INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D111/97

Profits tax – sale and purchase of shares – whether loss in one year can be available as a set off against profits for future years – whether a trade or business – Inland Revenue Ordinance section 19C.

Panel: Benjamin Yu SC (chairman), Andrew Chan Weng Yew and Benny Wong Man Ying.

Dates of hearing: 25, 29 September 1997 and 7 January 1998.
Date of decision: 20 February 1998.

The taxpayer ran a sole proprietorship in the name of Company A. In Company A's profits tax return for the year of assessment 1987/88, it reported a loss of $1,855,016. This amount was arrived at after taking into account a loss of $1,932,141 said to have arisen from the purchase and sale of quoted shares. These shares and warrants were originally purchased on Company A's account for trading purpose, and that in November 1987, he decided to convert these shares into his own account to offset the loan that he extended to Company A. The shares and warrants were sold in the market only in 1990.

Held:

(1) The Board ruled that loss in one year could be set off against the assessable profits from that trade, profession or business for subsequent years of assessment. (Section 19C of the IRO, D38/96, IRBRD, vol 11, 529 considered.)

(2) The Board was satisfied that when the taxpayer purchased the subject shares it intended to purchase them on Company A's account.

(3) The question of whether or not the taxpayer was carrying on a trade or business when dealing in shares is a matter of fact and degree to be decided in all the circumstances of the case. Private individuals would rarely be considered as carrying on a business of trading in shares unless there were other associated activities. Where there is no office and staff and organisation, there must be other clear evidence of carrying on a trade or business. (CIR v Dr Chang Liang-jen HKTC 975, Cooper v Stubbs 10 TC 29, 53 TC 143, D20/90, IRBRD, vol 5, 164, D42/90, IRBRD, vol 5, 316, D38/96, IRBRD, vol 11, 529 considered)

(4) Although the taxpayer thought that he was embarking on a trade when he purchased the shares, his intention at the time of the acquisition of shares did not

determine whether he was trading. (Simmons v IRC [1980] 1 WLR 1196, D42/90, IRBRD, vol 5, 316, Salt v Chamberlin 53 TC 143 considered.)

(5) Considering all the facts, the Board found that Company A did not carry on a trade or business in the sale and purchase of shares.

Per curium: Section 19C permits a notional loss to be set off against profits. (D47/91, IRBRD, vol 6, 256, Sharkey v Wernher [1956] AC 58, 36 TC 275, Petrotim Securities Ltd v Ayres [1964] 1 WLR 190, 41 TC 389, D21/76, IRBRD, vol 1, 291, D55/90, IRBRD, vol 5, 420, D49/92, IRBRD, vol 8, 1, Simmons v IRC [1980] 1 WLR 1196 considered)

Appeal dismissed.

Cases referred to:

D38/96, IRBRD, vol 11, 529
D47/91, IRBRD, vol 6, 256
Sharkey v Wernher [1956] AC 58, 36 TC 275
Petrotim Securities Ltd v Ayres [1964] 1 WLR 190, 41 TC 389
D21/76, IRBRD, vol 1, 291
D55/90, IRBRD, vol 5, 420
D49/92, IRBRD, vol 8, 1
Simmons v IRC [1980] 1 WLR 1196
CIR v Dr Chang Liang-jen HKTC 975
Cooper v Stubbs 10 TC 29
Salt v Chamberlain 53 TC 143
D20/90, IRBRD, vol 5, 164
D42/90, IRBRD, vol 5, 316
D57/94, IRBRD, vol 9, 335

Ma Wai Fong for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. The Taxpayer appeals against the determination of the Commissioner of Inland Revenue dated 19 September 1996. Under section 66(1) of the Inland Revenue Ordinance (the IRO), the Taxpayer may give notice of appeal to the Board within one month after the transmission of the determination. The first intimation given by the Taxpayer of his intention to appeal was in a letter dated 5 November 1996, which was received by the Clerk to the Board on 11 November 1996. Accordingly the first question which arose was

whether this appeal was out of time, and if so, whether the Board should exercise its power under section 66(1A) to extend the time for appeal.

2. Miss Ma informed us that the determination, although issued on 19 September 1996, was undelivered, and therefore redirected on 17 October 1996. She could not say when it was that the Taxpayer received it. Before us, the Taxpayer explained that he was not in Hong Kong at the time when the determination was despatched, and it was only redirected to him by his relative. He only received the determination on 5 November 1996 and he immediately gave notice of his intention to appeal to the Clerk of the Board.

