

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D1/02

**Profits tax** – whether profits on the gains realised from disposal of listed securities chargeable to profits tax – sections 2, 14(1) and 68(4) of the Inland Revenue Ordinance (‘IRO’) – whether or not short term speculation – loss cannot be deducted until it is realised.

Panel: Kenneth Kwok Hing Wai SC (chairman), Hans-Rainer Adalbert Ehrhardt and Susan Beatrice Johnson.

Date of hearing: 8 February 2002.

Date of decision: 9 April 2002.

The appellant is a private company incorporated in Hong Kong. The appellant objected to the profits tax assessment raised on the gains realised from the disposal of listed securities.

The appellant appealed and disputed on the grounds of chargeability and the quantum of assessment. The appellant contended that it did not carry on any business except the short-term investment activity, centralizing in subscription in newly floated share.

At the hearing, the chairman of the appellant gave evidence and agreed that the shares were not capital assets and contended that since on account the stock was still unsold, the profit was unrealized profit.

#### **Held:**

1. Section 68(4) of the IRO provides that the onus of proving the assessment appealed against is excessive or incorrect is on the appellant. Section 2 defines ‘trade’ as including ‘every trade and manufacture, and every adventure and concern in the nature of trade’. Section 14(1) excludes profits arising from the sale of capital assets.
2. The Board was of the decision that this was a clear case of short term speculation. If there was an intention to hold the object indefinitely, albeit with an intention to make a capital profit at the end of the day, that was a pointer towards a pure investment as opposed to a trading deal (Marson v Morton [1986] 1 WLR 1343; Simmons v IRC [1980] 1 WLR 1196; and All Best Wishes Limited v CIR [1992] 3 HKTC 750).

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3. It is a general principle of taxation that a loss cannot be deducted until it is realised. The appellant has not discharged the onus under section 68(4) of proving that the assessment appealed against is excessive or incorrect.

### **Appeal dismissed.**

Cases referred to:

Marson v Morton [1986] 1 WLR 1343  
Simmons v IRC [1980] 1 WLR 1196  
All Best Wishes Limited v CIR (1992) 3 HKTC 750  
D8/01, IRBRD, vol 16, 140

Cheung Lai Chun for the Commissioner of Inland Revenue.

Lau Kam Cheuk of Messrs S Y Leung & Co, Certified Public Accountants, for the taxpayer.

### **Decision:**

1. This is an appeal against the determination of the Commissioner of Inland Revenue dated 20 September 2001 whereby the profits tax assessment for the year of assessment 1997/98 under charge number 1-1056902-98-A, dated 29 October 1998, showing assessable profits of \$47,017 with tax payable thereon of \$6,982 (as reduced by Tax Exemption (1997 Tax Year) Order) was confirmed.

### **The agreed facts**

2. The parties have agreed the following facts and we find them as facts.
3. The Appellant had objected to the profits tax assessment for the year of assessment 1997/98 raised on it. The Appellant claimed that the gains realised from the disposals of listed securities should not be chargeable to profits tax.
4. The Appellant is a private company incorporated in Hong Kong on 28 May 1996. At all relevant times, its issued and paid-up capital was \$2 divided into two shares of \$1 each.
5. On 11 July 1996, the Appellant and Company A entered into an agreement by which Company A agreed to act as an agent for the Appellant in the purchase and sale of securities and options on margin or otherwise.

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6. On behalf of the Appellant, Messrs S Y Leung & Co submitted the Appellant's profits tax return for the year of assessment 1997/98 together with its financial statements covering the period from 30 September 1996 (the date of commencement of business) to 31 December 1997 and proposed tax computation. The Appellant declared in the profits tax return that its principal activity was short term investment in local listed securities. The financial statements of the Appellant show that, before taking the preliminary expenses into account, it made a profit of \$47,017.69 which is computed as follows:

	\$	\$
Interest income		17,046.50
<u>Less:</u> Audit fee	3,000.00	
Sundry expenses	896.66	
Business registration fee	4,500.00	
Bank charges	120.00	
Secretarial fee	800.00	
Business entertainment	<u>5,191.20</u>	<u>14,507.86</u>
		2,538.64
<u>Add:</u> Gain on short term investment	200,970.25	
<u>Less:</u> Diminution in market Value of securities held as at 31-12-1997	<u>156,491.20</u>	<u>44,479.05</u>
		<u><u>47,017.69</u></u>

The Appellant did not offer the above profit for assessment.

