Case No. D116/95

Profits tax – purchase of land, development and sale of units in second phase of an industrial building – proceeds of sale used to repay costs of financing – whether trade or disposal of a capital asset – whether change of intention during construction – Inland Revenue Ordinance section 14.

Panel: Andrew Halkyard (chairman), Chiu Chun Bong and Kenneth Ting Woo Shou.

Dates of hearing: 2 and 3 November 1995.
Date of decision: 27 February 1996.

In July 1980 the Company acquired a block of land on which it proposed to erect an industrial building. In December 1980 the Company's parent embarked upon a rights issue. The prospectus for this issue stated that the proceeds would be used, inter alia, to finance the construction costs for the development. The issue was successful, although ultimately the proceeds were not used for the stated purpose.

After a small amount of preliminary work was carried out, the project was postponed in 1984 following a general downturn in the property market. Development of Phase I of the project recommenced in 1985. The costs of construction were obtained from the Company's bankers. Phase I was completed in 1987 and, at all relevant times, the units were leased by the Company for earning rental income.

Construction of Phase II commenced in 1987, although significant activity only took place in 1988. After certain negotiations had taken place, in 1989 the construction loan from the bank was refinanced. Specifically, the original loan was extended as a ten-year term loan and an additional facility, also extendible up to ten years, was granted to the Company to complete the construction of Phase II. The occupation permit for Phase II was issued in July 1989.

In March 1989, the Company decided to pre-sell some of the Phase II units in order to repay the bank loan. Sufficient units in Phase II were sold to repay the bank loan in full. The remaining units were leased. The decision to pre-sell the Phase II units in 1989 was made in light of (a) rising interest rates and (b) rising construction costs. Moreover, the Company's parent could not advance any further funds to complete the construction of Phase II. It had other significant projects in hand which required capital.

The Commissioner assessed the Company on the profits arising from the sale of the Phase II units on the basis that it had engaged in a trade or business of property development for sale. On appeal, the Commissioner argued that the Company was simply financially unable to develop the whole of the land for investment purposes on the basis of the financial

resources available to it; that the Company needed to rely on external loans to finance the construction costs; and that its intention was to sell a portion of the developed units to repay the external loans. If this argument was not accepted, the Commissioner argued that the Company had changed its intention in 1988 and embarked upon a trade when it decided to continue the development of Phase II with additional bank financing. At this point in time the Commissioner contended that the Company had made a firm decision to pre-sell certain units and that, indeed, it could not continue the development without resort to selling some of the units.

The Company argued that at the time of acquisition it did not have the intention to sell any part of the developed units and that the land was acquired wholly for investment purposes. The Company also argued that its intention with regard to the land had never changed and that, in any event, continuation of the development to finance the construction costs by way of pre-sales did not in law amount to trading.

Held:

(1) The Company purchased the land to develop the whole site for letting purposes. At the time of purchase the Company had various options to finance the development without resort to selling the developed units. In this regard, particular emphasis should be paid to the prospectus for the rights issue and the fact that, as a result thereof, significant funds became available to the corporate group very soon after the land was acquired by the Company. When this is considered together with (a) the continued financial support from the Company's bankers, which was apparently available to the Company at all relevant times, (b) the fact that the Phase I units were, in accordance with the Company's stated intention, leased at all times and (c) the overall financial position of the corporate group, it could not be said that the Company's claimed intention was simply a wish incapable of fulfillment (All Best Wishes Ltd v CIR [1992] 3 HKTC 750 considered).

The Company's claimed reasons for selling some of the Phase II units were, to a certain degree, corroborated. It was also relevant that virtually all the sales proceeds were used to retire the Company's external debt and to pay the defrayed costs of construction.

Quare On the basis of the above conclusion, it was not necessary to consider whether it was within the concept of trading for a land owner to redevelop property and simply sell sufficient units to repay a bank loan and retain the remainder for rental purposes.

(2) For similar reasons to those set out at (1) above, at all relevant times the Company had various options to finance the construction of the Phase II units without resort to selling some of the units. Accordingly, in 1988 the Company did not change its intention with regard to the Phase II units from investment to trading; to conclude otherwise would be pure speculation.

Per curiam In any event, continuation of the project by the Company in 1988 did not amount to trading even if pre-sales were necessary to finance the costs of construction. The whole project was an integrated development and the construction of Phase II could not b considered as an isolated bare site development (Crawford Realty Ltd v CIR [1991] 3 HKTC 674 distinguished). At all relevant times the Company maintained its original intention of developing the land for the dominant purpose of investment.

Appeal allowed.

Cases referred to:

Simmons v IRC [1980] 53 TC 461
All Best Wishes Ltd v CIR [1992] 3 HKTC 750
D11/80, IRBRD, vol 1, 374
D60/87, IRBRD, vol 3, 24
Iswera v CIR [1965] 1 WLR 663
D65/87, IRBRD, vol 3, 66
Crawford Realty Ltd v CIR [1991] 3 HKTC 674

So Chau Chuen for the Commissioner of Inland Revenue.
J J E Swaine instructed by Messrs Woo Kwan Lee & Lo for the taxpayer.

Decision:

The Company has appealed against the Commissioner's decision to disallow its objection to its profits tax assessments for the years of assessment 1989/90 and 1990/91. The Company claims that a profit of $67,586,514 on the disposal of nine floor units in Phase II of a development at Place X was a capital gain and thus not chargeable to profits tax.

The facts

The following facts were not in dispute.