3. The time for appeal runs after 'transmission' of the written determination to the Taxpayer. It seems to us that transmission is accomplished not merely by sending off the written determination, but by actual reception. See **Stroud's Judicial Dictionary**, 5th edition page 2682. If, as the Taxpayer says, the determination did not reach him until 5 November 1996, time only commenced to run from that day. However, Miss Ma also pointed out that section 66(1) requires the notice of appeal to be accompanied with a statement of the grounds of appeal, and this was not done by the Taxpayer until 23 December 1996. We accept that section 66(1) requires the notice to be accompanied, inter alia, by a statement of the grounds of the appeal before it could be entertained, and that therefore, the Taxpayer did require an extension of time. The Taxpayer explained that because he was out of Hong Kong at the time and did not have the information at hand to prepare the grounds of appeal, he requested for an extension and made arrangement to come back to Hong Kong on 12 November 1996. He completed compiling the appeal document around 21 December 1996 and he left Hong Kong on 24 December 1996. Miss Ma did not object to the Board granting an extension of time, and at the commencement of the hearing, we indicated that in all the circumstances we would be prepared to extend time and proceeded to hear the appeal.

The Issues in this Appeal

4. The Taxpayer runs a sole proprietorship in the name of Company A. In Company A's profits tax return for the year of assessment 1987/88, its business was described as 'Import/Export, Consultancy Services and Shares Trading' and it reported a loss of $1,855,016. This amount was arrived at after taking into account a 'loss' of $1,932,141 said to have arisen from the purchase and sale of quoted shares. The alleged loss of $1,932,141 was computed as follows:

Date of transaction	**Company**	**Quantity bought/ (sold)**	**Purchases $**	**Sales $**	**Profit/ (loss) $**
28-8-1987	Company 1	200,000	58,837.88	-	-
4-9-1987	Company 2	30,000	43,450.80	-	-
8-9-1987	Company 1	(200,000)	-	66,614.75	7,776.87
22-9-1987	Company 3	100,000	548,133.75	-	-
23-9-1987	Company 4	30,000	76,186.29	-	-

23-9-1987	Company 5	50,000	120,690.00	-	-
25-9-1987	Company 6	40,000	227,352.61	-	-
25-9-1987	Company 2	(30,000)	-	45,336.60	1,885.80
30-9-1987	Company 7	60,000	414,873.38	-	-
1-10-1987	Company 8	50,000	271,552.50	-	-
1-10-1987	Company 5	(50,000)	-	128,008.91	7,318.91
2-10-1987	Company 4	(300,000)	-	90,972.32	14,786.03
13-10-1987	Company 9 Warrant	900,000	597,415.50	-	-
13.10.97	Company 9	300,000	431,466.75	-	-
5-11-1987	Company 3	(100,000)	-	170,000.00	(378,133.75)
5-11-1987	Company 6	(40,000)	-	74,800.00	(152,552.61)
5-11-1987	Company 7	(60,000)	-	75,000.00	(339,873.38)
5-11-1987	Company 8	(50,000)	-	53,500.00	(218,052.50)
5-11-1987	Company 9 Warrant	(900,000)	-	69,300.00	(528,115.50)
5-11-1987	Company 9	(300,000)	-	88,500.00	(342,966.75)
	Lodging Fee	-	1,565.00	-	(1,565.00)
	Interest Expense	-	2,648.90	-	(2,648.90)
		-	2,794,173.36	862,032.58	(1,932,140.78)

5. As a matter of fact, Company A did not actually sell the relevant shares in the market. The Taxpayer's evidence is that the sale of the shares in Company 3, Company 6, Company 7, Company 8 and Company 9, and Company 9 Warrant were all book entries between himself and Company A. His case is that these shares and warrant were originally purchased on Company A's account for trading purpose, and that in November 1987, he decided to convert these shares into his own account to offset the loan that he extended to Company A. The shares and warrant were sold in the market only in 1990.

6. What is in issue in whether the notional loss of $1,932,141 can be treated as the loss of Company A and be available as a set off against profits for future years. The other issue relating to deduction of medical expenses was not pursued.

7. Section 19C(1) of the IRO provides:

'Where in any year of assessment –

(a) an individual sustains a loss in any trade, profession or business carried on by him, …

> *the amount of that loss shall be carried forward and set off against the amount of his assessable profits from that trade, profession or business for subsequent years of assessment.'*

8. It should be noted that the wording of that section is that the loss could be set off against the assessable profits from *that* trade, profession or business. Thus, even though in law Company A is the same legal person as the Taxpayer, so that one may say that the loss of the Taxpayer is in law the loss of Company A, section 19C only permits the loss to be set off against the profit of the same trade or business. We have been referred to the decision of this Board in D38/96, IRBRD, vol 11, 529 where the Board held that where a loss had been suffered by one person carrying on business, it could not be set off against the profit of another business even though that other business was owned by the same proprietor.

