Case No. D142/00

Profits tax – acquisition and proposed development of real property by 50:50 joint venture between two groups of companies – transfer of 50% shareholding in joint venture vehicle of offshore company acquired by one joint venture partner – sale of offshore company to subsidiary of other group within short period of time – whether transfer of offshore company an adventure in the nature of trade – intention at time of purchase – whether profit earned – Sharkey v Wernher principle – sections 14 and 68(4) of the Inland Revenue Ordinance (' IRO').

Panel: Mathew Ho Chi Ming (chairman), Aarif Tyebjee Barma and Douglas C Oxley.

Dates of hearing: 9 and 10 November 1999.
Date of decision: 13 March 2001.

In 1986, two groups of companies (Groups B and D) decided to form a joint venture to purchase and redevelop several plots of land (' the Site'). Company G was nominated by both Groups as the joint venture corporate vehicle to complete the purchase of and then own the Site. Each Group held 50% of Company G' s two wholly issued shares. The taxpayer was the Hong Kong subsidiary of Company B, which formed part of Group B. The taxpayer, at the material time, held 50% of Company G through a company called Company H which took over one of Company G' s issued shares.

Seven months after completion, Group D obtained 100% of the beneficial interest in the Site by acquiring Group B' s 50% beneficial interest. The mechanism by which this was done was as follows:

(a) A foreign shell company (' Company J') was acquired by the taxpayer for US$1, being the par value of the only issued share and used in the transfer of the interest (' J share').

(b) Group B transferred its 50% interest in Company G into Company J.

(c) The taxpayer then sold Company J to Company C, a subsidiary of Group D for $141,352,731, being the net market value of the 50% interest in the Site.

The Board focused on the transfer of the J share from the taxpayer to Company C and as to whether the net surplus of HK$137,576,471 for the year of assessment 1988/89 created by the transfer mechanism was taxable.

The taxpayer argued that:

(a) The taxpayer, in law, did not trade the J share (first issue).

(b) Even if there was trading, no profit was earned since the increase in the value of Company J (upon transfer of the shares) had to be deducted in order to compute the taxable profit, following Sharkey v Wernher (1956) AC 58 (second issue).

(c) Alternatively, the value of the 'gift' to Company J, which increased the value of Company J, was the same consideration paid for the transfer of the J share. Hence, there was no profit. Similarly, when the J share was sold, there was no profit (third issue).

(d) The transfer mechanism was engaged in order to avoid stamp duty only.

The Revenue argued that the purchase and sale of the J share, rather than the underlying assets, must be looked at. Further, such revealed that:

(a) It was an adventure and concern in the nature of trade.

(b) The J share was acquired at US$1 with the intention of reselling it.

(c) There was no change of intention between the acquisition of Company J and its sale.

(d) Sharkey v Wernher was not applicable in Hong Kong in light of CIR v Quitsubdue (1999) 3 HKC 233.

The following legal principles were put forward:

(a) It was for the taxpayer to prove that the acquisition of the properties was not in the adventure of a trade. A bare assertion was not decisive and must be viewed in the light of the conduct of the parties (Lionel Simmons Properties Ltd (in liquidation) v CIR 35 TC 461 and All Best Wishes Limited v CIR 3 HKTC 750).

(b) There are certain features or badges of trade which might indicate whether there has been an adventure in the nature of a trade (Marson v Morton (1986) 1 WLR 1348).

(c) The onus of proof was on the appellant under section 68(4) of the IRO.

Held:

1. first issue

   (a) Company J was acquired and used by Group B with the intention, at the time of acquisition, to dispose of it to Company C.

   (b) The said acquisition and sale of Company J was trade under section 14 of the IRO, after considering the various badges of trade/indicia and all the facts of the case. Any surplus realised was subject to profits tax.

2. second issue

   (a) As to whether there was any taxable profit from the trade, the Sharkey v Wernher principle had only been applied by the Revenue in the past in ‘change of intention’ situations, but none existed in this case.

   (b) If this appeal were to succeed, Sharkey v Wernher would have to be applied in the reverse, but there was no legal basis to apply it in this way. Sharkey v Wernher did not apply in the present case or generally: CIR v Quitsubdue (1999) 3 HKC 233 applied.

3. third issue

   Although the taxpayer argued that Sharkey v Wernher was not necessary in order for the alternative view to succeed, it was found to be so necessary. Since it was in any event not applicable in Hong Kong (CIR v Quitsubdue, supra), this alternative view failed: D12/80, IRBRD, vol 1, 380 and D49/92, IRBRD, vol 8, 1 considered.

Appeal dismissed.

Cases referred to:

Marson v Morton (1986) 1 WLR 1348
Lionel Simmons Properties Ltd v CIR (1980) 35 TC 461
All Best Wishes Ltd v CIR (1992) 3 HKTC 750
Sharkey v Wernher (1956) AC 58
CIR v Quitsubdue Ltd (1999) 3 HKC 233
IRC v Livingston (1926) 11 TC 538

CIR v Reinhold (1953) 34 TC 389
Beautiland Co Ltd v CIR (1991) 2 HKLR 511
D36/89, IRBRD, vol 4, 394
D52/94, IRBRD, vol 9, 292
D74/91, IRBRD, vol 7, 16
D30/87, IRBRD, vol 3, 176
EBM Co Ltd v Dominion Bank (1937) 3 AER 555
CIR v Quitsubdue Ltd (1999) 2 HKLR 481
Petrotim Securities Ltd v Ayers (1963) 41 TC 389
Ridge Securities Ltd v IRC (1964) 44 TC 373
Dublin Corporation v M' Adam 2 TC 378
D41/91, IRBRD, vol 6, 211
Bath and West Counties Property Trust Ltd v Thomas (1977) 52 TC 20
D26/84, IRBRD, vol 2, 139
D35/96, IRBRD, vol 11, 504
The Birmingham & District Cattle By-Products Co Ltd (1919) 12 TC 92
D12/80, IRBRD, vol 1, 380
D49/92, IRBRD, vol 8, 1
Wing Tai Development Co Ltd v CIR (1979) 1 HKTC 1115
BR 2/77, IRBRD, vol 1, 263

David Milne QC instructed by Department of Justice for the Commissioner of Inland Revenue.
John Gardiner QC instructed by Messrs Woo Kwan Lee & Lo for the taxpayer.

Decision:

Nature of appeal

1. This appeal concerns the profits tax assessment raised on Company A ('the Taxpayer') for the year of assessment 1988/89. This assessment was confirmed by the Commissioner of Inland Revenue in his determination on 19 November 1998 ('the Determination'). The Taxpayer now appeals against this Determination.

Background facts

2. The basic facts are uncontroversial. The parties have reached an agreement on the facts and a statement of agreed facts dated 7 July 1999 was submitted to this Board. The agreed facts in the statement of agreed facts constitute part of our findings of fact.

3. The Taxpayer was the Hong Kong subsidiary of Company B, a Hong Kong listed

company (its group of companies including the Taxpayer is hereinafter referred to as the 'B Group'). It was not disputed that those controlling the Taxpayer and the parent company are the same.

4. Company C was a subsidiary of another Hong Kong listed company called Company D. Company D and its group of companies including Company C are hereinafter referred to as the 'D Group'. Initially Company C was owned by another company called Company D Overseas, Company C was injected into the D Group which was the subject of a successful takeover bid by Company D Overseas in Company E (renamed later to Company D). The parties have proceeded with this appeal on the basis that this change has no relevance to this appeal. This decision is made on the same basis.