1. The Company was incorporated in Hong Kong as a private company on 21 August 1963. At all relevant times, the Company's ultimate holding company was Company Y, a listed public company.

2. In its profits tax returns the Company described the nature of its business as 'Property Investment'.

3. In September 1979 the Company sold its premises at Place Z, and purchased land exchange entitlements ('Letters B') of approximately 157,000 square feet in area. The relevant Board minute stated that the Letters B were acquired:

> 'for the purpose of exchange of land with the Government for replenishing the Company's long term investments in land and property development.'

4. In July 1980 the Company applied for and was granted Place X by the Government in consideration of surrendering Letters A/B plus payments of premium by instalments as follows:

	$	$
Cost of Letters A/B surrendered		18,716,321.24
Premium paid by down payment and ten instalments:		
Principal sum	17,242,192.58	
Fixed interest	3,621,536.48	20,863,729.06
		39,580,050.30

After the initial down payment, the instalments were payable by the Company in ten annual amounts of $1,913,950.98. The final instalment was due and payable in July 1989. Under one of the conditions of the Government grant, the Company was required to complete construction of a building on Place X on or before 30 September 1984 at a cost not less than $31,000,000. Failure to observe or comply with any of the conditions of the Government grant would have rendered the land liable to re-entry and re-possession by the Government.

5. In October 1980 the Company resolved to finance the development of a factory building on Place X for an estimated building cost of $68,329,090. After certain revisions, the development involved erecting an integrated building. This comprised Phase I and Phase II with common facilities.

6. The Company incurred the following expenses on the development up to 17 July 1984:

	Year ended 31-12-81	Year ended 31-12-82	Year ended 31-12-83	Year ended 31-12-84

	$	$	$	$
Architect fee	400,000	-	150,000	-
Consultant fee	30,082	-	-	-
Interest on instalment of land (paid to Government)	680,201	618,514	567,428	-
Miscellaneous	87,413	32,317	5,432	-
	1,197,696	650,831	722,860	-
	=======	======	======	===

7. On 17 July 1984 the Company postponed development of Place X and resolved to seek an extension of time for payment of the premium instalment No 5 and for an extension of the building covenant. The relevant Board minute stated:

> 'In view of the continuous depression of demand for industrial premises in Place B where high vacancy of industrial premises [occurred] and lack of indication of recovery, directors deem it proper to refrain further investment and development of [Place X] as tangible return on investment is rather remote.'

The Government subsequently agreed to modify the conditions of grant relating to Place X and to extend the building covenant from 30 September 1984 (fact 4 refers) until 30 June 1985. The building covenant was further extended until 31 December 1986, conditional upon the Company paying a premium to the Government.

8. As at 31 December 1984 the Company had incurred total costs on the development of $38,929,901. The costs had been financed by an interest free advance of $25,060,313 from Company Y and from shareholders funds of $5,795,296. In addition, the Company owed $9,714,627 to Government for the outstanding instalments on the purchase of Place X.

9. The development of Place X recommenced in 1985. The Company's profits tax return for the year of assessment 1985/86 for the year ended 31 December 1985 disclosed an accounting loss of $155,094 and a tax loss of $577,005. The return also disclosed the following relevant particulars:

Rental income (Turnover)	Nil
Additions to the building under construction –	

Architect fee	$1,161,389
Consultant fee	155,616
Interest on instalment loan	900,052
Interest on mortgage loan	14,790
Bank charges	75,304
Miscellaneous payment	340,612
	$2,647,763

Total cost of land and building under development	$41,577,664
Amount due to Company Y	$28,748,460
Outstanding instalments due to Government for Place X	$6,786,775
Bank loan (secured)	$1,564,790
Shareholders funds	$5,704,315

10. As is apparent from fact 9, the development of Place X was initially financed mainly by interest free loans from Company Y. Due to the poor state of the property market and the uncertainty surrounding the future of Hong Kong during the early 1980's the financial position of Company Y was weakened. The Company had to seek external funds to complete the development project. The following figures were disclosed in the accounts of Company Y:

	Current Asset/Liabilities		**Long Term Liabilities**	
As at	**Case & Bank Balance $**	**Bank Loans & Bank Overdraft (Secured) $**	**Bank Loans (Unsecured) $**	**Bank Loans (Secured) $**
31-12-1980	4,080,097	-	-	-
31-12-1985	3,576,597	47,000,000	9,424,636	53,420,800

11. On 4 November 1985 the Company secured a $28,000,000 loan facility from a bank (Company C) to finance the construction costs for the building on Place X. The Company agreed to pay interest on any drawdowns at the current HIBOR rate plus a margin of 1 ¼ %. The Company was initially obliged to repay the loan in a lump sum in November 1987 or three months after the date of issue of the occupation permit for the building whichever occurred first. However, under the provisions of the debenture deed the Company was given an option, which was exercisable during the period of one month prior to the repayment date, to convert the facility into a term loan for an initial period of three years from the repayment date with a further option to extend the loan for an additional three year period. The facility was secured by a building mortgage over Place X and a floating charge over the Company's property and assets.