9. In her determination, the Commissioner rejected the claim for set off since she did not accept that the alleged losses arising from the share transactions were trading losses belonging to Company A. Before us, Miss Ma took essentially two points.

First, she submitted that the transactions in question were not on Company A's account. Secondly, she submitted that even if the shares were purchased on the account of Company A, the transactions did not amount to trading in shares. Thus, she submitted that the notional loss could not be set off against profits in subsequent years.

10. At the second session of the hearing of this appeal, we invited the parties to present submissions on whether it is open to the Taxpayer to claim a set off under section 19C when, on any view, Company A did not suffer any real loss. What was contended for by the Taxpayer was that there was a notional loss when the shares were transferred from Company A's account to his personal account by way of a book entry only. We gave directions for the parties to put in their written submissions on this issue and these were duly received. We shall first deal with this issue first before coming to the two issues raised by Miss Ma.

Does section 19 cover a notional loss?

11. Does section 19C permit a notional loss to be set-off against profits? By notional loss, we refer to the loss for accounting purpose when a taxpayer converts his trading stock from one business to his own use at below the cost of purchase. Miss Ma, for the Respondent (the CIR), conceded that section 19 covers a notional loss.

12. We drew Miss Ma's attention to the observations of the Board in D47/91, IRBRD, vol 6, 256:

> *'The charge on "profit" in section 14 of the Inland Revenue Ordinance is a charge on real profit, not on notional profit which a taxpayer never made. The Inland Revenue Ordinance contains no provisions similar to section 27 of the Stamp Duty Ordinance Chapter 113 which enables the collector to assess*

> *stamp duty based upon the 'gift' element of a transaction. Assume, for instance, that X Ltd were themselves traders in real estate and, in turn, sold the ground floor unit a year or two later at a profit. Would their tax liability as traders under section 14 be computed on the basis of a notional sale to them at $9,500,000, or on the actual cost price of $6,000,000 (thereby yielding a higher figure for profits tax purposes)? The answer must be that they would be assessed on the basis of the actual cost of the trading stock, not the higher notional cost. When it comes then to assess the Taxpayer on the sale of the property to X Ltd, what principles of law, or of commercial accountancy, require the Taxpayer to be assessed on the basis of a sale at a notional figure and not the actual figure? We are aware of none.'*

These observations suggest, by analogy, that a taxpayer only claim a set off where there has been a real loss. The question posed here must be a common one. Whenever trading stock is transferred to an investment account, a taxpayer may have a notional profit or loss, and we understand it is the practice of the Commissioner to tax any such profit and allow a set-off for any such loss. Is such practice justified in law?

The observations made in D47/91 quoted above were made in the context of the question whether Sharkey v Wernher [1956] AC 58, 36 TC 275 and Petrotim Securities Ltd v Ayres [1964] 1 WLR 190, 41 TC 389 apply in Hong Kong. In Sharkey v Wernher, the respondent's wife carried on the business of a stud farm, the profits of which were chargeable to income tax under Schedule D. She also carried on the activities of horse racing and training, which were agreed not to constitute trading. She transferred five horses from the stud farm for her racing stables. It was common ground between the parties that some amount must be credited in respect of the five horses upon their transfer and the question which was argued was whether this amount should be the cost of breeding or the market value of the horses. That question did not arise in the present case. But Viscount Simonds considered, albeit obiter, whether this concession was properly made. He said (at [1956] AC 72):

> *'My Lord, how far is this principle, which is implicit in the judgments that I have cited and in the admission upon which this case has proceeded, supportable in law? That it conflicts with the proposition taken in its broadest sense, that a man cannot trade with himself is, I think, obvious. Yet it seems to me that it is a necessary qualification of the broad proposition. For, if there are commodities which are the subject of a man's trade but may also be the subject of his use and enjoyment, I do not know how his account as a trader can properly be made up so as to ascertain his annual profits and gains unless his trading account is credited with a receipt in respect of those goods which he has diverted to his own use and enjoyment. I think, therefore, that the admission was rightly made that some sum must be brought into the stud farm account as a receipt though nothing was received and so far at least the taxpayer must be regarded as having traded with himself…'*

13. We have been referred to three previous decisions of this Board where Sharkey v Wernher had been held to apply with the result that where a trading stock was changed into a capital asset, the notional profit arising therefrom was held taxable: D21/76, IRBRD, vol 1, 291, D55/90, IRBRD, vol 5, 420 and D49/92, IRBRD, vol 8, 1. See also Simmons v Inland Revenue Commissioners [1980] 1 WLR 1196 *per* Lord Wilberforce at 1199C. Having regard to Viscount Simonds' dictum and these 3 decisions, we have come to the view that the Respondent's concession was properly made.

