

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. BR 11/76

Board of Review:

L. J. D'Almada Remedios, *Chairman*, M. W. Kwan, R. E. Moore, & V. O. Roberts, *Members*.

17th October 1977.

Profits tax – taxpayer requiring capital for expansion of business – share exchange transaction – acquired shares sold at a profit to finance business – whether shares acquired in the course of a scheme of profit making.

The appellant, a public company, was not only engaged in the textile business but also dealt in public quoted shares. It subsequently decided to expand its business into the property field and various means of raising fresh capital were considered. Finally, a company agreed to purchase a number of new shares which the appellant proposed to issue but insisted that payment was to be by an exchange of shares in lieu of cash. In consequence, the appellant acquired a certain number of shares in that company which it sold at a profit and the proceeds were used in the purchase of real property.

The appellant was charged to tax on the profits derived from the sale of the acquired shares. On appeal the appellant contended that it did not carry on a trade or business in respect of the shares acquired by way of exchange.

Decision: Appeal allowed. Assessment set aside.

Henry Litton, Q.C. instructed by Zimmern & Co. for the appellant.
Benjamin Shih for the Commissioner of Inland Revenue.

Cases referred to:-

1. The Dunn Trust Ltd. v. Williams (H.M. Inspector of Taxes), (1950) 31 T.C. 477.
2. J. P. Harrison (Watford) Ltd. v. Griffiths, 40 T.C. 281.
3. Erichen v. Last, 4 T.C. 422.

Reasons:

The facts of this case are rather exceptional. The Appellant is a public limited company. Until the end of 1971 the Appellant's main business was in the retail clothing field. In 1970/71, the Appellant purchased some shares in public quoted companies. These shares were sold prior to the 31st March 1971 and the profits were treated by the Appellant's

INLAND REVENUE BOARD OF REVIEW DECISIONS

accountants as trading profits and entered into the Profit and Loss Account. There did not appear to be any systematic buying and selling of shares. The Appellant went into an overdrawn position in 1972 and there were no further purchases of shares. However, it appears from the Statement of Agreed Facts that the auditors (“Representatives”) of the Appellant represented that the shares were acquired for the purpose of share dealing and elected to adjust the expenses of managing the portfolio on the same basis pursuant to Rule 2C (1)(a) of the Inland Revenue Rules. In these circumstances we do not think it is open to the Appellant to contend that in relation to the shares bought in 1970 and 1971 and sold in 1971 that it was not engaged in the business of dealing in shares.

Towards the end of 1971, a decision was made by the Appellant to diversify its business to include real estate investment and property development. Various ways and means were thought of and discussed and professional advice sought with a view to raising additional capital for expansion into the property field. The Appellant had in mind the purchase of flats in Repulse Bay and Prince Edward Road Towers and the object was to raise \$9 million for property acquisitions. A rights issue to be under-written by a bank was also explored but shelved as it would only have yielded \$6.6 million and the conditions to be attached did not render the operation viable.

It subsequently came to Appellant’s knowledge that X Ltd. had been acquiring substantial minority interests in public companies. Through a stockbroker, X Ltd. was approached to see if it would be interested in acquiring 750,000 of the Appellant’s shares at a price of \$12 per share. When an affirmative answer was received a meeting was arranged. It was held on the 1st June 1972. Prior to that date, the managing director of the Appellant did not know and had not met any of the directors of X Ltd. who were present at the meeting; nor had any of the directors of the Appellant discussed the matter with X Ltd. or with any of its directors. At the meeting, the managing director fully expected negotiation on the basis that the Appellant would be receiving \$9 million in cash. At the meeting the managing director told the directors of X Ltd. that the Appellant required \$9 million in cash for 750,000 shares to be issued to X Ltd. We accept the managing director’s evidence (corroborated by a director of X Ltd. who was present at the meeting) that he was surprised when he was told that under no circumstances would X Ltd. be prepared to pay cash for acquiring the shares. X Ltd.’s proposal was that the purchase of the Appellants’ shares were to be satisfied by the transfer to the Appellant of X Ltd. shares to value of \$9 million. At this point of the meeting the managing director was minded to discontinue further discussion. He felt that the market value of the X Ltd. shares at that time (\$56 per share) was high and he was no doubt apprehensive of what he could get on realization since the matter was to be completed when the Appellant was in a position to issue its own shares which involved the convening of an extraordinary general meeting and other necessary steps for the purpose. However, at the meeting and on the suggestion of the other directors present, the matter was discussed (in the absence of X Ltd. directors) and finally agreement reached was that the Appellant would accept the transfer of X Ltd. shares at the value of \$54 per share (instead of the market rate of \$56 per share) and thereby the Appellant would receive 167,000 X Ltd. shares, which at the price agreed, would be the equivalent of \$9 million. At that same meeting the agreement dated 1st June 1972 was then drawn and signed by the parties.

INLAND REVENUE BOARD OF REVIEW DECISIONS

Following the signature of the Agreement with X Ltd., the Appellant had to convene an extraordinary general meeting of its shareholders to increase its capital and to give the directors the requisite powers to issue the new shares to X Ltd. At the same time it took the opportunity of changing its name. The meeting was held on 28th July 1972 and the Agreement with X Ltd. was implemented on 1st August 1972 by the issue of 750,000 new shares by the Appellant in exchange for 167,000 shares in X Ltd.

By 1st August 1972, the market price for X Ltd. shares had increased from \$56 (the price when the Agreement with X Ltd. was concluded) to \$65. Moreover, the announced participation of X Ltd. as a 25% shareholder in the Appellant had increased the market rating of the Appellant's shares with the result that the Appellant was able to expand into the property field by the issue of its own shares far more ambitiously than it had originally intended. Between 1st August 1972 and 31st March 1973, the Appellant issued new shares to third parties for the acquisition of properties at prices in excess of \$12 per share.