12. Phase I of the development was completed in early 1987. The occupation permit was issued on 28 March 1987. The floor units in Phase I were let for rental income while construction of Phase II was in progress during the year ended 31 December 1987. The Company's profits tax returns for the years of assessment 1986/87 and 1987/88 for the years ended 31 December 1986 and 1987 disclosed the following relevant particulars:

	1986/87 **$**	**1987/88** **$**
Fixed Asset (Place X)		
As at 1 January	41,577,664	65,683,569
Additions during the year	24,105,905	10,306,048
As at 31 December		
Under development	65,683,569	20,296,315
Completed (Phase I)	-	55,693,302
Shareholders funds	5,644,390	3,170,373
Amount due to Company Y	32,061,077	35,145,520
Accounts payable	2,320,946	6,630,181
Long-term bank loan (secured)	19,879,961	-
Bank loan (secured) – current	2,000,000	26,706,286

Outstanding instalments for land	5,212,163	3,558,821
Proposed dividend	-	3,572,244
Rental income (gross)	-	3,834,140
Other income	371	51,739
Profit (Loss) per Accounts	(59,925)	1,110,411

13. In July 1988 the Company entered into further negotiations with Company C and an arrangement was confirmed on 12 January 1989, by a supplement to the debenture dated 4 November 1985 (fact 11 refers), to refinance the existing $28,000,000 loan as a ten year term loan and to grant additional loan facilities of $72,000,000 as follows:

    (a) The full principal amount of the existing $28,000,000 term loan be repaid by the Company by 40 equal quarterly instalments of $700,000 with the first instalment due on 18 February 1989 – Interest rate HIBOR plus 1%.

    (b) An additional construction facility of up to $50,000,000 to finance further construction costs expended on the development of Place X (irrespective of Phase I or II) – Interest rate HIBOR plus 1%. Repayment by one lump sum on 15 April 1991 or the date falling 3 months after the issue of the occupation permit, whichever is earlier. An option was given to the Company to convert this loan into a 7 ½ year term loan repayable by 29 quarterly instalments of $1,700,000 plus a final instalment of $700,000.

    (c) A $22,000,000 credit facility to finance working capital – Interest rate HIBOR plus 1%.

    The loans were secured by a mortgage over Phase I, a building mortgage over Phase II, the assignment of insurance policies and by a guarantee.

14. The whole property development project on Place X was completed when the occupation permit for Phase II was issued on 18 July 1989. The Company had made a decision on 8 March 1989 to presell some of the Phase II units. The Company advertised all the Phase II units for sale on 13 and 15 March 1989. Nine floor units were sold in March and April 1989 for a total consideration of $104,362,000 resulting in a profit of $67,586,514. The remainder were advertised for rental on 26 June 1989. The relevant Board minute authorising the sale of the Phase II units stated:

> 'The Chairman reported that in despite of the Company's intention in holding [Place X] for long-term rental income, disposal of the Phase II thereof by way of forward sales being deemed necessary in anticipation of the financial circumstance of the Company in repayment of the Construction Loan for the Phase I [construction] (the first of the 40 equal quarterly instalments of $700,000 each due 18 February 1989) and the burden of high interest rates on the construction borrowings for the Phase I and Phase II … of which interest rates are up rising.
>
> RESOLVED THAT … As soon as sales of certain units are made up to proceeds of sales in the region of aggregate [$100,000,000] to service repayments of construction loans and other payables of the Company, all other units remaining unsold thereof should be refrained from selling and be retained as rental property in the fixed assets of the Company as originally [intended].'

15. The sale proceeds of $104,000,000 were appropriated as follows:

	Received by the Company $	**In escrow to solicitors $**	**Total $**
Collection of sales Proceeds of $104,000,000	7,879,500.00	96,482,500.00	104,362,000.00
Interest earned	83,907.03	715,256.21	799,163.24
Transferred	6,299,818.78	(6,299,818.78)	
Cash derived	14,263,225.81	90,897,937.43	105,161,163.24
Application of cash: Repaid Company C loan and overdraft		(81,133,546.91)	(81,133,546.91)
Defrayed construction Costs	(14,263,225.81)	(9,764,390.52)	(24,027,616.33)
Net cash retained	Nil	Nil	Nil

16. The Company's profits tax returns for the years of assessment 1988/89, 1989/90 and 1990/91 for the years ended 31 December 1988, 1989 and 1990 disclosed the following relevant particulars:

	1988/89	**1989/90**	**1990/91**

	$	$	$
Fixed Asset (Place X)			
As at 1 January			
Phase I (completed)	55,693,302	114,000,000	-
Revaluation surplus (1987/88)	24,306,698	-	-
Additions	-	22,299	-
Restated	80,000,000	114,022,299	-
Phase II (under development)	20,296,315	45,874,796	-
Additions	25,578,481	28,480,899	-
	45,874,796	74,355,695	-
Phase I and II (completed)			-
	-	205,000,000	
Additions	-	-	218,394
As at 31 December			
Phase I	55,693,302	-	-
Cost written back	(5,060,614)	-	-
Revaluation surplus	24,306,698	-	-
Revaluation surplus (1988/89)	39,060,614	-	-
	114,000,000	-	-
Phase II (Under development)	45,874,796	-	-
Phase I (completed)	-	114,022,299	-

			205,218,394
Phase II (completed)	-	74,355,695	
Disposals (Phase II)	-	(36,775,486)	-
Revaluation surplus	-	53,397,492	12,781,606
		205,000,000	218,000,000
Shareholders funds [Including Asset Revaluation Reserve	66,507,491 63,367,312	120,143,164 116,764,804	133,083,670 129,546,410]
Amount due to Company Y	49,728,012	1,876,310	61,424,862
Accounts payable	3,147,603	1,996,344	2,011,031
Short-term bank loans	14,800,000	-	-
Long-term bank loans	25,200,000	-	-
Bank overdraft	5,692,280	-	-
Proposed dividend	4,121,820	77,856,600	15,571,320
Taxation	-	-	2,000,000
Rental income	5,824,453	11,983,107	21,249,929
Other income	58,857	806,871	-
Profit per Accounts	3,193,517	10,508,267	17,730,220
Extraordinary profit	-	67,586,514	-
Tax loss claimed (before loss brought forward)	4,412,031	-	-
Assessable Profits returned (before loss set-off)	-	7,560,208	15,194,642

17. After making certain adjustments to the tax losses claimed by the Company for the year of assessment 1988/89, the assessor raised profits tax assessments on the Company for the years of assessment 1989/90 and 1990/91 on the basis that the units sold by the Company in Phase II were trading stock and that the profit of $67,586,514 derived from those sales should be subject to profits tax.

