HCIA 1/2016

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE
INLAND REVENUE APPEAL NO 1 OF 2016

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BETWEEN

COMMISSIONER OF INLAND REVENUE Appellant

and

PERFEKTA ENTERPRISES LIMITED Respondent

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Before: Hon Chung J in Court
Date of Hearing: 18 January 2017
Date of Judgment: 27 April 2017

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J U D G M E N T

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Introduction

1. This is the appeal by way of case stated of the Commissioner of Inland Revenue ("*the Commissioner*") from the decision of the Board of Review ("*the Board*") dated 20 October 2015 ("*the Oct 2015 decision*"). The Board (by majority decision) allowed the appeal of Perfekta Enterprises Ltd ("*the taxpayer*") brought earlier against the Commissioner's determination dated 19 May 2011 ("*the May 2011 determination*").

2. By the May 2011 determination, the Commissioner increased the additional profits tax assessment for 1994/5. The Board remitted the May 2011 determination to the Commissioner effectively to be reduced or annuled.

3. The (former) case stated appeal procedure was provided for by the proviso to s 69, Inland Revenue Ordinance (Cap 112):

> "… either the [taxpayer] or the Commissioner may make an application requiring the Board to state a case on a question of law for the opinion of the Court of First Instance".

4. Different questions of law, respectively submitted by the parties, have been posed by the Board in the case stated. In gist, those submitted by the Commissioner are:

(a) was there sufficient evidence for the Board's conclusions reached in para 154, 166 and 168, Board's decision (set out in more details in para 20 below);

(b) bearing in mind the burden of proof rested with the taxpayer, did the Board err to reach the conclusions mentioned in sub-para (a) above, when they have not been so put forth by the taxpayer, and were unknown to the Commissioner beforehand;

(c) on the true construction of Cap 112, and the Board's finding that there was a change of intention on the taxpayer's part, did the Board err to hold the initial payment (defined in para 12 below) was not chargeable to profits tax (rather than as that found by the Board's minority).

5. The questions submitted by the taxpayer are (in summary):

(1) did the Board err to find that there has been a change of intention on the taxpayer's part (and whether there was evidence in support thereof), especially when the transaction was to be implemented by one of the taxpayer's subsidiary companies;

(2) did the Board err to take into account the said subsidiary company's activities and intention when ascertaining the taxpayer's intention;

(3) did the Board err in its conclusion at para 173, the Oct 2015 decision;

(4) did the Board err to refuse the taxpayer's application to add an additional ground of appeal.

Background

6. The background is substantially undisputed.

7. The taxpayer has a long history going back to the 1960s. Its scope of business was toy manufacturing. The property concerned was a land lot in Kwun Tong,

which was partly acquired in May 1969 (and partly in 1977) ("*the subject land*"). It was used as the taxpayer's manufacturing base in Hong Kong. The taxpayer's manufacturing operation in Tsuen Wan ceased, and that piece of land was disposed of in 1987.

8. From about July 1991 to about February 1993, the taxpayer made various attempts to modify the subject land's lease conditions for redeveloping it into a composite industrial/office complex.

9. By early 1994, government indicated that $61.42 million land premium would be payable for the proposed modification.

10. In April 1994, the taxpayer's board of directors resolved to redevelop the subject land with a major land developer. A redevelopment agreement was entered into by the taxpayer and the land developer (and Great Poka Ltd ("*Great Poka*"), a subsidiary of the land developer) on 30 July 1994 ("*the subject agreement*").

11. Prior to the subject agreement, a valuation was undertaken at the taxpayer's instruction. The development potential of the subject land was valued at $418 million (exclusive of land premium) in April 1994.

12. Initial payment (payable pursuant to the subject agreement) was made to the taxpayer by Great Poka; it amounted to some $165 million.

13. Manufacturing operation at the subject land ceased in December 1994; vacant possession of the subject land was delivered to Great Poka at that time.

14. In November 1994, the taxpayer conveyed the subject land to a subsidiary, one Prodes Co Ltd ("*Prodes*") (the consideration was expressed to be some $314 million). As will be made clear in para 24 and 26 below, the taxpayer did so in accordance with the terms of the subject agreement.

15. It would appear construction on the subject land was completed in about 1997 (or 1998; see para 16 below) because the taxpayer informed Great Poka in August 1997:

(a) the taxpayer wished to reserve certain parts of the new building for its own use;

(b) the taxpayer wished to name the new building.