Were the Shares in question purchased on Company A's account?

14. On behalf of the Respondent (the CIR), Miss Ma relied on various matters to show that the shares in question were purchased by the Taxpayer in his own name, and not on Company A's account. The Taxpayer gave evidence on these matters and was cross-examined on some of them. We shall deal with these points in the following paragraphs.

15. Company A's business was declared as 'management and marketing consultancy' in the Business Registration Form dated 20 April 1979, and no application had been made subsequently to indicate that it intended to carry on a business in share trading. The Taxpayer's answer on this is that this was an oversight on his part to inform the Business Registration Office of the change in the nature of business. He said that this type of administration oversight was not uncommon when a business entered into a new line of business.

16. Miss Ma also relied on an application made by the Taxpayer on 26 February 1988 for registration or renewal of registration as an investment adviser, in which the Taxpayer reported the business of Company A as 'trading, management & marketing consultancy'.

17. The Taxpayer had used three brokers, Company B, Company C and Company D. The account opening form for share trading with Company B recorded the Taxpayer as the account holder. The monthly statements of the margin account issued by another firm of broker, Company E, were sent to the Taxpayer at his residential address. And although the bought and sold note issued by Company D had the words 'Company A A/C' inserted under the Taxpayer's name as the customer; this insertion was type-written and Miss Ma put to the Taxpayer that this was inserted by he himself.

18. The Taxpayer's evidence is that when he placed the order with Company B to purchase 100,000 shares in Company 3, he instructed the broker, one Mr F, that the order was for Company A. When he received the bought note on 23 September 1987, he discovered that it was addressed to him personally. This caused him to write a letter dated 24 September 1987 to Company B in the following terms:

'Subject: A/C#

Purchase of 100,000 Company 3 shares

> I refer to the Bought Note for the subject shares and regret that it was incorrectly addressed to me.
>
> I had told your Mr F, when opening the account and placing the order that these shares were purchased by my Company, Company A, for trading purpose. Consequently, all relevant documents should address to my Company and not myself personally.
>
> Could you reissue me a replacement bought note.'

The Taxpayer called Mr F to give evidence before us. He confirmed that when the Taxpayer gave him instructions to purchase shares, he did say it was for a company. He said he did pass those instructions to his colleague in the company, but could not remember why the company had not followed those instructions. He also remembered that when the Taxpayer raised this matter with the company, a manger of the company dealt with the Taxpayer, but he did not know what was exchanged between them.

19. As for the point that Company E sent the monthly statements to his residential address, the Taxpayer's evidence is that this was also done contrary to his instructions. The Taxpayer produced a letter dated 3 October 1987 to Company C in which he said:

> 'Subject: <u>Margin Account#</u>
>
> I refer to your Statement of 2 October 1987 and note that it was addressed to me personally.
>
> I had told your Mr G, when opening the subject account, that this account is for share trading of my Company, Company A. Consequently, all relevant documents should address to my Company and not me personally.'

The Taxpayer further relied on a letter dated 4 November 1987 to Company E where he reiterated that the account was opened for trading of shares on behalf of Company A. (This letter was produced after the hearing ended in September 1997 but we gave leave to the Taxpayer to rely on it during the resumed hearing on 7 January 1998.) There is a minor discrepancy between the contents of this letter and the previous one dated 3 October 1987 on a point which is immaterial, save to reflect on the veracity of the earlier letter.

20. As for the bought and sold notes issued by Company D, the Taxpayer called Mr H, who is also his brother-at-law. Mr H came to confirm that the copy bought and sold notes were indeed issued by his firm.

21. Miss Ma also submitted that none of the share transactions went through Company A's bank account. The Taxpayer was not cross-examined on this point. But since he himself said that the shares were transferred from Company A's account to his own

account to offset the loan he extended to Company A, we infer that he did provide the funds for the purchase of the shares in the first place.

22. The Taxpayer emphasized in his evidence that he had taken the necessary precautions to segregate the shares purchased by Company A for trading purpose from his own personal shares for long term investment.