18. The Company objected against the assessments on the grounds that the gain on disposal of units in Phase II of Place X was a capital gain which is exempt from profits tax.

19. In a determination dated 10 November 1994 the Commissioner disallowed the Company's objection to the assessments and concluded that the profits derived from the disposal of the units in Phase II were properly chargeable to profits tax.

20. On 5 December 1994 the Company appealed to the Board of Review against the Commissioner's determination.

Proceedings before the Board

During the course of the Board hearing, one witness, Mr D, gave evidence for the Company and was cross-examined by the Commissioner's representative. We found Mr D to be a competent witness. On the basis of Mr D's testimony and various documents produced by him, we find the following additional facts.

21. At all relevant times, Mr D was a director of the Company and of Company Y. He is the current Chairman of Company Y. Mr D was appointed Managing Director of the Company in November 1980. At all relevant times, he was privy to all major decisions concerning the Company. Mr D became responsible for all critical decisions relating to the Company in 1984.

22. When Place X was acquired in July 1980 the Company envisaged that the finance for the development project was to be provided by Company Y. At this time the Company had no plan to borrow external finance to complete the development. This intention was consistent with the policy of the then Chairman of the Y Group, Mr E, who took the view that the Group should incur minimal external debt.

23. When the Company made the initial plan in October 1980 to develop Place X (fact 5 refers) the estimated floor area of the building to be erected was 450,000 square feet. At that time the Place X development was the Y Group's second largest development project. The Group's largest development project at that time was a container storage centre in Place F. Details of this project are set out at fact 36.

24. In December 1980 Company Y decided to embark upon a rights issue to raise $101,000,000. The prospectus for the issue, which was dated 6 January 1981, stated:

> 'The net proceeds of the Issue, will amount to approximately $99,000,000 and will be applied principally towards financing the estimated construction costs of Phases II and III of the Group's development of a container storage centre in Place F and the construction costs of an industrial site at Place X. … Phase II of [Place F] project is expected to be completed by mid-1981 and Phase III by mid-1982.
>
> The development at [Place X] is planned to provide approximately 450,000 square feet of factory and godown space. The plans for this development are to be submitted to Government in the near future and the Directors expect the project to be completed by the end of 1982. The total outstanding construction cost for these two projects amounts to approximately $115,000,000.'

The issue was successful and nearly fully subscribed.

25. Notwithstanding the initial plan for the development of Place X, the project was held in abeyance until 1985. During the period up to the year ended 31 December 1984 the site was let at a small rent by the Company for open storage. Although some preliminary work on the development commenced in 1985 (architects and consultants were engaged in connection with the redevelopment; fact 9 refers), substantial development did not commence until 1986. Mr D stated that the postponement of the development was due to uncertainty as to Hong Kong's future, a depressed property market (compare fact 7), and fluctuating interest rates which varied widely during this period touching a peak of 20% in October 1981 and reaching 17% in July 1984.

26. Initially the Company did not plan to develop Place X in Phases. But after the Y group's experience with the Place F project (see further, fact 36 below), which involved a vertical development constructed in different stages and which elicited complaints from various tenants, the Company wished to avoid similar problems. It therefore eventually decided to proceed with the development of Place X in Phases.

27. Mr D stated that one reason for seeking external funding from Company C in November 1985 (fact 11 refers) was to minimise further reliance on the Y Group's capital. The decision to borrow $28,000,000 from Company C was made to finance construction of Phase 1 of the development project. Ultimately, the total cost, including interest, of constructing Phase I amounted to approximately $37,000,000

28. The Company intended to repay this loan from Company C out of the rental income derived from Phase I. Although the initial period of the loan was no more than two years, the Company had an option to extend that loan for a further six year period (see further, fact 11) and expected to be able to repay that loan over that extended period. In this regard, although the Company did not embark upon any formal feasibility study at the time of taking out this loan, Mr D was aware of the likely costs of construction and rate of rental return. Once Phase I was completed in the first quarter of 1987, the Company earned approximately $3,800,000 and $5,800,000 rent from letting Phase I during the last three quarters of 1987 and the whole of 1988 respectively.

29. In March 1988 the Company signed the construction contract for Phase II. The estimated cost of constructing Phase II was $49,500,000, excluding interest costs. Mr D was confident at this time that further funding from Company C would be available. Construction of Phase II commenced in late 1987.

30. Prior to obtaining the further loan and finance facilities from Company C for a total amount of $100,000,000 (fact 13 refers), the Company again did not embark upon any formal feasibility study. However, Mr D was aware of the likely costs of construction and rate of rental return (compare fact 28) and in July 1988 Mr D felt confident that the Company would be able to repay the total amount borrowed out of rental income from Phases I and II without resort to selling any of the developed Units.

