Case No. BR 18/76

Board of Review:

S. V. Gittins, *Chairman*, Michael Asome, Stephen C. C. Cheung & David B. K. Lam, M*embers*.

12th December 1977.

Profits tax – real property recently acquired resold to company at higher price – allotment of shares in company in satisfaction of purchase money – shares unsold – whether profits derived from resale of property chargeable to tax.

The Taxpayers, directors of a private limited company, purchased in their own names for $13,889,502 certain property for addition to the assets of the company. This was just before the company went public but the prospectus therefore had been prepared so that if the company made the purchase direct, extensive amendment of the prospectus would be required and this was impracticable. There was an understanding between the Taxpayers and the other directors that the property would be assigned to the company after its shares were listed for 12 million shares in the company (based on the net asset value per share stated in the prospectus). No written agreement was possible since such would have had to be disclosed in the prospectus. On the day of the first listing of the company's shares, the taxpayers entered into an agreement for sale and purchase with the company whereby the company agreed to purchase the property at the consideration of $21,600,000.00 to be satisfied by the allotment to the taxpayers of $12,000,000 fully paid ordinary shares of $1.00 each at $1.80 per share, being the day's quoted price. It was agreed that the issue of the shares to the taxpayers was to take place on the date of the completion of the purchase and the shares were not marketable before a certain date. In consequence of the transaction assessable profits in the sum of $7,710,498.00 were raised against the taxpayers on which tax of $1,156,574.00 was payable.

On appeal the taxpayers denied liability to tax on the grounds that the transaction was not a venture in trade but an investment, that there was no realized profits as the shares were still unsold and that the transaction produced no profit since the shares were of par value on the date of their becoming marketable.

Decision: Appeal disallowed, assessment confirmed.

Fong Hup of M. W. Kwan & Co. for the taxpayers.
Benjamin Shih for the Commissioner of Inland Revenue.

Cases referred to:-

1. Californian Copper Syndicate v. Harris, 5 T.C. 159.
2. Humphrey v. Gold Coast Selection Trust Ltd., 30 T.C. 209.

Reasons:

1. Mr. A is the Chairman and Messrs. B, C and D are directors of M. Ltd. These gentlemen have considerable experience in finance, banking, shipping and real estate business, and they are hereinafter referred to as "the Taxpayer".

2. On the 20th November 1972, the Taxpayers entered into an agreement with the Vendor, whereby they agreed to purchase from the Vendor 60 flats in a building then in the course of erection. These 60 flats are hereinafter referred to as "the Property". The purchase price was $13,889,502.00 and was to be paid in the following manner:-

(a)	on or before the signing of the agreement for sale and purchase …………………………………………..	$ 2,777,900.40
(b)	upon completion of R.C.C. construction work up to the first floor level …………………………………...	1,388,950.20
(c)	upon the completion of R.C.C. construction work up to the twelfth floor level ……………………………..	1,388,950.20
(d)	upon the completion of R.C.C. construction work up to the roof level ……………………………………...	1,388,950.20
(e)	upon the issuance of the occupation permit …………	6,944,751.00
		$13,889,502.00

The Sale and Purchase Agreement shows that, amongst other things, the Vendor was to complete the building on or before 31st October 1973, and the Taxpayers had paid the deposit of $2,777,900.40 on the date of the Agreement, the 20th November 1972.

3. On the 14th December 1972, the Taxpayers entered into an agreement with M. Ltd. (the Company) whereby they agreed to sell the Property to the Company at the price of $21,600,000.00. Clauses 2, 3 and 4 of the agreement read as follows:-

> "2. The purchase money shall be $21,600,000 which shall be satisfied by the allotment by the purchaser to the vendors or their nominee or nominees of 12,000,000 fully paid ordinary shares of $1.00 each in the Purchaser at $1.80 per share.
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> 3. The purchase shall be completed on or before the 30th day of September 1973 when the aforesaid shares shall be issued to the vendors.
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> 4. On satisfaction of the said purchase money in manner aforesaid the vendors and all other necessary parties (if any) will execute a proper Assignment of the said premises sold to the purchaser subject as hereinafter appears but otherwise free from incumbrances.".

4. On 22nd December 1975, the Assessor raised on the Taxpayers a Profits Tax assessment for the year of assessment 1972/73, particulars of which are as follows:-

Year of Assessment 1972/73
Section 18(3). Basis Period: 20/11/72 to 31/3/73

Estimated Assessable Profits under section 59(2)(b)	$7,710,498

5. The Taxpayers lodged a notice of objection against the assessment through their Representatives on the grounds that the Taxpayers did not carry on a trade or made any profit.

6. By the Commissioner's determination on the objection the assessment of Assessable Profits of $7,710,498 with tax payable thereon of $1,156,574 was confirmed.