5. In 1986, the B and D Groups decided to go into a joint venture in the redevelopment of several plots of land in District F. Between 3 and 4 December 1986, the Taxpayer together with Company C purchased four pieces of land in District F as tenants in common in equal shares through two formal agreements to purchase. (Although the parties intended to purchase more, as evident in the JV Agreement referred to below, it appeared that no further land was added to the Site.) The four pieces of properties purchased are herein referred to as the 'Site'. Completion of both agreements to purchase was to take place two months later on 2 February 1987.

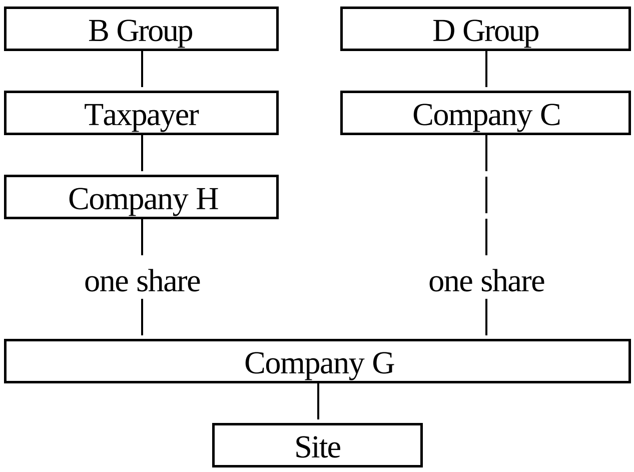
6. Prior to completion, the B and D Groups nominated another company, Company G, to complete the purchase of the Site. Company G was to be the joint venture corporate vehicle to own the Site. On 28 January 1987, the Taxpayer and Company C jointly declared to the vendors of the Site of the vesting of their interest in the Site to Company G and authorizing the vendors to assign the Site to Company G. Company G was a shell company taken over by the two groups on 26 January 1987 for the purpose of taking up the Site. At that time, it was 50-50 owned by the two groups in the following manner:

a. by the Taxpayer through a company called Company H which took over one of Company G's two wholly issued shares; and

b. by the D Group through Company C which took over the other (and balance of) Company G's wholly issued shares.

7. Also on 28 January, Company C, Company H, Company G, the Taxpayer, Company D and a D Group company called Company I ('Project Manager') entered into a joint venture agreement ('JV Agreement') to redevelop the Site with the Project Manager acting as the project manager of the redevelopment.

8. Completion of the purchase took place on 2 February 1987. The simplified corporate structure at the time of completion of the purchase of the Site was as follows:



9. About seven months after completion, through a rather convoluted mechanism (which we shall refer to as ‘the Transfer Mechanism’), the D Group took over 100% of the beneficial interest in the Site by acquiring the 50% beneficial interest of the B Group in the Site. The Transfer Mechanism involved using a newly acquired foreign shell company called Company J. Company J had only one issued share of US$1 (‘J Share’) which was acquired by the Taxpayer on 8 September 1987. Two days thereafter, on 10 September 1987, three events occurred as part of the Transfer Mechanism:

a. Company H’s 50% shareholding in Company G was significantly diluted when Company G allotted 9,998 new shares at their par values ($1) to Company J and Company C equally (4,999 shares to Company J, which represented 49.99% of Company G’s issued shares, and 4,999 shares to Company C).

b. The single share in Company G held by Company H (representing Company H’s 50% in Company G before the allotment of new issued share capital of Company G and 0.01% after the said allotment) was transferred at par value ($1) to Company J. Combined with the allotment of new shares just mentioned, this meant that Company J would hold 5,000 shares in Company G representing 50% of Company G’s total issued shares.

c. The Taxpayer, Company C and Company D entered into an agreement (‘the Disposal Agreement’) whereby the J Share (constituting its entire issued share capital) was to be sold to Company C with an assignment of shareholders' loan for a consideration of $208,500,000. Out of this total consideration, $141,352,731 was attributed to the J Share and $67,147,269 was attributed to the assignment of Company H's shareholder loan (of the same amount) to Company J.

10. The Disposal Agreement provided linkages to the two other events in the Transfer Mechanism (mentioned in sub-paragraphs a and b of the preceding paragraph):

a. Completion of the Disposal Agreement was conditional upon sub-paragraph b above and upon the consent of Bank K who was financing the purchase and redevelopment of the Site.

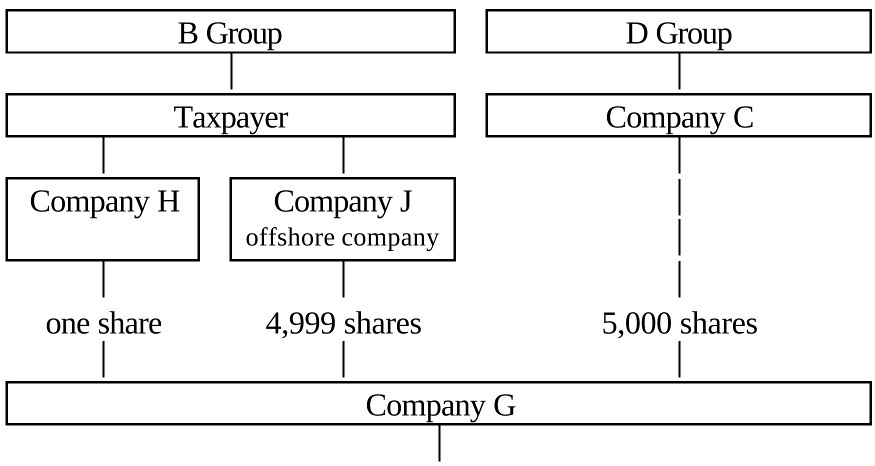
b. The Taxpayer as vendor of the J Share warranted (inter alia) that Company J had no assets and liabilities other than 5,000 shares in Company G mentioned in sub-paragraph a above.

One further housekeeping matter was attended to in the Disposal Agreement. The parties to the Disposal Agreement agreed to the release of obligations under the JV Agreement, effectively canceling the JV Agreement and the joint venture in the Site.

Completion of the Disposal Agreement took place on 1 March 1988 as scheduled.

11. The necessary board resolutions of Company G, the Taxpayer and Company J to authorize the implementation of the Transfer Mechanism were dated one day prior to the occurrence of these events, that is, 9 September 1987.

12. The simplified corporate structure immediately prior to the transfer of (a) Company H's one share in Company G to Company J and (b) the Taxpayer's entire interest in Company J to Company C is set out as follows:



Site

13. To look at the Transfer Mechanism from a simpler perspective, what had occurred was the creation of an offshore company (Company J) into which the bulk of B Group's 50% shareholding in Company G (and therefore indirectly 50% of the Site) was injected or transferred by way of the allotment of new Company G shares. Then the almost insignificant one share in Company G still held by Company H was transferred to Company J making Company J holder of the entire 50% of Company G. And then the Taxpayer at the same time sold Company J to Company C. On completion of this sale, the net result was, in laymen's terms, transfer of 50% of the Site to the D Group rendering the D Group (through Company C and Company G) 100% beneficial owner of the Site.