31. In March 1989 it became apparent to Mr D that the Company would be unable to finance its borrowings from the expected rental income. Mr D's reasons for this conclusion were two-fold:

    (a) The best lending interest rate had risen to 11% (meaning that the Company had to pay 12% to Company C) and it appeared to be on an upward trend. In this regard, interest rates rose periodically throughout 1987 and 1988 and, in light of the exceedingly high rates prevalent in the early 1980's, this became a major concern to Mr D. Although he appreciated that interest rates were trending upwards in 1988, when the loan from Company C was obtained, he did not expect the rates to rise so rapidly; and

    (b) The construction costs of Phase II were rising considerably over budget. Ultimately, these costs were $54,000,000.

32. Also in March 1989 Company Y's financial position was such that it would not consider advancing further funds to the Company to finance the construction of Phase II. Company Y had other projects in hand, not specified by Mr D, which demanded finance.

33. In the circumstances described in facts 31 and 32 the Company decided to presell some of the Phase II units in March 1989. In accordance with the Board resolution of 8 March 1989 (fact 14 refers), the Company stopped selling these units once $100,000,000 had been raised because this was the amount necessary to clear all its external debt to Company C and to complete the construction of Phase II. The sales proceeds were used for this purpose (fact 15 refers). Mr D admitted that, in order to make the development of Place X self-financing, it was not necessary to sell up to this amount because Phase I was yielding a reasonable return on investment. However, he explained that the figure of $100,000,000 was chosen because this represented the total external debts of the Company.

34. At all relevant times after the sales described a fact 33, the Company held the Phase I units and the remainder of the Phase II units for rental purposes.

35. The consolidated accounts of Company Y for the years ended 31 December 1987 and 1988 showed that the took value of its fixed assets was $869,170,000 and $1,600,000,000, the book value of its net assets was $412,200,000 and $1,120,000,000, the long-term liabilities amounted to $36,800,000 and $259,000,000 and the net current liabilities amounted to $427,300,000 and $232,100,000 respectively.

36. In 1980 the Y Group was in the process of developing a container storage centre in Place F. This consisted of a building with a projected total floor area of between 1,200,000 to 1,500,000 square feet. The development was for Group use and investment purposes. Phase I of the development was completed in 1979. In 1980 Company Y had no plan to sell any of the units in this development. The estimated total construction cost for the whole development, excluding finance costs, was between $130,000,000 - $150,000,000. Phase II and Phase III of the development were completed in 1981 and 1985 respectively. The actual cost for the development, including finance costs, was approximately $200,000,000. As at 1980 this was the Group’s biggest development. Mr D stated that the development of the Place F site was financed partly by a rights issue (fact 24 refers), partly by the proceeds of sale of certain long-term projects and partly by external finance. In this latter regard, Mr D admitted that the increase in liabilities incurred by Company Y during the period 1980 to 1985 (fact 10 refers) was due, at least in part, to the Place F project but he could not recall to what extent.

37. In 1981 Company Y acquired a site in Country G on which a commercial complex was eventually built for investment purposes. In 1981 the estimated total cost of construction for this project was between $234,000,000 to $273,000,000. In 1981 Company Y had no intention of selling the redeveloped property, although it ultimately turned out that the project could not be self-financing. Construction costs were at least partly financed by Company Y obtaining long-term building loans on which significant amounts of interest

were paid. The redevelopment was completed around 1985 for an eventual total construction cost of $330,000,000.

38. In 1987 Company Y acquired a site in Place H for the development of a 150,000 square foot residential complex. This project was completed in 1993. Although redeveloped for letting purposes, sales of several of the residences took place in 1992/93. The units sold represented approximately 3% to 4% of the redeveloped property. The proceeds of these sales were used to repay approximately 15% to 20% of the building loan.

39. In response to the assessor's enquiries, the Company stated that as at July 1980 the Y Group had $10,000,000 in ready cash and no external debt. The unconsolidated balance sheet of Company Y as at 31 December 1980 discloses that the Company had net current liabilities of $10,960,000 and net assets with a book value of $237,000,000.

40. From April 1987 to April 1989 the average rental yield obtained by the Company from the lease of the Phase I units increased by approximately 100%.

41. We have had the opportunity of viewing various photos of the building eventually constructed on Place X (see further, fact 4). Apart from the height difference it is not easy to determine from those photos what is Phase I and what is Phase II. It appears that the structure on Place X is one building, notwithstanding that it was constructed in two Phases and that the construction of Phase II started later than Phase I.

The primary issue in dispute

Notwithstanding the complex facts surrounding this appeal, the main issue in dispute between the parties became very clear during the course of argument. In essence, the Commissioner's primary contention was that when the Company acquired Place X its intention was to develop the site into an industrial building partly for resale and partly for letting. What portion was to be sold ultimately depended upon factors such as the construction costs, the interest on the building loans and the selling prices of the units sold. The Commissioner submitted that the Company was simply financially unable to develop the whole of the property for investment purposes on the basis of the financial resources available to it; that the Company needed to rely on external loans to finance the construction costs; and that its intention was to sell a portion of the developed units to repay the external loans.

The Company's response was equally straightforward. It was submitted that this Board could only find for the Commissioner by disregarding all Mr D's evidence, by disregarding the various books of account of the Company and of Company Y placed before us, and by substituting what counsel for the Company, Mr J J E Swaine, described as the Commissioner's 'new theory'. In this regard, Mr Swaine argued rhetorically: why would the Company have acquired the land for the purpose contended by the Commissioner?