23. In our view, the fact that the Taxpayer did not inform the Business Registration Office of his intention to trade in the shares is not a matter of great weight. Nor do we find the description of Company A's business as 'trading, management & marketing consultancy' in the February 1988 application to be of assistance. We find the letters written by the Taxpayer to Company B and to Company E dated 24 September 1987 and 3 October 1987 to be sufficiently cogent evidence to tip the balance in favour of the Taxpayer's contention. We do not accept the Respondent's (the CIR's) suggestion that the insertion of 'Company A A/C' in the bought notes issued by Company D was done by the Taxpayer. There is simply no evidence to support this rather serious allegation. Nor do we accept that suggestion that the letter dated 3 October 1987 was not written on the day it was purported to have been written. On these matters, we accept the evidence of the Taxpayer and of the two witnesses he called.

24. Having considered all the evidence, we find on this issue that the Taxpayer has satisfied us on the balance of probabilities that when the subject shares were purchased through the various brokers, the Taxpayer did intend to purchase them on Company A's account.

Did Company A carry on a trade or business in the sale and purchase of shares?

25. Accepting, as we do, that the Taxpayer purchased the shares on Company A's account, it does not necessarily mean that this was done by way of a business or trade. Miss Ma pointed out that Company A did not have a history of trading in shares, that the share purchases only took place within a short period of time, and that there had been no evidence of any system or organisation in the share transactions. On the Taxpayer's evidence, he did not hire any salaried staff to handle the affairs of Company A. Common sense would suggest that the few purchases that were made did not require any administrative or organisation work.

26. We have been referred to the line of authorities on whether an individual who engages in dealing in shares is carrying on a trade or business. These are: Commissioner of Inland Revneue v Dr Chang Liang-jen HKTC 975, Cooper v Stubbs 10 TC 29, Salt v Chamberlain 53 TC 143, D20/90, IRBRD, vol 5, 164, D42/90, IRBRD, vol 5, 316, D57/94, IRBRD, vol 9, 335 and D38/96, IRBRD, vol 11, 529. These cases establish the following propositions:

(1) The question of whether or not the taxpayer was carrying on a trade or business when dealing in shares is a matter of fact and degree to be decided in all the circumstances of the case.

(2) A person can buy and sell shares on the stock market without starting the business of share trading. Private individuals would rarely be considered as carrying on a business of trading in shares unless there were other associated activities. Thus, the prima facie presumption is that an individual is not trading or carrying on a business merely by buying and selling shares in the stock market.

(3) Though it is not essential that a person carrying on a business or trade must have an office and staff and organisation, where none of these attributes exist, there must be other clear evidence of carrying on a trade or business.

27. In the present case, the Taxpayer did not adduce any evidence of any system or organisation in the share dealings by Company A. However, the letters of 24 September 1987 and 3 October 1987 written by the Taxpayer to Company B and Company E do suggest that the Taxpayer did think that he was embarking on a trade or an adventure in the nature of trade when he purchased the shares. Also, the whole purchase of the Taxpayer putting these shares on Company A's account as opposed to his personal account was for the purpose of segregating his personal investment portfolio from the shares in question which he intended to hold for trading. He explained to us that in each of the acquisitions, he only intended to hold the shares for a short term, in contradistinction to the shares in Bank I which he held in his personal name on an investment basis.

28. Does the intention by the taxpayer at the time of acquisition of shares determine whether he is trading? If the property purchased was landed property, the well-established principle is that it does: see Simmons v Inland Revenue Commissioners [1980] 1 WLR 1196. However, it does not seem to be so where the property acquired is a financial instrument such as quoted shares or Hang Seng index futures contracts. In D42/90, IRBRD, vol 5, 316, the Board found that the taxpayer entered the Hang Seng index market purely and simply with the intention of making short term trading gains, in other words, for pure speculation (see page 320 of the report). The Board nevertheless held that the taxpayer was not carrying on a trade or business, as all he did was to open an account with a broker, paid a deposit and gave instructions. In Salt v Chamberlain 53 TC 143, the taxpayer engaged in a number of speculative purchases and sales of securities on the Stock Exchange. He was held not to be carrying on a trade or business.

29. These cases show that the law places different weight on the taxpayer's intention depending on the nature of the property purchased. One may question whether the distinction is justified in the circumstances we have nowadays in Hong Kong where speculation in landed properties is as prevalent and as unsophisticated as speculation in securities. Nevertheless, our duty is to apply the law as we understand it. Instead of looking only at the intention of the taxpayer, we must consider all the facts and ask ourselves the question whether Company A did carry on a trade or business in the purchase and sale of shares. Our conclusion is that it was not. What the Taxpayer did, albeit using the name of Company A, was in substance no different from what most people were doing in speculating in the stock market, without actually carrying on a trade or business.

Conclusion

30. As we have not been satisfied that Company A was carrying on a trade or business in share transactions, it follows that we must dismiss this appeal.