7. The Taxpayers have appealed to the Board of Review and the grounds of appeal are:-

> "1. The Commissioner was wrong in holding that the transaction was an adventure or concern in the nature of trade. The Appellants were not trading in that they purchased the said property as an investment. This was to be exchanged for the said shares to be issued, which shares were also to be held as investments.
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> 2. The Commissioner was wrong in holding that the purported allotment of shares in exchange for the property is a transaction chargeable to profits tax even if a book profit was made. Unless and until the shares were sold, any such profit would not have been realised profit or profit received and is therefore not taxable.
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> 3. The Commissioner was wrong in holding that the transaction yielded a profit of $7,710,498. The 12,000,000 shares were not to have been issued prior to the 30th September, 1973 and permission to deal in the said shares by the two Stock Exchanges concerned was not to be given prior to the 1st February, 1974 at which date the market value of the Company's shares was quoted at $1.00.".

8. At the hearing before the Board, Mr. A, the first named of the Taxpayers, gave evidence and Mr. Fong Hup of the Representatives made statements as to facts. On the evidence and statements the following additional facts were found by the Board:-

(a) In November 1972 the Company had made preparations to go public.

(b) At this time a large number of companies in Hong Kong were seeking quotations for their shares on stock exchanges, so that arrangements for the first listing of the shares had to be made well in advance.

(c) The prospectus was issued on 29th November 1972 and the tentative date for the

listing of the shares was fixed for 14th December 1972.

(d) The Taxpayers, with the intention of acquiring the Property for addition to the assets of the Company, negotiated for its purchase and entered into the agreement to purchase it on 20th November 1972. Although this date was prior to the issue of the prospectus, this document had been prepared. To include that property in the prospectus would require extensive amendment of the prospectus which was impractical, so the Taxpayers purchased it themselves. There was an understanding between them and the other directors of the Company that the Property would be assigned to the Company after its shares were listed.

(e) There was no written agreement between the Taxpayers and the Company since such would have had to be disclosed in the prospectus.

(f) The net asset value per share of the Company was $1.13 after taking into account the public issue. This was stated in the prospectus. The Representatives also calculated the net asset value per share before the public issue at $1.19 so that the average net asset value was $1.16 per share.

9. It is convenient to deal first with the second ground of appeal: that where the consideration for the sale of property was not cash but the allotment of shares in a company, the shares must be sold before profit is realized and therefore taxable.

10. There is express authority against this contention. In **Californian Copper Syndicate v. Harris**[1]**,** Lord Trayner said:-

> "But it was said that the profit – if it was profit – was not realised profit, and, therefore, not taxable. I think the profit was realised. A profit is realised when the seller gets the price he has bargained for. No doubt here the price took the form of fully paid shares in another company, but, if there can be no realised profit, except when that is paid in cash, the shares were realisable and could have been turned into cash, if the Appellants had been pleased to do so.".

Although in the present case as contended by the Taxpayers, the 12,000,000 shares which was the consideration were shares which would not be issued for 9 months and quoted 4 months later, this was the price the Taxpayers as sellers bargained for and obtained.

11. And in **Humphrey v. Gold Coast Selection Trust Ltd.**[2]**,** Lord Simon in the House of Lords, cited with approval the above quoted passage from Lord Trayner's judgment and added:-

> "I read this last sentence as rejecting the syndicate's contention that it could not be liable because the shares had not been realised, it should not be understood to mean that the

[1] 5 T.C. 159 at p. 167.
[2] 30 T.C. 209 at p. 239.

crucial test is prompt readability.".

12. The second ground of appeal therefore fails.

13. The third ground of appeal was that there was no profit in that the 12,000,000 shares were not to be issued before 30th September 1973 and could not be dealt with on the stock exchange before 1st February 1974. On 1st February 1974 the market price of the shares was $1.00.

14. The judgment of Lord Simon in **Humphrey v. Gold Coast Selection Trust Ltd.** at 240 is in point:-

> "In my view the principle to be applied is the following. In cases such as this, when a trader in the course of his trade receives a new and valuable asset, not being money, as the result of sale or exchange, that asset, for the purpose of computing the annual profits or gains arising or accruing to him from his trade, should be valued as at the end of the accounting period in which it was received, even though it is neither realised nor realisable till later. The fact that it cannot be realised at once may reduce its present value, but that is no reason for treating it, for the purposes of Income Tax, as though it had no value until it could be realised. If the asset takes the form of fully paid shares, the valuation will take into account not only the terms of the agreement but a number of other factors, such as prospective yield, marketability, the general outlook for the type of business of the company which has allotted the shares, the result of a contemporary prospectus offering similar shares for subscription, the capital position of the company, and so forth. There may also be an element of value in the fact that the holding of the shares gives control of the company. If the asset is difficult to value, but is none the less of a money value, the best valuation possible must be made. Valuation is an art, not an exact science. Mathematical certainty is not demanded, nor indeed is it possible. It is for the Commissioners to express, in the money value attributed by them to the asset, their estimate, and this is a conclusion of fact to be drawn from the evidence before them.".