The issue

14. The crucial transfer element in the Transfer Mechanism was the transfer of J Share from the Taxpayer to Company C. This was the transfer that rendered the D Group 100% owner of Company J, 100% indirect owner of Company G and 100% indirect beneficial owner of the Site. The transfer was legally structured as a sale at a consideration of $141,352,731 for the J Share. After deducting agreed expenses, the surplus that the Taxpayer realized from the sale of the J Share was $137,576,471 which was agreed between the parties and particularized as follows:

		$	$
Contract selling price		141,352,731	
<u>Add</u>	price adjustments (interest over prov.)	425,000	
	Actual selling price:		141,777,731
<u>Less</u>	Purchase price	7.80	
	Commission to Company L	1,110,000.00	
	Commission to Company M	2,850,000.00	
	Legal fees	236,259.00	
	Miscellaneous	4,993.20	4,201,260
	Net surplus:		137,576,471

The issue to be decided in this appeal is whether the net surplus of $137,576,471 created by the Transfer Mechanism is taxable.

The law

15. Section 14(1) of the IRO, the charging section for profits tax, reads as follows:

'*Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person* *carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.*'

16. Section 2(1) of the IRO defines 'trade' to '*include every trade and manufacture, and every adventure and concern in the nature of trade*'. In Marson v Morton (1986) 1 WLR 1348, Sir Nicholas Browne-Wilkinson V-C said (at page 1348 of the report):

> '*It is clear that the question whether or not there has been adventure in the nature of trade depends on all the facts and circumstances of each particular case and depends on the interaction between the various factors that are present in any given case. The most that I have been able to detect from the reading of the authorities is that there are certain features or badges which may point to one conclusion rather than another.*'

17. The learned Judge then went on to list out (at pages 1348 to 1349 of the report) some of these features or badges, which, as he carefully pointed out, were by no means exhaustive:

a. Whether the transaction was a one-off transaction?

b. Was the transaction related to the trade which the taxpayer otherwise carries on?

c. What is the nature of the subject matter?

d. What was the way in which the transaction was carried out?

e. What was the source of finance of the transaction?

f. Was work done to the item purchased before it was resold?

g. Was the item resold in one lot or broken down into saleable lots?

h. What were the purchasers' intentions at the time of purchase? and

i. Did the item provide enjoyment for the purchasers?

18. We were asked by the Taxpayer to consider the six badges of trade suggested by the 1955 Final Report of the English Royal Commission on the Taxation of Profits and Income which were:

a. The subject matter of the realization.

b. The length of the period of ownership.

c. The frequency or number of similar transactions by the same person.

d. Supplementary work on or in connection with the property realized.

e. The circumstances responsible for the realization.

f. Motive.

19. The proper approach in deciding on whether trading existed in a given transaction bearing in mind the possibility of changes of intention is found in Lionel Simmons Properties Ltd v CIR (1980) 35 TC 461, HL where Lord Wilberforce said (at page 491):

> ‘ *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? Often it is necessary to ask further questions: a permanent investment may be sold in order to acquire another investment thought to be more satisfactory; that does not involve an operation of trade, whether the first investment is sold at a profit or at a loss. Intentions may be changed. What was first an investment may be put into the trading stock - and, I suppose, vice versa. If findings of this kind are to be made precision is required, since a shift of an asset from one category to another will involve changes in the company's accounts, and possibly, a liability to Tax (cf. Sharkey v. Wernher [1956] A.C. 58). 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. It must be one or other, even though, and this seems to me legitimate and intelligible, the company, in whatever character it acquires the asset, may reserve an intention to change its character. To do so would, in fact, amount to little more than making explicit what is necessarily implicit in all commercial operations, namely that situations are open to review.’*

20. In Hong Kong the same approach is found in All Best Wishes Ltd v CIR (1992) 3 HKTC 750, where Mortimer J summed up the position (at page 771) as follows:

> ‘ *This is a decision of fact and the fact to be decided is defined by the Statute - was this an adventure and concern in the nature of trade? The intention of the taxpayer, at the time of acquisition, and at the time when he is*

holding the asset is undoubtedly of very great weight. And if the intention is on the evidence, genuinely held, realistic and realizable, and if all the circumstances show that at the time of the acquisition of the asset, the taxpayer was investing in it, then I agree. But as it is a question of fact, no single test can produce the answer. In particular, the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of the evidence. Indeed, decisions upon a person's intention are commonplace in the law. It is probably the most litigated issue of all. 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.'

21. Finally, we remind ourselves that section 68(4) of the IRO puts the onus of proof on the Taxpayer as follows: '*The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.'*

Parties' submissions

22. At the risk of over simplification and doing grave injustice to the well thought-out and clearly presented submissions from leading counsel of both parties, we set out their arguments in simplified form.

a. The Taxpayer's submission is divided into two areas (or two issues as put to us by the Taxpayer):

i. The Taxpayer did not, in law, trade in the J Share. Nor was the purchase and sale of the J Share an adventure and concern in the nature of trade.

ii. Even if there was trading, no profit was earned because the increase in the value of Company J (through the allotment of new Company G shares and transfer of one subscriber share of Company G to Company J) should be deducted in computing the taxable profit. The second part of Taxpayer's submission relied on <u>Sharkey v Wernher</u> (1956) AC 58. The Taxpayer argued that this case established the principle that the existing value of an investment has to be deducted in computing any taxable trading profit. This part of the argument was presented in two alternative forms:

(1) There should be deducted from the assessable profit (earned in the disposal of Company J) the value of the 'gift' (of the 50%

shareholding in Company G) given to Company J which substantially increased Company J's value. The value of this gift was exactly the consideration paid for the transfer of the J Share. Hence there was no profit.

(2) The J Share was incapable of being traded or sold until it was made valuable by, essentially, the injection of the new Company G share allotments. The 'trade' could not have commenced until Company J held the 50% in Company G and, at this point, the market value of Company J should be increased (reflecting the addition of the Company G shares to Company J's asset). Therefore at the time Company J became tradable, its increased value (the consideration paid for the transfer of the J Share) must be the starting point in the calculation of assessable profits. When the J Share was sold at that consideration, there was no profit.

b. The Revenue's case was to look at the purchase and sale of the J Share and not its underlying assets. It was an adventure and concern in the nature of trade by virtue of the definition of 'trade' in section 2(1) of the IRO. The J Share was acquired at US$1 with the intention of reselling. And it was sold at a substantial profit. There was no unexpected change of circumstances and no change of intention between the acquisition of Company J and its sale. Hence, argued the Revenue, the net surplus realized on the sale of the J Share is taxable under section 14(1) of the IRO. <u>Sharkey & Wernher</u> was incapable of being applied in Hong Kong as decided in <u>CIR v Quitsubdue Ltd</u> (1999) 3 HKC 233. And even if applied, <u>Sharkey & Wernher</u> applied only when trading stock is appropriated by a trader for the trader's own purpose since a person cannot trade with himself/herself.

The Revenue was also careful to refute the principal pre-Determination argument put forward by Company N, the tax representative for the Taxpayer. In their correspondence with the Revenue, the Taxpayer asked the Revenue to look at the underlying transaction which was the transfer of 50% of the Site. According to Company N, the Taxpayer entered into the joint venture redevelopment of the Site with the D Group with long term investment intentions. The sale of its 50% beneficial ownership of the Site through the complex transactions was, in essence, the sale of a capital asset and hence not taxable. The Revenue stated that it was not the Revenue's case to strip away the corporate veil and look at the underlying transactions. But if the underlying transaction were examined, the Revenue argued that there was an intention to sell the redeveloped Site which was a clear trading intent.

Disputed factual areas

23. The appeal is to be decided more on a matter of the law than on facts. Certain disputed facts relating to intention must be first decided as a matter of finding of fact on the evidence presented to us. Some of our findings may not be relevant when we consider the issues as a matter of law rather than as a matter of fact (for example, whether the Site was to be sold or held long-term after redevelopment).

24. The disputed facts were minimal. The disputed areas related mainly to the intention of the B Group towards the Site and whether the Taxpayer had a share trading history.