16. Marketing of the sale of the new development began in December 1998.

17. In August 2007, the taxpayer received about $386,000 (being half of the balance in the stakeholders' account kept in accordance with the subject agreement).

18. By the May 2011 determination, the Commissioner assessed additional profits tax against the taxpayer in March 2001 in relation to the initial payment (less expenses and adjustments). The additional tax payable came to about $26.8 million.

The Oct 2015 Decision

19. As stated above, the majority of the Board ("*the majority*") decided effectively in the taxpayer's favour by remitting the May 2011 determination back for reconsideration.

20. While concluding that the taxpayer has changed its intention on 30 July 1994 from capital holding to trading, the majority also observed in the Oct 2015 decision:

> "Where a joint venture agreement provides for profit to be shared equally, the assumption must be that the *perceived* value of the parties' contributions should/would also be equally. Contribution, of course, may take different forms" (para 154 thereof);
>
> "… a permanent investment may be sold in order to acquire another investment. What the [taxpayer] has done here was to sell [the subject land] for HK$418 million [para 11 above], and then use part of it (HK$252,895,500, representing the balance after payment of the Initial Payment) to invest in a joint venture. This joint venture was to be carried out by a subsidiary company, [Prodes]" (para 166 thereof);
>
> "The change of intention that took place on 30 July 1994 was therefore not simply that the [taxpayer] would thereupon embark on an adventure in the nature of trade. The intention of the [taxpayer] was to dispose of its capital asset, 'take home' part of its value (about 40%) in the form of cash (by way of Initial Payment), while reinvesting the balance (approximately 60%) in a joint venture with [the land developer] with a view to earn more profit. The evidence of [the taxpayer's Mr Yeung, a witness described as having 'a lead role in the negotiations'] should be understood in this context" (para 168 thereof).
>
> (Relevant parts of Mr Yeung's testimony are quoted in para 55 below)

21. Based on the above observations, the majority concluded in effect that the taxpayer's change of intention to trade concerned only half of the total capital injected into the redevelopment project ("*the 're-investment' finding*").

22. Thus, the majority said:

> "… I find that the [taxpayer] had not injected the entire value of [the subject land] (HK$418 million) into the joint venture project at its start-up … " (para 171 thereof);

> "The Initial Payment therefore was not … in the nature of a trading or revenue receipt. It was a balancing payment made to equalize the parties' contribution *before* trading commenced. … " (para 172 thereof).
>
> The same conclusion was repeated in different language:
>
> "… I agree … that the substance of the transaction in the present appeal as set out in [the subject agreement] was the sale of [the subject land] by the [taxpayer] followed by the subsequent reinvestment of a part of the realized value in a joint venture … The Initial Payment was in effect the surplus of the value of the [subject land] which itself was a capital asset in addition to what was required to invest in the joint venture" (para 192 thereof).

The Subject Agreement

23. The background leading to, and surrounding, the subject agreement has been outlined above.

24. The subject agreement recited (among other things):

> "WHEREAS :
>
> [The taxpayer] has resolved to grant permission to the Developer to redevelop the [subject land] by constructing thereon the Development … in accordance with the Conditions …, and ***to sell and assign*** undivided shares of and in the [subject land] and the Development ***to purchasers of the Units*** … ***upon completion*** of the Development" (recital (3) thereof);
>
> "To ***enable the redevelopment*** of the [subject land] to take place, the Government has agreed in principle with [the taxpayer] for the surrender … of the [subject land] … " (recital (4) thereof);
> "The Developer has agreed in principle to be responsible for the redevelopment and construction ***referred to in Recital (3) hereof*** … " (recital (5) thereof).
>
> (emphasis supplied)
>
> Recital (6) then stated that the taxpayer would in turn transfer the subject land to Prodes.

25. Clause 3.02 provided for the payment of the initial payment:

> "… as consideration for [the taxpayer] granting to the Developer the right to redevelop the [subject land] … ".

26. In effect, clause 5.02 obligated:

(1) the taxpayer to procure Prodes to enter into an agreement with regarding the subject land;

(2) the land developer to enter into an agreement with Prodes regarding the subject land.

27. Clause 8.01 provided that:

(a) the subject agreement was in the nature of a joint venture and sale and purchase of interest in property;

(b) the subject agreement should not be deemed to constitute a partnership.

28. Without going into the details, the other terms of the subject agreement were consistent with (and can be seen as giving effect to) the underlying transaction (the redevelopment) summarized under "Background" above.