7. The assessor was of the opinion that the purchase and resale of the listed securities amounted to a trade. He raised the following profits tax assessment for the year of assessment 1997/98 on the Appellant:

	\$	
Assessable profits as per paragraph 6	<u>47,017</u>	
Tax payable thereon	<u><u>7,757</u></u>	

8. On behalf of the Appellant, Messrs S Y Leung & Co objected against the above assessment on the following grounds:

- (a) 'Our clients invested in newly floated Quoted Share application and allotment and they invested on their own money. In this respect, they concentrated a short-term investment so as to obtain the money for next investment.'
- (b) '... their activity did not amount to any trading adventure.'

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9. In response to the assessor's enquiries, Messrs S Y Leung & Co put forth the following contentions and documents:

- (a) 'Our clients participated in shares investment, centralizing in new share subscription, through [Company A]. Our clients were required to maintain a cash account balance about 0.5M in order to participate in new shares subscription, hence the already subscribed shares have to be sold to maintain the cash balance of \$0.5M available for next subscription of new shares. Our clients have not commenced business, or alternatively, the gain is capital gain.'
- (b) The interest income of \$17,046 [see paragraph 6] was awarded by Company A in respect of the account maintained with it. As at 31 December 1997, the cash maintained in the account of Company A stood at \$639,361.
- (c) 'Our client did not carry on any trading activity except that of participation in Short-Term Investment in shares and to subscribe new shares prior to commencement of listing. ... In this respect, our clients consider that the interest are exempted as they did not carry on business, ...'
- (d) A schedule showing details of all the shares purchased and sold together with the profit and loss, as the case may be, derived therefrom. The schedule shows that more than half of the securities in the schedule were sold within seven days from the date of acquisition or allotment.
- (e) Copies of letters of authority issued by the Appellant to Company A showing that applications for new issue of certain shares would be applied by Company A's nominee and if the application was successful, the shares would be allotted to Company A's nominee.

10. The following details in respect of applications for allotment of shares made by the Appellant and the subsequent allotment are extracted from appendices C and D1 to D12 to the determination:

<b>Date</b>	<b>Name of shares</b>	<b>Share applied</b>	<b>Share allotted</b>
5-9-1996	Company B	600,000	8,000
17-9-1996	Company C	500,000	48,000
29-10-1996	Company D	3,000,000	16,000
15-11-1996	Company E	3,000,000	12,000
17-12-1996	Company F	1,500,000	40,000
4-3-1997	Company G	1,000,000	94,000
17-3-1997	Company H	2,000,000	4,000

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22-4-1997	Company I	3,000,000	70,000
15-5-1997	Company J	5,000,000	12,000
3-6-1997	Company K	2,000,000	8,000
12-6-1997	Company L	5,000,000	78,000
23-9-1997	Company M	1,300,000	52,000

11. In response to the assessor's comments that the Appellant acquired shares for the purpose of re-sale, Messrs S Y Leung & Co advanced the following arguments:

'... [there is] ... not a profit-making motive, but centralized to newly floated shares subscription. It is a pattern of short term investment. Our clients through the merchant bank subscribed newly floated shares. After the subscription, our clients were bound to sell the subscribed shares so that there would be adequate cash to subscribe another newly floated share.'

12. By virtue of the Tax Exemption (1997 Tax Year) Order, the amount of tax payable was reduced by 10% to \$6,982.

### **The appeal**

13. Having failed in the objection, the Appellant gave notice of appeal through Messrs S Y Leung & Co by letter dated 17 October 2001 on the following grounds (written exactly as it stands in the original):

#### 'Chargeability

The chargeability is disputed:

1. The appellant did not carry on any business except the short-term investment activity.
2. The appellant participated in short-term investment through [Company A] (Merchant Bank), centralizing in subscription in newly floated share.
3. The Commissioner considered there is little difference in the acquisition of shares and subscription of shares. Please be informed that the risk of subscription of new shares and the acquisition of listed shares from open market are different.
4. The short-term investment made by individuals is not chargeable. Will it be similar to a corporation?

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### Quantum of Assessment

The quantum of assessment is disputed as the loss on value of short-term investment is restricted the balance sheet date.'

14. At the hearing of the appeal, the Appellant was represented by Mr Lau Kam-cheuk of Messrs S Y Leung & Co. The Respondent was represented by Miss Cheung Lai-chun.

15. Mr Lau Kam-cheuk called Mr N, a director and the beneficial owner of all the shares in the Appellant and a practising solicitor by profession to give evidence.