According to Mr Swaine, this was neither the Company's intention nor was it consistent with the established reputation of the Y Group. Mr D's evidence that Place X was purchased wholly for investment purposes should, it was argued, be believed.

The law relating to the primary issue

The law relating to the above issue is clear and not in dispute between the parties. To determine whether Place X was a capital asset or a trading asset, the Company's intention at the time of acquisition is crucial. In Simmons v IRC [1980] 53 TC 461, Lord Wilberforce stated at 491-492:

> *'Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment? ... What I think is not possible is for an asset to be both trading stock and permanent investment at the same time, nor to possess an indeterminate status – neither trading stock nor permanent asset.'*

An intention to hold property as a capital investment must be definite and not simply a wish incapable of fulfilment. Moreover, the stated intention of a person is not decisive. Actual intention can only be determined objectively. In All Best Wishes Ltd v CIR [1992] 3 HKTC 750, Mortimer J stated at 771:

> *'It is trite to say that intention can only be judged by considering the whole of the surrounding circumstances, including things said and things done. Things said at the time, before and after, and things done at the time, before and after. Often it is rightly said that actions speak louder than words.'*

Similar comments were made by the Board of Review in D11/80, IRBRD, vol 1, 374 at 379:

> *'Intention connotes an ability to carry it into effect. It is idle to speak of intention if the person so intending did not have the means to bring it about or had made no arrangements or taken any steps to enable such intention to be implemented.'*

The contentions of the parties and our decision on the primary issue

In our discussion above, we have not set out the full and very able arguments of the Commissioner's representative, Mr So Chau-chuen, to support his main submission. Suffice to say that Mr So directly challenged Mr D's testimony as to the events in the early 1980's. In particular, Mr So did challenge Mr D's assertion that the Y Group could develop Place F, Place X and Country G projects without resort to selling the Phase II units. He put to Mr D the proposition, which Mr D denied, that the Group had insufficient funds to implement its stated purpose in relation to Place X.

In support of his argument that, objectively, the Company could not afford to develop the whole of the property for investment purposes with the financial resources available to it, Mr So pointed to facts such as: the Y Group had only $10,000,000 cash as at July 1980 (fact 39 refers), that no real construction work was carried out on Place X until 1986 (fact 25 refers), that in any event the extent of the Phase I construction was scaled down from what was originally envisaged (facts 5 and 12 refer), that one must not look at the Place X project in isolation from the Group's other projects in Place F and in Country G (facts 36 and 37 refer) and that as Place F project was partly financed by external loans (fact 36 refers), it would be impossible for the Place X development to be financed by the Group's internal funds.

In summary, Mr So argued that upon acquisition of Place X the Company could not develop the site wholly for letting; it needed to rely upon external loans to finance the construction costs; external loans were in fact used for this purpose in relation to both Phases of the development; and that the Company's intention was at the outset to sell a portion of the developed units in order to repay the external loans. In Mr So's submission, this was the essence of trading.

As is apparent from our findings of fact, we broadly accept Mr D's evidence that when the Company purchased Place X in July 1980 it was with the desire to develop the whole site for letting purposes. However, this finding does not, of itself, dispose of the primary issue before us. Contrary to part of Mr Swaine's submission, and inherent in Mr So's submission, we must determine *objectively* whether the Company's intention on acquisition of Place X was as Mr D believed it to be or whether it was simply a wish incapable of fulfilment.

In this regard, we make the preliminary observations that the history of the Y Group as disclosed to us, and the negative attitude of its former Chairman, Mr E, to incurring external debt support Mr Swaine's submission that Place X was not purchased for the purpose of selling any of the developed units at a profit. We then remind ourselves of Mr D's evidence that as at July 1980, which is the crucial time for present purposes, the Company had various options to finance the development of Place X without resort to selling the developed units.

One of these options included the sale of other properties held by the Y Group. We are in no position to evaluate this option. It was not developed by Mr D in his evidence and was not elucidated upon by Mr Swaine. However, we conclude that the other options referred to by Mr D, that is, the raising of finance by a rights issue and using internal funds, were sufficiently corroborated.

In December 1980 Company Y did raise approximately $100,000,000 by way of a rights issue. The prospectus published in respect thereof stated:

> 'The net proceeds of the Issue, will amount to approximately $99,000,000 and will be applied principally towards financing the estimated construction costs of Phases II and III of the Group's development of a container storage centre in

> Place F *and the construction costs of an industrial site at Place X.* … Phase II of [Place F] project is expected to be completed by mid-1981 and Phase III by mid-1982.
>
> … The total outstanding construction cost for these two projects amounts to approximately $115,000,000.' (fact 24 refers, emphasis added)

We place particular emphasis upon this document, which was issued by a listed company to the public. Significant penalties can attach to false statement and it is not a category of document to be taken lightly by companies or by their professional advisers.

We appreciate that the ultimate construction costs of both projects appears to be far in excess of that projected in the prospectus (contrast fact 24 with facts 27, 31(b) and 36), that the development of Place X was held in abeyance for several years (fact 25 refers), that the construction of Phases I and II was financed by loans from Company C (facts 11 and 13 refer), and that the proceeds of the rights issue do not appear to be used for the construction of either Phase of the building erected on Place X.

Although we have insufficient evidence before us to comment usefully upon the discrepancies in the projected and ultimate costs of construction, we accept Mr D's evidence as to the reasons for the postponement of the development of Place X (fact 25 refers) and why it became necessary or desirable for the Company to borrow funds from Company C (fact 27 refers). We also accept Mr D's evidence that when the original loan from Company C was obtained to finance the construction of Phase I it was intended that the loan be extended beyond the initial period and that this stage of the development be self-financing (fact 28 refers).