Evidence and findings on disputed areas

(a) **The evidence and the Taxpayer's witness**

25. The present chairman and managing director of the Taxpayer Mr O appeared and gave oral testimony at the hearing of the appeal. His statement dated 9 September 1999 was tendered as evidence in chief. His cross-examination was brief but to the point. There were the agreed facts which we do not repeat here. There were also various documents that were referred to us during the appeal and other documents not referred to but contained in the agreed bundle of documents.

26. There is some hesitation on our part on the level of Mr O's involvement and the depth of his personal knowledge in this matter. In a letter from the tax representative of the Taxpayer, Company N, to the Revenue dated 14 August 1998 (complaining about the long time that span the disposal of the subject matter of this appeal and the tax investigations on this matter), Company N stated that the former chairman, Mr P and Mr Q (who appeared in various board minutes) were actively involved in the Taxpayer's business affairs and in particular the transactions under appeal and that they had since passed away in 1997 and 1994 respectively. No mention was made of Mr O in this letter. This does not necessarily mean Mr O had no personal knowledge. Mr O mentioned in his statement that he arrived in Hong Kong in or about November 1986 to take over the management and operation of the B Group and, since his arrival, had been actively involved in the B Group's activities including that of the Taxpayer. Mr O's arrival was only about one month prior to the commencement of the acquisition of the Site and close to a year to the disposal of Company J (and with it, Company G and the Site).

27. Except for this hesitation, we are prepared to accept generally, but not uncategorically, the testimony of Mr O on the facts. We take the view that certain parts of his testimony were not entirely accurate which, when viewed accurately, puts on a different complexion.

(b) **What the annual reports and accounts said**

28. The annual reports and financial statements of Company B and the Taxpayer give us some contemporaneous records and chronology of the history of the joint venture and the Site. Except for the purpose of using Company J in the Transfer Mechanism, these records accord generally with Mr O's testimony.

29. The principal activities stated in the directors' report of the 1986 and 1987 financial statements of the Taxpayer were 'the business of property investment, property management and investment holdings.' In the directors' report of the 1988 financial statements 'share investment and share dealings' was added to the list of principal activities. The payment of the deposit by the Taxpayer for the Site was recorded in note 7 of the notes to accounts of the 1986 financial statements. Company J, Company H and Company G were not mentioned in the 1986 financial statements since the Taxpayer had not yet, at the time, owned them.

30. In note 4 of the notes to accounts of the 1987 financial statements of the Taxpayer (titled unlisted investments), Company H and Company J are found as wholly owned subsidiaries with the principal activity of 'investment holding'. After completion of the sale of Company J having taken place on 1 March 1988, only Company H remained in note 4 of the notes to accounts of the 1988 financial statements.

31. The 1986-7 annual reports of Company B stated that Company B 'carry on the business of investment holding and property investment. Its subsidiaries continued to carry on the business of property investment and property development.' In the notes to the financial statements of both annual reports and that of the 1988 annual report, the Taxpayer was listed as a Hong Kong wholly owned subsidiary with the principal activities of 'property development and investment'.

32. In the chairman's business review of the 1986 annual report of Company B, Mr P, the then chairman, stated that 'The Group entered into a 50:50 joint venture with the D Overseas Group to acquire the (Site) with a total site area of…. It is planned for a redevelopment of commercial/residential complex of some 400,000 square feet. The anticipated completion date is around 1990.'

33. In the following year's (1987) chairman's business review of Company B, it was stated that 'As already announced in September 1987, a major sale of the Group's investment was its 50% equity interest in the development project at (the Site) for a total consideration of $209,000,000. The sale is completed today (1 March 1988), which will result in an extraordinary profit of approximately $130,000,000 to the Group…'.

34. Note 16 of the notes to accounts of the 1987 annual report of Company B (titled subsequent event) stated 'The Group sold for $208,900,000 a wholly owned subsidiary which had a 50% equity interest in the (Site).' The name of the subsidiary was not identified and could have been either (a) Company J (found in note 7 of the same notes to accounts, titled subsidiaries,

stated as a wholly owned subsidiary with the principal activity of 'investment holding') or (b) Company G (found in note 8(d), titled long term investment, stated as a 50% held unlisted Hong Kong company with the principal activities of 'property development and investment').

35. In the chairman's business review of the 1988 annual report of Company B, it was stated that 'Sales of the 50% interest in the (Site) and the Building R were both completed in the first half year, contributing approximately $182,000,000 to the profit for the year. This was previously announced in our interim report as extraordinary profits, but has now been re-classified as exceptional items in accordance with standard accounting practice.' Out of the $182,000,000 profit so stated, it can be seen (from note 3 of the notes to accounts) that $137,588,743 was attributed to the surplus on sale of an overseas subsidiary (the balance $44,700,000 odd being surplus on realization of properties). Further, the directors' report of the same (1988) annual report stated the sale of an overseas subsidiary for $208,925,000 which contributed $137,588,743 to the operating profits of the B Group. Tax provision was made in the 1988 accounts in the sum of $23,390,000 for the surplus on the sale of an overseas subsidiary. Although there is no direct evidence, there is no doubt that the overseas subsidiary was Company J.

36. Note 4(b) of the notes to accounts in the 1988 annual report of Company B was titled exceptional items of the group and stated that 'the surplus on sale of an overseas subsidiary is not subject to Hong Kong profits tax but, as a matter of prudence, a tax provision of 17% on the surplus amounting to $23,390,000 has been made.' $23,390,000 was 17% of the $137,588,743 operating profit contributed by the sale of the overseas subsidiary.

(c) **Break-up of joint venture**

37. The view expressed in note 4(b) of the notes to accounts in the 1988 annual report was a gross simplification of the law. While Hong Kong's tax regime is source based and while it can be very generally stated that sale of offshore assets are not taxable, that view would be inaccurate when subjected to scrutiny. However inaccurate note 4(b) was, it reflected a certain thinking in the B Group which led us to believe that perhaps the directors and their advisors thought of using Company J, as an offshore company, in a tax scheme where its sale proceeds would not come under Hong Kong's tax umbrella.

38. Mr O's testimony on the breakup and the origination of the Transfer Mechanism was as follows. Despite the long term intentions of the B Group towards the holding of the Site through Company H and Company G, the reason why their 50% interest in the project was sold to the D Group was due to the frequent quarrels and deteriorating relationship between the two groups. The D Group wanted complete control without really consulting the B Group. In September 1987, the breakup of the joint venture was successfully negotiated with the D Group taking over the project completely through the Transfer Mechanism. According to Mr O, the use of Company J was an idea which originated from the D Group. Mr O had assumed that Company H's one share in Company G would be transferred to the D Group. Mr O was informed by the middleman who

brokered the breakup that the D Group wanted to use Company J in the transfer. Mr O was not concerned with the mechanism of the transfer as long as the B Group received the sale price. It was Company S, the solicitors acting for the D Group in the sale, who prepared all the documents required for the Transfer Mechanism. According to Mr O, Company J and the Transfer Mechanism originated from the D Group and he was told that the reasons for adopting the mechanism were to facilitate a re-organization of the D Group and to minimize stamp duty on the transaction.

39. Clause 12.02 of the Disposal Agreement stated that the stamp duty of the Disposal Agreement was also to be shared equally. Hence the minimization of stamp duty benefited both sides. Further clause 12.01 of the Disposal Agreement stated that the costs of the allotment of new shares in Company G and establishment of Company J were to be shared equally between the Taxpayer and Company C. And Company B was charged with half of establishment costs of Company J in the sum of $5,000 charged by Company S in their bill dated 21 October 1987.