The parcel of 167,000 X Ltd. shares was sold by the Appellant over the period 8th September 1972 to 12th February 1973 resulting in a profit, after expenses, of \$11,530,981.40. Evidence was given before us by the managing director that the sales were timed to meet payments due for the acquisition of properties and for development costs.

The issue now before us is whether the profits derived from the sale of the X Ltd. shares are chargeable to profits tax.

The Revenue's case is attractive for its simplicity: The Appellant had previously dealt with in shares; share dealing is part of its business. In 1972 it acquired a large bulk of X Ltd. shares. They were acquired not for investment, but for the purpose of resale. The motive for the re-sale of the X Ltd. shares is irrelevant and it matters not what the Appellant intended to do with the proceeds. As the shares were trading assets which were disposed of, the profits are taxable. That is the Revenue's case.

The Appellant contends on the other hand that even if, which is not admitted, the Appellant had carried on a trade of dealing in shares in 1970 and 1971, the Appellant did not carry on a trade or business in respect of the 167,000 shares acquired from X Ltd. and that the profits arising from their sale did not arise, or were not derived, from carrying on a trade or business in the Colony within the meaning of section 14 of the Ordinance.

In his reasons for disallowing the Appellant's objection to the assessment, the Commissioner states:-

“When a company which has engaged in share dealing acquires shares, not for long term investment, but for the purposes of re-sale at a profit, it will need very convincing evidence indeed to demonstrate that such shares were not acquired in the course of a scheme of profit making”.

INLAND REVENUE BOARD OF REVIEW DECISIONS

With this view, we respectfully, agree subject only to a reservation as to whether the word “re-sale” is apposite to describe the disposal of the X Ltd. shares which were not acquired by purchase in the ordinary meaning of that word. However, the Commissioner did not have the advantage of the testimony of the managing director and the director of X Ltd. given before us which makes it perfectly plain that the Appellant acquired the shares in lieu of \$9,000,000 cash in the form of new capital because it had no alternative but to accept the new capital in this form if it was to raise the \$9,000,000 it required on commercially acceptable terms. We use the word “capital” here in its ordinary meaning of money or cash, and not to make any distinction between capital assets and trading assets. That it is possible to discharge the burden of proof to which the Commissioner refers is demonstrated by the case of **The Dunn Trust Ltd. (in voluntary liquidation) v. Williams (H.M. Inspector of Taxes)**¹.

The word “trade” is not easy to define. As Lord Denning said in **J. P. Harrison (Watford) Ltd. v. Griffiths**²:-

“Parliament did not define a “trade”. And I do not know that any Judge has attempted it. Try as you will, the word “trade” is one of those common English words which do not lend themselves readily to definition but which all of us think we understand well enough. We can recognise a “trade” when we see it, and also an “adventure in the nature of trade”. But we are hard pressed to define it.”

In **Erichen v. Last**³, the Master of the Rolls put it in this way:-

“I do not think there is any principle of law which lays down what carrying on a trade is. There are a multitude of incidents which together make the carrying on a trade, but I know of no one distinguishing incident which makes a practice a carrying on of a trade, and another practice not the carrying on of a trade. If I may use the expression, it is a compound fact made up of a variety of incidents.”

What we have to decide is not whether the Appellant’s business includes that of share dealing. It is because the Appellant did carry on a business of share dealing that the parties are now before us. We think Mr. Litton (on behalf of the Appellant) is right when he stressed that although it may be relevant to take into account that the Appellant had previously dealt with in shares, the transactions in that business do not “infect” other transactions not carried out as part of that business.

The question is: Did the Appellant embark on a trading activity in the acquisition and sale of the X Ltd. shares? That is the crux of matter. If the ‘transaction’, viewed in the light of all circumstances, was not a trading operation then any profit from sale not arising, or being derived from, the carrying on of a trade or business would not be exigible to tax.

¹ (1950) 31 T.C. 477.

² 40 T.C. 281.

³ 4 T.C. 422 at p. 423.

INLAND REVENUE BOARD OF REVIEW DECISIONS

The features of this case militate against the suggestion that the Appellant intended to embark on a trading venture in relation to these shares. The Appellant required \$9 million for employment in its real estate business. The proposal to issue its own shares to X Ltd. was on the expectation of receiving this sum in cash but X Ltd. declined to pay for the shares in cash and insisted on effecting payment in kind to the value of \$9 million represented by the 167,000 X Ltd. shares at \$54 per share. The Appellant had no intention of trading. Its intention from the outset was to raise \$9,000,000 in cash by the issue of its shares and the agreement with X Ltd. was the means of carrying out this intention even though, against its wishes, the Appellant was forced to take payment in kind. The importance of motive in cases of this kind involving special circumstances is well illustrated by the cases cited in *Whiteman and Whentcroft* on pages 263 and 264.

We have also considered the manner in which the X Ltd. shares were disposed of, the sales being effected in numerous different lots over the period 8th September 1972 to 28th February 1973. The evidence of the managing director regarding the reasons for and timing of the sales was not challenged but we do not think that they lead to the conclusion in this case that the shares became part of the Appellant's trading stock and that their realization over a period of 6 months as funds were needed for the Appellant's property business constituted the carrying on of a trade.

We therefore find on the special facts of this case that the Appellant was not carrying on a trade or business in relation to the acquisition and disposal of the 167,000 X Ltd. shares and that accordingly, the profits arising from their disposal were not derived from the carrying on of a trade or business in Hong Kong.

The assessment which is the subject matter of this appeal is therefore set aside.