The Commissioner's Case

29. The Commissioner's first main complaint is that the majority's conclusions quoted above (especially the "re-investment" finding) lack evidential basis (questions (a) and (c) above (para 4(a) and (c) above)). Evidence adduced before the Board was by way of documents and testimony. Neither of these supported the majority's said conclusions.

30. The Commissioner's second main complaint is essentially that:

(1) the taxpayer's case before the Board was that the sale and purchase of the subject land was the sale and purchase of a capital asset; hence, any income so derived was capital in nature and not assessable as trading profits. It was part of that case that there was never any change of intention when the taxpayer disposed of the subject land;

(2) despite the above, and without alerting the Commissioner sufficiently and/or timeously, the majority concluded in the way quoted above (that is, the "re-investment" finding). The Commissioner was thereby prejudiced by being deprived of a proper chance to deal with the issue by evidence and submissions.

31. Second main complaint (1) (para 30(1)) above also covers questions (a) and (c) and questions (1) to (3) above (that is, para 4(a) and (c) and 5(1) to (3) above).

32. Second main complaint (2) (para 30(2)) above covers question (b) above (that is, para 4(b) above).

The Taxpayer's Case

33. The taxpayer's primary argument is that the Board's ultimate conclusion (that is, there has not been trading intention concerning the initial payment, and hence no assessable profits) can be supported, even if the Board's reasons for doing so are ignored.

34. First, the subject land was accepted to have been acquired as a capital asset. It is therefore for the Commissioner to establish there has been a change of intention on disposing of that property. There was no identifiable fact which could support a finding of the taxpayer's change of intention to trade.

35. Secondly, there was proper evidential basis for the Board to draw the inference in support of the Board's ultimate conclusion, such as the finding that it was Prodes which carried out the redevelopment (which was the adventure in the nature of trade).

36. As regards the Commissioner's complaint that he has not been given a proper opportunity to deal with the Board's "re-investment" finding, the majority in fact did raise the issue with the Commissioner during his final submissions. In any event, the "re-investment" finding was based on evidence properly adduced already, and not fresh evidence unknown or unavailable to the Commissioner.

37. The taxpayer's alternative ground for supporting the Oct 2015 decision is that the subject agreement was merely a sale by the taxpayer of the right to redevelop the subject land; the actual redevelopment itself was carried out by Prodes.

38. Finally, the taxpayer also argues that the Board ought not have refused to consider the ground put forth at the Board hearing to the effect no assessable profits have been made from the redevelopment, after the sums received (the initial payment (para 12 above) and the shared stakeholder balance (para 17 above)) have been set off against the capital injected by way of the subject land.

This Appeal

39. In view of the summary given above, it is apparent the principal issue in this appeal is whether there has been a change of the taxpayer's intention when the subject land was disposed of by way of the subject agreement (the Commissioner having accepted that the subject land was a capital asset when it was acquired (para 2, Commissioner's closing submissions before the Board)).

40. The Commissioner contended before the Board the change of intention occurred:

(a) when the taxpayer resolved on 21 April 1994 to redevelop the subject land;

(b) at the time of the subject agreement (30 July 1994).

According to the Commissioner, evidence in support of such a change can be found in:

(1) the board of directors meeting minutes ("*the said board minutes*");

(2) the testimony of Mr Yeung;

(3) the subject agreement.

41. The taxpayer disagreed with the Commissioner with regard to para 40(1) above. As for para 40(3) above, the taxpayer contended that the initial payment was consideration for transferring the right to develop the subject land (rather than the subject land for redevelopment) (see also para 37 above).

42. As will be elaborated below, the Commissioner's contentions are correct whereas the that of the taxpayer is untenable.

43. It does not appear to be (and in fact cannot be) disputed that whether the said board minutes, or the subject agreement, is evidence which can support a conclusion that there has been a change of intention is a matter of the interpretation of the language used in those documents.

44. The relevant parts of the said board minutes said:

> "… as the manufacturing business of [the taxpayer] was seen to be a 'sunset industry' in Hong Kong … the ***redevelopment*** of the [subject land] and ***subsequent sale*** would be an ***appropriate method*** for [the taxpayer] to realise its long term asset.";
>
> "It was agreed that any ***joint development program*** would have to provide for [the taxpayer] to have an ***entitlement to take up sufficient space*** for its own manufacturing requirements in the future.";

> "It was decided that ***for internal purposes*** any such joint development should be carried out in an entity separate from [the taxpayer] … ".
>
> (emphasis supplied)

45. First, in the first quoted passage above, the "sale" was expressly said to be "subsequent" (to the redevelopment). In the context of the said board minutes, the word must have referred to the sale of the redeveloped property (rather than the subject land *simpliciter*). That interpretation is reinforced by the second quoted passage (which concerns the taxpayer's entitlement to take up parts of the redeveloped property for its own future requirements).