(d) **Purpose of Company J**

40. The Transfer Mechanism did succeed as a stamp duty scheme as could be seen by the letter from Company S dated 17 September 1987 to the D Group advising that the transfer of the one share in Company G to Company J has been stamped with a nominal rate (and, as a matter of law, no stamp duty being payable on the allotment of the 4,999 shares of Company G each to Company J and to Company C). The Transfer Mechanism as a stamp duty saving scheme did not explain the necessity of an offshore company. The allotment of new Company G shares was at the heart of the stamp duty savings. All the new Company G shares could have been allotted to Company C. There was no need of an offshore company. There were two possible explanations from the evidence on the purpose served by Company J. Firstly, for Company D’ s re-organization but we have seen no evidence or suggestion on how Company J was relevant to any re-organization of the D Group. The other explanation is the erroneous belief that there would be tax savings for the B Group as contained in the above mentioned note 4(b) of the notes to accounts in the 1988 annual report. If Company J was for the sole purpose of facilitating Company D, there was no reason that its setting up cost was to be shared by the Taxpayer at all.

41. We find that it was the D Group who initiated the idea of using Company J. While it may very well be that the genesis of Company J came from the D Group, we find that the B Group agreed to it willingly; seeing its stamp duty advantage and an apparent tax opportunity for them as well. Inherent with this finding, the inescapable logic is that Company J was acquired with the intention at the time of its acquisition (and even before) to dispose of it to Company C.

(e) **Purpose of Company G and Company H**

42. According to Mr O, the B Group never intended to use the Taxpayer to hold its interest in the Site. It was intended that a joint venture company would be used to hold the Site

(Company G subsequently fulfilled that role) and that a separate corporate entity would be used to hold the B Group's interest in the joint venture company (Company H subsequently fulfilled that role). Mr O said that the intention was to hold Company H and Company G as long term capital investment; there was never any intention to sell the shares in Company H or Company G. The failure to use a joint venture to enter into the formal agreements to purchase the Site was due to the lack of time in setting up a properly constituted joint venture company for the signing of the formal agreements.

43. The reason why the B Group did not initially use a separate company rather than the Taxpayer (which has other substantial assets to hold its 50% interest in the Site) was not clear from Mr O's evidence. Mr O mentioned why using a separate corporate entity would make sense (a company with substantial assets should not give the inevitable substantial undertakings to the financier of the project and their joint venture partner used a single asset corporate entity), but did not mention why a shell company could not have been used from the very beginning instead of the Taxpayer.

44. The JV Agreement contained the terms under which the Site would be redeveloped. There were also the usual terms relating to its share capital, composition and proceedings of its board of directors. The shares of Company G were not freely transferable. Clause 7 prevented disposition of the Company G shares without the prior written consent of Company C and Company H (unless it were a default transfer between the parties for failure to contribute to the redevelopment costs). Each side also had a right of first refusal prior to any transfer of the Company G shares although it was not clear what would occur if a party, having refused to exercise its right of first refusal when given the opportunity to do so, refused also to give its consent to a transfer to a third party. In the absence of clear provisions in the joint venture relating to this possibility, the prior written consent of the other party would still be required. Trading of the Company G shares was not contractually possible without the cooperation of the joint venture partner.

45. We are prepared to accept and find that, due to involvement of a third party, that is, the D Group, there was insufficient time to acquire a joint venture company which was subsequently rectified through the use of Company G. We find that the purpose of using Company G was to hold the Site and that the shares of Company G were not acquired or held for the purpose of trading. We doubt the significance of the intentions towards or purpose of Company G when the law is applied to the facts of the case.

46. We make no findings relating to the use of Company H. It was not apparent from the evidence why the B Group could not have used a shell company (subsequently Company H fulfilled that role) when it used the Taxpayer to sign the formal agreements to purchase the Site jointly with Company C.

(f) **Intention towards the Site**

47. Another disputed fact was the intention of the B Group or the Taxpayer towards the redevelopment of the Site. For the moment, we make no distinction between whether we should be addressing the issue of intention towards the Site by looking at the intention of Company G or Company H or by looking at the intention of the Taxpayer or the B Group. In any event, looking at the intention of the Taxpayer towards the Site is not entirely irrelevant as it was the Taxpayer which initially signed the formal agreements to purchase the Site.

48. The Taxpayer contended that the intention was to redevelop the Site, sell the redeveloped residential complex and hold on to the commercial complex for long term investment purpose. The Revenue pointed to an intention of sale in the JV Agreement (clause 2.01(b)) which stated that the business of the Taxpayer was 'develop the Site for sale…'. Mr O pointed to clause 5.01(h) which stated that the Project Manager was to use its best endeavours 'to sell or lease the properties arising from this Development. All such sales or leases shall be co-coordinated by the Project Manager. The minimum sales or lease prices shall be determined by the Company…'. There were other parts of the JV Agreement pointing to either direction. On the one hand, the definition of 'development' in clause 1.02 stated that the development meant the development of the Site 'and the disposal thereof by sale or lease'. On the other hand, there was the clear indication of sale in the cost estimate annexed to the JV Agreement showing 'estimated return on sale' of the commercial/residential block and the commercial block and the fact that the Project Manager was only remunerated according to a percentage of the gross sale proceeds only (in clause 5.05 of the JV Agreement). Thus, it was by no means clear from the wording of the JV Agreement that the redevelopment was for resale or lease. However the areas of the JV Agreement which had financial implications for the joint venture partners pointed to a sale.

49. The intention of the B Group for the Site was the subject matter of pre-Determination correspondence between the parties. Company N informed the Revenue in paragraph 2c of its letter to the Revenue dated 28 July 1989, that the Site was 'acquired for re-development into a commercial/residential complex for resale' and in paragraph 3b, 'Company G would re-develop the (Site) for resale. The profit on the sale of the redeveloped property would be reflected in Company G's accounts and subject to profits tax.' This was repeated in various parts of Company N's letter to the Revenue on 22 December 1990 which mentioned in various parts of that letter that the Site was acquired by Company G for redevelopment and resale.

50. Whether the redevelopment of the Site was for a commercial/residential redevelopment as professed by the Taxpayer was not clear. Certainly documents contemporaneous with the acquisition of the Site showed that the intention was for commercial/office use. The notifiable transaction notice of Company D Overseas dated 3 December 1986 (the date of acquisition of the Site) mentioned that the Site was to 'be redeveloped into multi-storey composite commercial and office buildings'. There was no mention of any residential element. The notifiable transaction notice of the B Group dated 3 December 1986 gave mere notice of the acquisition of the Site with no mention of intended use of the Site. By

28 January 1987, when the JV Agreement was signed, the residential element was added. As just mentioned above the cost estimate annexed to the JV Agreement showed a commercial/residential block and a commercial block. The letter from Company T dated 3 February 1987 to Company D Overseas stated that the purpose of the facilities to be granted to Company G by Bank K was to acquire the Site and construction of a 'complex consisting of two blocks of residential buildings with a total floor area of 140,000 square feet, one block of office building with total floor area of 170,000 square feet and a commercial podium with total floor area of 100,000 square feet'. In the notes of meeting between the B and D Groups held on 3 April 1987, it could be seen that the B Group indicated its support 'to the concept of developing a good-quality office block on (one part of the Site) and a residential block on (another part of the Site). Both blocks would sit on a podium development with well balanced accommodation for shops, restaurants, mini-cinema and other compatible entertainment uses.' In the same meeting, the possibility of developing the residential block as service apartment would be studied by the architect. The redevelopment proposal dated 30 June 1987 and its revision dated 21 July 1987 shown to this Board as part of the agreed bundle showed that two buildings were to be erected. One was an office complex with shops and carparks on the lower floors and the other was an entertainment complex with only three floors targeted as service apartments (which could not ordinarily be said to be for residential purpose). The progress report by the D Group dated 1 August 1987 stated that the building plans for the redevelopment scheme 'containing commercial complex and entertainment centre' were to be prepared. The notifiable transaction of the D Group dated 10 September 1987 mentioned that 'a commercial, office and entertainment complex of 480,000 square feet gross floor area is planned for this site.'