To a certain degree, other facts are available to corroborate Mr D's evidence in this matter: adequate rental yield was derived by the Company from Phase I, at crucial times the Company had the support of its investment banker Company C and, in essence, the original loan of $28,000,000 from Company C was rolled over for a much longer period (fact 13 refers). This leaves us with the fact that some six months after the purchase of Place X, Company Y was able to raise over 80% of the then projected construction cost for both the Place F and Place X projects. We cannot, therefore, dismiss Mr D's claims as a flight of fancy. Mr D admitted that he did not rule out the Company obtaining building mortgage loans to finance construction of the Place X development. Indeed, this was what ultimately happened. But it is a far cry from this to conclude that, at the time of acquisition of Place X in July 1980, the Company *must* have intended to resort to sales of the developed units to finance the costs of construction.

In relation to the final option, that is, the use of Group funds to finance the development of Place X, we appreciate Mr So's argument that we should concentrate on the fact that the Y Group had only $10,000,000 cash as at July 1980. We accept also that, at the time the Company acquired Place X, it was developing the much larger Place F project.

For his part, Mr Swaine agrees that we should examine the financial position of the Y Group as a whole. He argues, rhetorically: should we ignore the fact of the rights issue? should we ignore the fact that the construction of Phase I was financed, albeit with external funding, and then at all relevant times leased in accordance with the Company's stated intention? and should we disregard Mr D's evidence as to postponement of the development in favour of the argument that the Company simply had insufficient funds to commence the development earlier? These arguments found favour with us. Not only do we accept Mr D's evidence as to the reasons why the Company postponed the development of Place X, we cannot ignore the fact that in the year ended 31 December 1980 Company Y had net assets of $237,000,000 and that, when necessary, it also appears to have had the support of its investment bankers.

In this regard, we agree with Mr Swaine that, when considered together with Mr D's evidence and the fact that the Phase I units were let for a reasonable return on investment (fact 33 refers), we should not simply look at the cash position of the Company to determine the financial capability of the Company to accomplish its stated investment purpose in relation to Place X as at July 1980. To do so would, in our view, be inconsistent with our acceptance of Mr D's evidence that the Company did have an investment intention *and* that it had certain options available to implement that intention.

Finally, Mr So argued that the Company's reasons for sale of the Phase II units (fact 31 refers) were not convincing.

In relation to the issue of rising interest rates, Mr D conceded that he was concerned about this matter during the first half of 1988 when the $100,000,000 dollar loan was negotiated with Company C. The continued rise in interest rates was thus not unexpected. However, this admission is not inconsistent with our accepting Mr D's evidence that he became alarmed when the rate hit 12% early in March 1989, particularly in light of the interest rate fluctuations in the early 1980's (fact 31 refers) of which Mr D was particularly aware. Mr So also argued that the increase in interest rates from 10% in July 1988 to 12% in March 1989 was hardly extraordinary and was more than matched by the increase in yield derived by the Company from letting the Phase I units. Mr So buttressed his argument by noting that, in any event, it was not necessary for the Company to sell so many units in Phase II if the aim of the Company was to put the whole development onto a self-financing state. That may well be. But the facts before us are that the percentage increase in interest rates over this period amounted to 20%, a not insignificant rise; relatively recent experience indicated that major fluctuations of interest rates should not be discounted; and the proceeds of sale were used for the claimed purpose of retiring all of the Company's external debt (fact 15 refers). It would be wrong for us to judge this matter with the benefit of hindsight and to second guess what we regard as a considered commercial decision of the Company.

In relation to the issue of the Company being concerned about the possible overrun of the budgeted construction costs, Mr So is on stronger ground. When the decision was made by the Company to sell the Phase II units in March 1989 it appears that construction of this Phase was well under way: it started in late 1987 and the occupation

permit was issued in July 1989 (fact 14 refers). It should follow that the Company should be reasonably aware of the likely costs, which ultimately amounted to $54,000,000 (fact 31(b) refers), an amount not greatly in excess of the budgeted costs of $49,500,000 (fact 29 refers). Notwithstanding this inference, it is again relevant to reiterate that the costs *did* exceed the budget and that the sale proceeds *were* used wholly to retire all of the Company's external debt and to pay defrayed construction costs (fact 15 refers). We are not therefore prepared to find that the overrun of costs was irrelevant to the Company's decision to sell the Phase II units.

To conclude, as the Commissioner wishes us to do, that Mr D's evidence as to the intention of the Company was mere wishful thinking, is, on the facts we have found, simply not open to us. In short, we accept that in July 1980 the Company had various options to obtain sufficient funds to finance the development without resort to selling part of the developed units in Phase II. On the basis of our findings of facts and on the basis that this appeal was argued before us, it must follow that we accept that when the Company acquired Place X it purchased a capital asset with the intention of developing the whole site for rental purposes.

Even if we doubted our analysis set out above (which we do not), and we were inclined to find that the Company had insufficient funds to finance the development and always intended to resort to selling the units in Phase II to finance the development, Mr Swaine had at least two other weapons in his argument armoury. He contended, on the basis of Simmons v IRC [1980] 53 TC 461 per Lord Wilberforce at 491-492 (quoted above) and at 493-494 that the Commissioner's arguments must be rejected because assets cannot have an indeterminate status – and as at July 1980 the Commissioner simply cannot point to what is trading stock and what is not. In Mr Swaine's words, the Commissioner's argument had a 'metaphysical quality' given that ultimately the Company decided, some nine years after acquisition, to sell sufficient units in Phase II (which was not even contemplated in July 1980) to repay the total amount of the Company's external debt.