15. The Board is therefore concerned with the value of the consideration received by the Taxpayers on 14th December 1972. The best evidence of this is in the Agreement for sale and purchase of that date. The relevant part states:-

> "2. The purchase money shall be $21,600,000 which shall be satisfied by the allotment by the Purchaser to the Vendors or their nominee or nominees of 12,000,000 fully paid ordinary shares of $1.00 each in the Purchaser at $1.80 per share."

> "4. On satisfaction of the purchase money in manner aforesaid ..."

The price is categorically stated to $21,600,000. There is no suggestion that the Agreement is in any way bogus or a sham: The fact that the parties agreed to take this amount of money in the form of shares cannot detract from the agreed monetary consideration.

16. It is of interest to note that the Company's accounts incorporate the purchase price as $21,600,000. Also, as pointed out by Mr. Shih, if the market price of the shares on 1st February 1974 happened to be $3.00, it would be untenable for the Commissioner to contend that the profit would be increased by $14.4 million.

17. The third ground of appeal also fails.

18. We have left the first ground of appeal to be dealt with last for although we have found against the Taxpayers on the second and third grounds, it is rightly conceded by Mr. Benjamin Shih for the Commissioner, that if the Taxpayers establish that they were not trading in the transaction, the assessment must be annulled.

19. It was given in evidence on behalf of the Taxpayers that they bought the Property for the benefit of the Company, and that they would transfer it to the Company at cost.

20. Mr. A in evidence said that the Taxpayers, in the negotiations with the Vendor, were acting on their own behalf, but with the intention at the time of re-selling it to the Company after its shares were listed. That after the price had been determined by the Sale and Purchase Agreement of 20th November 1972 there was an understanding with the other directors that the Taxpayers would take 12,000,000 shares calculated on a net-asset value of $1.15 per share. But because the price of the shares was $1.80 on the first day of listing, which was the date of the sale by the Taxpayers to the Company, the directors considered that they could be criticized if the 12,000,000 shares were issued to the Taxpayers at a price less than $1.80.

21. In favour of the Taxpayers' contention that they were not engaged in a trading transaction are the facts that the evidence was unchallenged that none of the Taxpayers had sold any of their original shares or of the 12,000,000 new shares, up to the present time, nor was it suggested that their partnership had previously engaged in property dealing.

22. An examination of the figures in evidence does not support the Taxpayers' stated purpose of transferring the Property to the Company at their cost price.

23. 12,000,000 shares at the selected net asset value of $1.15 per share would be $13,800,000 and this is $89,500 less than the Taxpayers' purchase price. Also, the appropriate net asset value should be that after the public issue, i.e., $1.13 in which case the deficiency would be $329,500.

24. In answer to questions from the Board, Mr. A stated that the Taxpayers paid the whole purchase price to the Vendor by instalments under the contract as set out in paragraph 2 above. Since the 12,000,000 shares they received could not be realized until 1st February 1974 at the earliest, they were out of pocket in respect of interest of instalments amounting to nearly $14 million. With the interest rate at about 1 % per month, their outlay on this head would be substantial.

25. It is abundantly clear that the Taxpayers did not buy the Property as an investment since it was bought for the purpose of resale to the Company and the resale was effected 24 days after the purchase. If the resale, being for a consideration based on the market value of the shares on 14th December 1972, had been for the number of shares equivalent to the cost price to the Taxpayers, there could be a substantial argument that they had merely changed the nature of their investment. But that was not the case.

26. We therefore reject the contention that the receipt of 12,000,000 shares by the Taxpayers represented the cost to them. At the net asset value of $1.15 or $1.13 this would amount to a substantial loss to them, especially when the loss of interest is taken into account.

27. It follows from our view thus taken that the only other value available is $21,600,000 as stated by the Taxpayers and the Company in their agreement for sale and purchase. We have not overlooked the fact that the 12,000,000 shares to be taken in satisfaction of the $21,600,000 would not be marketable until 1st February 1974, but we consider that in the conditions then prevailing in the share market, the expectation of the Taxpayers was probably that the shares were more likely to increase in value than the contrary; also that the then market price of $1.80 per share would provide adequate protection.

28. In connection with this ground of appeal we repeat our observations contained in paragraph 15 above.

29. Taking all the facts into consideration we find that the elements pointing to the transaction as a venture in trade outweigh those pointing to investment.

30. Therefore the first ground of appeal fails.

31. The Appeal is dismissed on all grounds and the assessment is confirmed.