51. It would appear from these documents that the initial intention was for a commercial/office redevelopment without residential elements. The residential element was added later in early 1987 and then abandoned and replaced by the entertainment complex idea by mid-1987.

52. There was little evidence on the financing of the acquisition and redevelopment of the Site. The major piece of evidence was the above mentioned letter from Company T dated 3 February 1987 to Company D Overseas which was a bank facilities letter. There was a list of securities which were to be provided to Bank K which was for the financing of the project. The securities required were: legal charge, share pledges, subordination of shareholder loans, guarantee, shareholders funding agreements of unfinanced portions, insurance policy assignment, construction contract assignment and sale proceeds assignment. Out of this comprehensive list of securities as would have been expected as being required by prudent bankers, the assignment of rent proceeds was noticeably absent.

53. The intentions for the Site was one area of Mr O's testimony which we reject as the written evidence showed otherwise. For what it is worth (and we think that it is irrelevant), we find that the intention of the B Group and the D Group at the time of acquisition towards the Site was to redevelop and sell for three reasons:

a. The economic elements of the JV Agreement pointed to a sale and also due to the indications of sale from Company N' s pre-Determination correspondence with the Revenue mentioned herein. The cost estimate and estimated profit there certainly indicated only returns on sales with no mention of rental income. The Project Manager was paid only on sales.

b. There was no reason to doubt the accuracy of what Company N had stated in its correspondence with the Revenue stating the redevelopment and resale intention in relation to the Site.

c. The financing of the acquisition and the development of the Site from Bank K points to a sale after redevelopment.

(g) **History of share trading**

54. There remains the final controverted area of whether the B Group had a history of trading in unlisted shares. Mr O testified that the Taxpayer had only traded in listed shares, not shares in private companies. Through the cross examination of Mr O, the Revenue drew our attention to the loss and gain on disposal of unlisted investments found in the tax computation of the Taxpayer for the year of assessment 1987/88 and the provisions for and writing back of diminution in value of unlisted investments for the same year and the following year of assessment. Certainly the loss and gain in unlisted investments in the said tax computations did not show trading because the gain was deducted from the profits of the Taxpayer while the loss was added back in. This is more consistent with the treatment of the unlisted shares as a capital asset rather than trading asset. But it could be that the gain and loss was non-taxable for other reasons, such as the income or loss being offshore Hong Kong. No further evidence or submissions were made on this issue. We do not derive much assistance from this. We find that the Taxpayer had no history in trading of private company shares. Trading of private company shares was not part of its business.

Summary of findings of facts on disputed areas

55. We summarize our findings of facts on the disputed areas of the evidence:

a. The D Group initiated the idea of using Company J. The B Group agreed to it willingly; seeing its stamp duty advantage and an apparent tax opportunity for them as well. Company J was acquired with the intention at the time of its acquisition (and even before) that it would be disposed of to Company C.

b. The purpose of using Company G was to hold the Site. The shares of Company G were not acquired or held for the purpose of trading.

c. The intention of the B Group at the time of acquisition towards the Site was to redevelop and sell it.

d. The Taxpayer had no history in the trading of private company shares. Trading of private company shares was not part of its business.

56. Against the background of the agreed facts and our above findings of facts, we now seek to address the legal issues raised by the parties and the application of the law to these findings.

First issue - adventure and concern in nature of trade

57. The first issue which we need to address, as framed by leading counsel for the Taxpayer, is to determine if the acquisition and disposal of the J Share amounted to a trade or an adventure and concern in the nature of trade. The Taxpayer's contention was that the Taxpayer was essentially an investment holding company and never traded in unlisted shares. We have accepted this contention. But this does not dispose of the issue. We still need to consider whether the acquisition and sale of Company J was trade under section 14 of the IRO. We have already set out statutory provisions and basic case law relevant to the question of trade.

Badges of trade/investment

58. The following indicia or badges of trade or investment were submitted to us. When looking at these badges, the fundamental element to bear in mind is that none of them, or any other badge, are decisive. We also bear in mind the observations of the learned judges in Marson v Morton and in All Best Wishes Ltd v CIR that all the facts and circumstances, the whole picture, should be looked at. And we admit that what was confusing to us at first was: how much of the facts and circumstances were to be included? How 'whole' a picture should be taken when deciding on the taxability of the surplus realized on the disposal of the J Share?

(i) Subject matter of transaction

a. The subject matter of the transaction was the shareholding of a foreign company. The Taxpayer contended that shares of unlisted companies are by their very nature instruments of investment and unmarketable. The Revenue contended that shares may be the subject of trade or investment. Despite the normal restrictions that may be applicable against transfer of private company shares which has a direct effect on its marketability, these restrictions are meaningless where one controls the entire shareholdings of the company or has the unrestricted ability to overcome the non-transferability restrictions. The J Share was the entire shareholding of Company J and the normal restrictions on transfer of private company shares were meaningless. We are of the view that shares in private or public companies can be held for trade or for long term investment. We do not agree with the Taxpayer that there is any prima facie assumption that shares in private companies are investments. This badge assisted neither party.

b. For the B Group, the real subject matter of the transaction was the 50% interest in the redevelopment of the Site. Initially the Taxpayer did have a direct interest in the Site as the co-purchaser in the formal agreements to purchase the Site. Firstly Company H and Company G were added. Then Company J was further added. We have already commented on the evidence presented to us on the interposition of these three companies. Neither parties had made any suggestions to us in this appeal that we should look at the Site and the Company G shares as the subject matter of the transaction, although Company N did make the suggestions in its pre-Determination correspondence with the Revenue.

(ii) Period of ownership

c. The period of ownership of the J Share was two days. This is not an indication of long term investment at all. If one were to look at the period of ownership of the 50% interest in the Site from the B Group point of view (and there was no suggestion at the appeal that we should do so), the period of ownership was about ten months. From either angle, the period of ownership was short.