Then, putting the argument at an even higher level, Mr Swaine contended that even if we accepted the Commissioner's primary argument, we should in light of cases such as D60/87, IRBRD, vol 3, 24 at 30, hold that it is not within the concept of trading for a land owner to redevelop property, sell sufficient units to repay a bank loan and retain the remainder for rental purposes. In this regard, Mr Swaine drew our attention to the following passage in All Best Wishes Ltd v CIR [1992] 3 HKTC 750, where Mortimer J stated at 771, albeit by way of *obiter dicta*:

> *'[It is self evident] also that the redevelopment of property is not per se, or necessarily, an adventure in the nature of trade. This is so even if the intention is to sell part to cover the development costs provided that the remainder is for investment.'*

Mr So countered this argument by referring to the Privy Council decision in Iswera v CIR [1965] 1 WLR 663, where Lord Reid stated at 667-668:

> *'No doubt [the taxpayer] acquired the part of the site which she retained as a capital investment, but in order to acquire it she had to buy, divide, and immediately resell the rest of the site. ... If, in order to get what he wants, the taxpayer has to embark on an adventure which has all the characteristics of trading, his purpose or object alone cannot prevail over what he in fact does.'*

In the event, it is not necessary for us to determine these interesting issues because our findings of fact and decision are that the Company acquired Place X as a capital asset to be used wholly for rental purposes. We appreciate that the Commissioner was successful in the All Best Wishes case but, unlike the appeal before us, the Board of Review found on the evidence that from the very outset the appellant intended to embark upon a scheme of sales and that the appellant's desire to keep some units amounted to no more than a contingent hope. We would make a similar observation in relation to Iswera's case where, unlike the appeal before us, the fact finding tribunal held that the appellant's dominant motive was to make a profit (see [1965] 3 WLR 663 at 667F-H and 668C). In the present appeal we have made no such findings.

The alternative argument of the Commissioner

As we have rejected the Commissioner's primary submission, we must consider his alternative contention, that is, that the Company changed its intention from investment to trading on 28 July 1988, the date by which the Company had made a firm decision to build Phase II with a building loan (see also fact 13). Mr So submitted that at this time the Company had no intention to keep *all* the Phase II units; rather, the Company intended to sell sufficient units to repay all its building loans and to keep the remainder for letting. In essence, Mr So contended that the Y Group had insufficient internal funds to build Phase II without recourse to sales of the developed units. In this regard, Mr So noted that as at 31 December 1987 the consolidated accounts of Company Y disclose net current liabilities of $427,300,000 and long-term liabilities of $36,800,000 (fact 35 refers). Mr So also reiterated that Mr D's evidence as to reasons for sale of the units was unconvincing and should be rejected by us.

We reject these contentions on similar grounds to those set out above in relation to the Commissioner's primary submission. To reiterate, in view of our acceptance of Mr D's evidence that even by 1988 various options were available for the Company to finance the development, it would be pure speculation on our part to conclude that the Y Group could not finance the construction of Phase II without resort to selling some of the developed units. This acceptance is supported by the same accounts relied upon by Mr So. We are not prepared to simply focus upon the extent of the Y Group's liabilities as at 31 December 1987 (or at any other time) when those accounts disclose that the book value of its fixed assets and net assets was $869,170,000 and $412,200,000 respectively. Moreover, as indicated above, we substantially accept Mr D's evidence as to the reasons for the decision to sell the units in March 1989.

Finally, we agree with Mr Swaine who argued that although the date of the alleged change of intention appears precise, it does not sit well with Mr D's unchallenged

evidence that the construction contract was signed in March 1988 (fact 29 refers). Why the Commissioner did not pick this time for founding the change of intention argument is unclear to us. However, speculation does not advance matters in this case. It is our conclusion that the Company continued to develop Phase II throughout 1988 for the purpose of letting and only decided to sell certain of the Phase II units in March 1989. This does not amount to a change of intention in the sense that this concept has been explained in cases such as Simmons v IRC.

Even if we were wrong in our analysis, and the Commissioner were correct, we would conclude that in continuing the development on 28 July 1988 the Company was simply enhancing the value of its capital asset (compare D65/87, IRBRD, vol 3, 66). In reaching this conclusion, we would distinguish the later case of Crawford Realty Ltd v CIR [1991] 3 HKTC 674, where Barnett J stated at 693:

> *'Enhancement of an asset, making it as attractive and saleable as reasonable expenditure of time and money can achieve, is one thing. The end product remains substantially the same. Substitution, however, is another matter.'*

Unlike the facts in Crawford Realty, the construction of Phase II was not a bare site development. In our view the building erected on Place X was an integrated building, albeit that it was developed in two stages with Phase II construction commencing after the completion of Phase I construction (see also fact 41). Accordingly, we would conclude that, even assuming a decision to sell on 28 July 1988, this decision was made during the course of an ongoing development of an established capital asset. Continuing with the construction of Phase II did not turn Place X from a bare site into a new industrial building; nor did the Company thereby embark upon a trade; rather, the Company maintained its original intention of developing the site for the dominant purpose of investment.

Conclusion

For all the above reasons, we conclude that the profits from the sale of the Phase II units in Place X are capital gains. The appeal is therefore allowed.