16. At the end of the Appellant's case and in the course of Mr Lau Kam-cheuk's submission, the Chairman asked what the meaning of 'capital assets' was. Mr Lau Kam-cheuk told us his understanding, agreed that the shares were not capital assets and that the appeal on chargeability ought to be dismissed. We reprobate the waste of the time and resources of the Board of Review.

17. Mr Lau Kam-cheuk then contended (written exactly as it stands in the original):

### 'Quantum of Assessment

The appellant wish to draw the Board's attention to the letter of determination as it is unrealized profit, on account as the stock was still unsold.

The appellant wish to apply S. 70A of I.R.O. to revise the accounts as the loss of local listed share up to 31<sup>st</sup> December, 2000.

Gain on Short Term Investment	\$200,970.75
<u>Less:</u> Loss of Value up to 31.12.2000 (Cost - Market Value at 31.12.2000) (\$240,991.20 - \$17,200.00)	<u>223,791.20</u>
Adjusted Loss 1997/98	<u><u>\$22,820.45'</u></u>

18. At the end of the submission of Mr Lau Kam-cheuk, we told the parties that we were not calling on the Respondent and that we would give our decision in writing.

### **Our decision**

19. Section 68(4) of the IRO provides that the onus of proving that the assessment appealed against is excessive or incorrect is on the Appellant. Section 2 defines 'trade' as including 'every trade and manufacture, and every adventure and concern in the nature of trade'. Section 14(1) excludes profits arising from the sale of capital assets.

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20. We remind ourselves of what Sir Nicholas Browne-Wilkinson VC said in Marson v Morton [1986] 1 WLR 1343 at pages 1347 to 1349 and [1986] STC 463 at pages 470 to 471; what Lord Wilberforce authoritatively stated in Simmons v IRC [1980] 1 WLR 1196 at page 1199 and (1980) 53 Tax Cases 461 at pages 491 to 492; and the statement of the law by Orr LJ at pages 488 and 489 of the report in Tax Cases, which was approved by Lord Wilberforce as a generally correct statement (WLR at page 1202 and Tax Cases at page 495).

21. We also remind ourselves of what Mortimer J (as he then was) said in All Best Wishes Limited v CIR (1992) 3 HKTC 750 at page 770 and page 771.

22. In our decision, this is a clear case of short term speculation. If there was an intention to hold the object indefinitely, albeit with an intention to make a capital profit at the end of the day, that is a pointer towards a pure investment as opposed to a trading deal, see Marson v Morton [1986] 1 WLR 1343 at pages 1348 to 1349. In this case, there was a clear intention to resell in the short term. The Appellant used 90% borrowed funds in subscribing for shares. The beneficial owner of the Appellant subscribed in the name of the Appellant because he did not wish to incur personal liability on funds borrowed for the subscription.

23. We illustrate the point by reference to the first four transactions. Company B's shares allotted on 13 September 1996 were sold on 17 September 1996, the first dealing date, for \$18,569.06 at a gain of \$5,634.4. The next acquisition did not take place until 20 September 1996 when the Appellant subscribed for Company C's shares which were allotted on 26 September 1996 and sold on 30 September 1996, the first dealing date, for \$88,432.96 at a loss of \$2,726.17. The next acquisition did not take place until 1 November 1996 when the Appellant subscribed for Company D's shares which were allotted on 6 November 1996 and sold on 12 November 1996 for \$31,747.84 at a gain of \$12,588.56. The next transaction took place on 6 November 1996 when the Appellant purchased Company O's shares and sold them on the following day for \$174,874.17 at a gain of \$14,734.74.

24. As conceded by the Appellant, none of the shares was capital asset and the first ground of appeal must and does fail.

25. We do not think Mr Lau Kam-cheuk's contention is covered by the grounds of appeal. There is no application to amend the grounds of appeal.

26. Further, no application had ever been made under section 70A to the Inland Revenue Department. There was no decision by an assessor. There was no objection. There was no determination.

27. Further and in any event, it is a general principle of taxation that a loss cannot be deducted until it is realised. Mr Lau Kam-cheuk has cited no authority in law and no statement of

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accounting practice or principle authorising or requiring adjustment on account of an alleged drop in value of the stock which did not occur until three years (31 December 2000) after the balance sheet date (31 December 1997), compare D8/01, IRBRD, vol 16, 140.

28. Mr Lau Kam-cheuk's contention fails.

29. The Appellant has not discharged the onus under section 68(4) of proving that the assessment appealed against is excessive or incorrect. We dismiss the appeal and confirm the assessment as confirmed by the Commissioner.

30. The Appellant should consider itself fortunate that we have not made an order of costs.