime not only will the property have earned income but that it will have risen in value. The scale of activity coupled with the source of the funds leads to the inference that a purpose or intention of the acquisition is eventual resale at a profit. But in so far as the original capital or that capital enhanced by accumulated profits is losses on a sale thereof will not be profits of the business of banking or insurance. The banking and insurance cases thus do not provide an answer to the question which arises in the instance case. The source of moneys for the activities of the appellant company is not money of a kind which can be described as circulating capital. It is

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<sup>7</sup> 40 T.C. 698.

<sup>8</sup> 77 A.T.C. 398.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

essentially investment and reinvestment of moneys which were originally part of, or which were added out of capital profits to, the capital structure of the appellant.”

15. We accept the authorities cited by the Bank’s representative, and applying the enunciated principles to the facts, we find with respect to the properties under consideration:-

- (a) That Property A was purchased as an investment and therefore a capital asset.
- (b) That Property B, although acquired for the purpose of the Bank’s business and used as such, was not acquired as a current asset but as a fixed or capital asset.
- (c) That Properties C and D were also acquired for the purpose of the Bank’s business and used as such. On the balance of probability we find that they were not acquired for resale at profit and not trading stock and were therefore capital assets.

16. We would add that we do not accept the Revenue’s contention that the Board has to be “absolutely satisfied that the appellant has conclusively discharged” the onus of proving that the assessments appealed against are excessive. We hold that the onus of proof is discharged on a balance of probability.

17. The appeal in respect of the 4 properties is allowed.

18. The appeal in respect of the disallowance of interest paid by the Bank, paragraph 4(b) above, is dismissed.

19. The case is remitted to the Commissioner for the assessments to be revised in accordance with the opinion of the Board expressed herein.