46. Secondly, the use of another legal entity to carry out the redevelopment was meant to be an "internal" arrangement (hence the phrase "for internal purposes").

47. Thus, it is clear the said board minutes showed the taxpayer intended to realize the value of the subject land by redeveloping it *and* selling it (or parts of it).

48. A similar exercise can be done with regard to the subject agreement. Its terms expressly stated the nature of the transaction to be carried out; namely, a joint venture (as opposed to a partnership) *and* a sale and purchase of interest in property (clause 8.01; para 27 above). The phrase "interest in property" has not been expressly defined, but in the context of the subject agreement, it must mean interest in the subject land. Likewise, the phrase "joint venture" has not been expressly defined, but in the context of the subject agreement, it must mean a joint venture for redeveloping the subject land (recital (3); para 24 above).

49. Thus, just as clause 8.01 was not about the sale and purchase of the subject land *simpliciter,* it was not about the sale of a right to redevelop *simpliciter* either. It was both a sale and purchase of interest in the subject land *and* a joint venture (to redevelop it).

50. The said sale and purchase was to enable the subject land to be redeveloped by the construction of a building (or buildings) (recitals (3) and (5); para 24 above). It was also to enable units of such building (or buildings) to be sold to purchasers (by way of the sale of undivided shares) (recital (3); para 24 above).

51. The taxpayer relies on clause 3.02 in support of its case that there was a mere sale of the right to redevelop (the taxpayer's case before the Board). It is true that term stipulated that the initial payment was for granting the right to develop the subject land to the developer. But it has to be read together with the other terms (especially those referred to in para 48 to 50 above).

52. As regards the taxpayer's argument that the redevelopment was carried out by a subsidiary (Prodes), para 46 above is repeated. In this connection, it should be

noted the taxpayer's obligations under the subject agreement did not necessarily end with the transfer of the subject land to Prodes. In the event Prodes should fail to enter into a "new agreement" with the developer (and Great Poka), clause 5.02 stipulated:

> "… the assignment of the [subject land] to [Prodes] shall not take effect and shall become null and void and [the taxpayer] shall be deemed to have replaced [Prodes] in its position and continue as the registered and beneficial owner of the [subject land] under the New Agreement … At the request of the Developer, [the taxpayer] shall execute the New Agreement … ".
>
> Further, clause 8.01 made clear that the joint venture mentioned therein was between the taxpayer on the one part and the developer and Great Poka on the other.

53. None of the terms in the subject agreement expressly stated that the taxpayer "re-invested" by injecting part of the value of the subject land into the redevelopment (but leaving the redevelopment to be carried out by a subsidiary) (the Oct 2015 decision). Likewise, there was nothing in the said board minutes or Mr Yeung's testimony concerning that either. It is also noted that the "investment value" ascribed by para 166, the Oct 2015 decision (about $253 million) (para 20 above) was not the consideration for conveying the subject land to Prodes (about $314 million) (para 14 above).

54. In fact, as has been shown above, the relevant parts of:

(a) the said board minutes;

(b) Mr Yeung's testimony;

(c) the subject agreement,

militate against such a conclusion.

55. The testimony of Mr Yeung, quoted in para 117 of the Oct 2015 decision, also supports the conclusion reached in para 42 above. The relevant parts of the testimony include:

> "[Mr Yeung agreed to the suggestion] Instead the transaction was going to be a cooperation with [the developer] whereby the building was to be knocked down, a new building was to be built, units were going to be sold and proceeds to be divided and shared";

> "[Mr Yeung explained the reason for the above] We were hoping to make more money because whether we [cooperate] and then we could−, the price could have value added on it";
>
> "[Mr Yeung clarified the earlier testimony] When we worked together to build buildings, of course, we were hoping to make more money but whether it is going to happen or not, is not my wish".
>
> The majority was in effect trying to put a gloss ("take home [some] value [of the subject land and reinvest] the balance …") on Mr Yeung's testimony when para 117 said that his testimony "should be understood ***in this context***" (para 20 above).

56. Having found that there was no evidential basis for the majority to conclude the way it did, I agree with the Commissioner there is no legal basis for the majority to find that there was an "assumption that the … value of the parties' contribution [in a joint venture with equally shared profit] would … be equal" (para 20 above). It should be noted here that the subject agreement was not a partnership (clause 8.01; para 27 above), and none of the legal principles applicable to partnerships are applicable in the absence of a proper evidential basis.