(iii) Isolated transaction

d. The Taxpayer was not in the habit of trading in private company shares. The purchase and sale of the J Share was an isolated transaction. Can an isolated transaction constitute trade or adventure and concern in the nature of trade? There was no suggestion during the appeal hearing that we look at this badge of trade from the landed property point of view.

e. An isolated transaction means that one is not in the business of trading and, in that sense, an isolated transaction negates trading intent. But, conversely, an isolated transaction can be an ‘ adventure and concern in the nature of trade’ . We were referred to passages in the Scottish case <u>IRC v Livingston</u> (1926) 11 TC 538. Lords Sands and Blackburn in <u>Livingston</u> (at pages 543 and 546 respectively) did mention in their judgments that ‘ *it has been recognized that the profit of an isolated* *transaction, by way of purchase and resale at a profit, not within the ambit or trade of the party making the profit, is not assessable to Income Tax…*'. and that '*it is well settled that an isolated trading transaction of a simple character outside a man's ordinary business does not amount to the carrying on of a trade within the meaning of the Section so as to render the profits of the transaction liable to taxation.*' The same court (but differently composed and earlier in time) in CIR v Reinhold (1953) 34 TC 389, cited to us by the Taxpayer gave an opposite view. Lord Russell in Reinhold (at page 394) stated that '*the profit of an isolated transaction by way of purchase and resale at a profit may be taxable as income under Schedule D if the transaction is properly to be regarded as 'an adventure in the nature of trade'. In each case regard must be had to the character and circumstances of the particular transaction.*'

f. We do not take the view that the Livingston case supports any proposition that an isolated transaction cannot constitute trade. Clearly an isolated transaction can constitute trade if it were an adventure and concern in the nature of trade. The transaction in the Livingston case itself was an isolated one undertaken by three partners who joint ventured to purchase, repair then sell a cargo steamer as a one-off deal. Section 237 of the English Income Tax Act in Livingston had a definition of trade similar to that of Hong Kong. Trade meant 'every trade, manufacture, adventure or concern in the nature of trade'. What was perhaps more crucial than the isolated transaction factor, as an indicia of trade or investment, for the judges in the Livingston case was another badge of trade; the fact that the taxpayer added value to the goods traded (repairing and refitting the cargo vessel). To the judges, this indicated trade.

(iv) Work done/value added

g. Applying the 'work done/added value' badge, one way of looking at the facts would enable one to conclude that that work was done or value was added and hence this badge of trade was present in the facts of this appeal. The Company J that was initially acquired by the Taxpayer was substantially different from the Company J by the time of signing of the Disposal Agreement. Due to implementation of the Transfer Mechanism, Company J was rendered from an empty shell company with zero value into a company holding 50% of Company G's shares and indirectly 50% of the Site which was worth the $141,000,000 odd price negotiated between the B and D Groups. It could not be doubted that both the seller and buyer had worked in unison to greatly enhance the asset of Company J and indirectly the value of the J Share.

h. Another way of looking at the facts was that the work done or value added element was the allotment of Company G shares and the transfer of the remaining one share to Company J and that it was Company J that was the recipient of the work done and value added. If Company J then sold the Company G shares, then the badge of trade was applicable. But in the facts of this case, it was not Company J selling. Instead it was Company J that was sold. Would this badge of trade apply from this point of view?

(v) Circumstances responsible for realization and motive

i. The Taxpayer argued that two further badges mentioned in the said 1955 Royal Commission on Taxation of Profits were relevant in this appeal; that of the circumstances responsible for the realization and motive should be considered as badges of investment.

j. The circumstances responsible for the realization of the J Share was the B Group's dissatisfaction with the joint venture and the suggestion of the use of the Transfer Mechanism from the D Group. The dissatisfaction related, naturally, to the Site rather than the direction and management of Company G. The D Group wanted to award contracts for the redevelopment through its subsidiary, the Project Manager and it wanted complete control of the project costs. As Mr O testified, the D Group wanted complete control of the redevelopment. There were frequent quarrels with deterioration of the JV partners' relationship. Through a third party, the sale was negotiated. We have already described the circumstances leading to the Transfer Mechanism which we will not repeat here.

k. If we were to look at the ultimate motive of the B Group, the Transfer Mechanism was just one way of selling its 50% interest in the Site to the D Group. Whether this sale of the Site would constitute a trade or adventure and concern in the nature of trade would then depend on the B Group's intentions towards the Site when it was purchased and on the presence or absence of other badges of trade as applied towards the Site (and ignoring the intentions and badges of trade towards the Company G, Company H and/or Company J shareholdings).

l. If we were to look solely at motive or intention vis-à-vis the J Share alone, there can be no doubt that even prior to the acquisition of the J Share, the intention was to transfer/sell it. Company J was parachuted into the Transfer Mechanism for the sole purpose of its shareholding being ultimately transferred, or (to be more legally correct and based on the Disposal Agreement) sold from the B Group to the D Group. Its multi-facet purpose was to minimize stamp duty, obtain an apparent tax advantage and to suit the re-organization of the D Group (but note that we have made no findings on the last facet).

m. It was in the consideration of these two badges that the perspective of looking at just Company J and the perspective of looking at the underlying Company G and the Site began to blur. Hints of this blurring were present in consideration of the work done/value added badge. The Taxpayer argued that in spite of the Transfer Mechanism, there was never any intention to trade in the J Share. According to the Taxpayer, the insertion of Company J was at the request and for the convenience of the D Group (which we have accepted but not in its entirety as the B Group thought that it had an apparent tax advantage as well as the stamp duty savings benefiting both sides). Furthering this line of argument, the intent of the Transfer Mechanism was the realization of capital investment (in the Company G shareholding). The Revenue argued that the underlying transactions were irrelevant for tax purpose and that the corporate veil created by Company J could not be lifted. Although the Taxpayer had not directly argued that the corporate veil could be lifted, consideration of the underlying transfer of 50% of the Company G shares indirectly lifts the veil. When looking at the motive and the circumstances responsible for the realization badges, we would look through the entire corporate structure and how it came into being, how and why the Transfer Mechanism took place. And inevitably, Company G and the Site would be considered. As we have noted, how big a picture should be framed? If we were to look at the underlying holding of the Company G shares (which was, according to the Taxpayer, a capital investment), why shouldn't we look at the real underlying asset that was transferred, that is, the Site? If we were to penetrate the surface of the Transfer Mechanism (which was the transfer of the J Share) and treat it as a transfer of the 50% interest in the Company G shares, why are we unable to penetrate further to look at the 'real' transfer which was 50% of the Site?

n. Perhaps this is where these two badges of trade break down serving as meaningful tools in deciding the question of trade or investment. In modern complex corporate structures constructed for a variety of real, commercial and legitimate reasons (including avoidance of tax), could we look at ALL the circumstances and the motives? Whose motives are we looking at when the motive of a company could very well be the motive of its controlling shareholder? Indeed the foundation of many tax schemes rests on the legal concept of separation of the company from those who are beneficial owners of the company and on the legal trustee-beneficiary distinctions.

(vi) Another look at motive/intention

o. The Taxpayer's submission on the motive badge had a further element. Even if we were to look at the transfer of the J Share and ignore the underlying transactions and come to the view that there was an intention to sell the J Share at the time when it was acquired, intention to sell was insufficient to establish a trade. Reliance on this proposition was based on Reinhold previously mentioned. In this case, the taxpayer admitted that he had purchased four houses with a view to resale and had instructed his agents to sell whenever a suitable opportunity arose. Despite this admission, it was held that profits made on the sale of the houses were not taxable. We take the view that Lord Keith best summarized the judgments of the three Lords in Reinhold at page 396 where he stated '*the intention to re-sell some day at a profit is not* ***per se*** (emphasis added) *sufficient in this case to attract tax*'. From a reading of the three judgments, it is reasonably clear that the decision in favour of the taxpayer was based on a number of other badges: the houses were sold three years after purchase, the taxpayer was not in the business of property agent, the transaction was an isolated one, the four houses were prima facie a form of investment capable of yielding an income. What Reinhold tells us is that we cannot just look at one element. We must consider other elements as well.