57. The Commissioner's other complaint is that he has not been given a reasonable opportunity to consider and/or deal with the "re-investment" finding. It is a complaint about knowing in good time the nature of the case which he has to meet, so as to prepare his case properly (both regarding evidence and submissions).

58. The taxpayer refutes the complaint, asserting that the Board has not relied on matters not already adduced as evidence. However, that assertion does not answer the Commissioner's point that he might have questioned the taxpayer's witnesses differently, or gathered (and adduced) further evidence in respond. In this connection, whether there has been a change of intention on the taxpayer's part is ultimately a question of mixed law and fact.

59. The taxpayer relies on the exchange between the majority and the Commissioner during the Commissioner's final submissions as showing that the Commissioner has adequately been informed of a possible "re-investment" finding by the Board. I will assume in the taxpayer's favour regarding that. However, that is still not a sufficient answer to the Commissioner's complaint that the issue has not been dealt with in evidence (because the Commissioner was unaware of such a case). The witnesses' testimony (especially that of Mr Yeung) did not touch on that. An intention to trade being a factual matter, parties to the hearing should be entitled to explore the factual evidence regarding that aspect in the context of the case put forth against them.

60. In support, the taxpayer also refers to *Church Body of Hong Kong Sheng Kung Hui v Commissioner of Inland Revenue* (2016) 19 HKCFAR 54 for the

proposition that a tribunal should determine whether trade or business has been carried on based on a consideration of all the circumstances. But "all the circumstances" is a fluid concept; the circumstances which may be placed before a tribunal often depend on what the parties have chosen to elicit from the evidence (according to the case they have to meet). Hence, this cannot provide an answer to the complaint of procedural unfairness. Similarly, the categorization of an intention to trade as being subjective (or objective) in nature does not assist to determine what factual evidence should be elicited by the parties.

61. An issue has also been raised as to whether the disposal of the right of redevelopment is a disposal of a capital nature (para 173, the Oct 2015 decision (para 5(3) above)). The taxpayer contends it is, relying on *McClure v Petre* [1988] 1 WLR 1386. It contends that a redevelopment right represents a "once-and-for-all realization of the capital value of the part of the asset". I agree with the Commissioner that the minority has given the correct reason for distinguishing the *McClure* decision: it dealt with a different tax charging provision (s 67(1), Income and Corporation Taxes Act 1970, as opposed to s 14, Cap 112) (para 132-139, the Oct 2015 decision).

62. Finally, the taxpayer complains that the Board erred in refusing its application to add a new ground of appeal (the calculation of profit should take into account all expenses and outgoings (including the value of the subject land)). I also agree with the Commissioner that the Board has given the correct reasons for refusing the application. The minority's reasons were in gist:

(1) the relevant provision (s 16, Cap 112) does not permit the deduction of *any* expenses and expenses, but only those incurred during the basis period for that year of assessment;

(2) the application lacked the necessary supporting factual particulars;

(3) the taxpayer's own tax computation did not mention such expenses and outgoings, but reported a total capital gain of about $474 million.

The minority's above reasons were agreed to by the majority (para 147 and 185, the Oct 2015 decision).

Conclusion

63. The questions of law posed in the case stated are answered as follows:

(a) para 4(a) above, in the negative (there was insufficient evidence);

(b) para 4(b) and (c) above, in the positive (the Board did err);

(c) para 5(1) to (4) above, in the negative (the Board did not err).

Accordingly, the Oct 2015 decision (to remit the assessment to the Commissioner) is set aside.

Other matters

64. The parties' written submissions also mentioned various other points. These have not been expressly set out or dealt with above. This is so only because of the need to balance between the length of the judgment and its comprehension. It does not mean those other points are thought to be irrelevant (or have been overlooked). To avoid doubt, those other points have also been considered.

Costs order

65. The parties agree that costs should follow the event. The Commissioner is the successful party. There will accordingly be a costs order that the costs of the case stated (including any reserved costs) are to be paid by the taxpayer to the Commissioner, to be taxed if not agreed (with certificate for two counsel).

(Andrew Chung)
Judge of the Court of First Instance
High Court

Mr Paul Shieh SC leading Mr Mike Lui, instructed by Department of Justice, for the appellant

Mr Clifford Smith SC leading Mr Justin Lam, instructed by Pang & Associates, for the respondent