Case law on trade (first issue) / the legitimacy of underlying transactions

59. The Respondent referred us to Beautiland Co Ltd v CIR (1991) 2 HKLR 511 to support the proposition that the underlying transactions should be ignored in the taxation of the proceeds realized from the Transfer Mechanism. Beautiland was also referred to us by the Taxpayer as an example that companies do not ordinarily trade in the shares of their own subsidiaries. In Beautiland, the Privy Council did not find anything in the joint venture agreement between the Cheung Kong group and the Wheelock Mardin group which indicated that the parties had in contemplation trading in the shares of subsidiaries or associated company. The Privy Council analyzed the wording of the joint venture agreement which formed part of the basis of the

conclusion made by the Board of Review that trading of shares was contemplated. The Privy Council saw that such wording referred to landed properties rather than to shares and disagreed with the Board's way of looking at that joint venture agreement when considering the sale of the shares.

60. The joint venture agreement in the Beautiland case is different from the JV Agreement in the present appeal. The JV Agreement related only to Company G and the Site and much of its provisions concentrated on the redevelopment of the Site. Insofar as the shares in Company G were concerned, as we have mentioned above, from the wording of the JV Agreement, it was obvious that the Company G shares were not freely transferable.

61. Adopting the same approach as the Privy Council did in Beautiland, from the analysis of the JV Agreement, it was obvious (and we have made a finding) that the B Group had not contemplated trading the Company G shares. But also adopting the Privy Council's Beautiland approach of not looking at the underlying asset of the company that was transferred (which were shares in another company which in turn held land), we should be looking at the transfer of the J Share and not the underlying assets of Company J (whether they be the Company G shares or the Site). It was not the shareholding in Company G or the Site that were sold. It was the J Share.

62. This approach was applied in Hong Kong by a number of Board decisions.

a. In D36/89, IRBRD, vol 4, 394, shares of a joint venture company which held property for joint redevelopment purpose were sold and the proceeds were subject to tax. The question was whether the shares of the joint venture company had been acquired for investment or trade. The Board decided that the shares were acquired for trade and, as the appellant rightly pointed out, this was due to the Board rejecting the testimony of the taxpayer's witness. What is important for us is that the intention of the parties towards the redevelopment of properties was never a part of the consideration.

b. D52/94, IRBRD, vol 9, 292 applied Beautiland in a case of transfer of shares in a joint venture company holding property for sale. The taxpayer alleged that his shares were capital assets. The Board was careful in addressing its mind on the issue to confine itself to the shares. It did not concern itself with the property. Ultimately it came to the conclusion that the taxpayer had failed to satisfy its onus of proving that the shares were capital assets.

c. D74/91, IRBRD, vol 7, 16 was another case of companies using subsidiaries to develop property and disposing shares of the subsidiary at a profit. The Board did not agree with the proposition that a company cannot trade in the shares of its unlisted subsidiaries or embark upon an adventure in the nature of trade in respect of the shares of its subsidiaries. The facts in that case satisfied the Board that the taxpayer in that case did not trade in the shares of its subsidiary. It was noted by that Board that '*in the same way as there can be no legal concept of dealing in land through shares of a subsidiary company (as embodied in Beautiland), there can be no concept of investing in land through the shares of a subsidiary company.*'

d. In D30/87, IRBRD, vol 3, 176, the Board decision itself was unreported because the case, as reported, concerned the function of the Board of Review and what constituted proper questions of law in an appeal by way of case stated to the High Court. The facts were that there was a sale of the shares of a company which owned valuable Letters B (Letters of land exchange entitlements in the New Territories that were as valuable as land). On the face of it, the transaction from which the taxable profit was derived was the sale of the shares. Extensive evidence was canvassed by the Board. Ultimately it reached the conclusion on the facts and found that the shares of company holding Letters B, acquired for the purpose of the joint venture, constituted capital assets. The Board commented that the fact that Letters B were current assets in the company did not make the shares in the company any less in the nature of capital. The reverse would be true in the circumstances of this appeal. That Board further observed that the distinction between the shares in a company and the assets of the company is one which was fundamental to the law. The Board cited Lord Russell of Killowen who observed in the Privy Council case, EBM Co Ltd v Dominion Bank (1937) 3 AER 555 at page 564, that it is '*of supreme importance that the distinction should be clearly marked, observed and maintained between an incorporated company's legal entity and its actions, assets, rights and liabilities on the one hand, and the individual shareholders and their actions, assets, rights and liabilities on the other hand.*' What is interesting in D30/87 was that Counsel for the appellant had appeared for that taxpayer and advanced as an alternative argument that there was no taxable gain because the shares were sold at a value equal to their value at the stage when the shareholder formed the intention to sell them (the value of the share being equal to the value of Letters B transferred). This is precisely the second issue framed by the appellant in this appeal. The Board in D30/87 did not decide on this issue as it held that the shares sold were capital assets.

63. This approach of looking at Company J rather than Company G or the Site was also the same approach approved of in the Hong Kong High Court in CIR v Quitsubdue Ltd (1999) 2 HKLR 481. Quitsubdue reaffirmed the principle that a shareholder has no proprietary interest in the property of the company of which he is a shareholder (at page 488). What is perhaps more relevant was the comment (also at page 488) by Yuen J who decided Quitsubdue that it was not a legitimate exercise for the Board to, in effect, equate the shareholders' intentions for their

shareholdings with the taxpayer' s intention for its properties. In similar way, we must divorce the intention of the Taxpayer (the shareholder) for the J Share and Company J' s (the company' s) intention for Company J' s assets (Company G and indirectly the Site). We must confess that the distinction between the intention of the Taxpayer and the intention of Company J is artificial in the sense that the controlling minds of the Taxpayer and Company J are one and the same. The distinction is, in essence, the different intentions of the same controlling minds towards, on the one hand, the holding of the shares of a company and, on the other hand, ignoring the intervening corporate structure, the holding of the Site. As mentioned by Yuen J in Quitsubdue, there is nothing inherently incongruous for a person wearing the cap of a director to decide that the company should invest in properties, and wearing the cap of a shareholder, to decide to sell his shares in the company.

64. If we were incorrect on our approach on this issue of trade and we must look at the ' reality' of the Transfer Mechanism as not being a transfer of the J Share but a transfer of the 50% of Company G, then an analysis of the JV Agreement will show that the Company G shares were not intended to be traded and hence there was in fact a realization of a long term investment. No profits tax would be chargeable in this event. But having pierced the Company J veil to look at Company G, there is no reason for us not to pierce the Company G veil as well and look at the Site to address the question whether there is any trade or an adventure and concern in the nature of trade in respect of the Site. And looking at the Site, we would conclude that it was trading asset from the time of acquisition and its disposal through the Transfer Mechanism was a trade. The realized gains from the disposal would then be taxable. However we do not believe that either of the above approaches is the correct one.

Conclusions on trade

65. The perspective which should be taken into account when examining the badges of trade affects the outcome of a decision on trade or investment. While the authorities (Marson v Morton, Lionel Simmons and All Best Wishes) point to legitimate consideration of surrounding circumstances and motives, other authorities (Beautiland and Quitsubdue) require us to make a distinction between the company and its shareholders and between the intention of shareholders towards the share of a company and the intention of the company towards the company' s assets.

66. We take the view that the underlying disposal of the Company G shares and the further underlying disposal of 50% of the Site cannot be taken into consideration. We use the badges of trade as the touchstone against which the facts relevant to the J Share are tested; and not (in so far as there may be conflict between the two) as the touchstone against which the facts relevant to the Company G shares or the Site are tested. We have already intimated our views on the badges as may be applicable in either scenarios. Taking into consideration only those views as are relevant to the J Shares to the exclusion of considering the Company G shares or the Site and also taking into consideration our finding on the purpose of Company J mentioned above, we conclude, on our interpretation of legal principles, that the purchase and sale of the J Share by the

Taxpayer was an adventure and concern in the nature of trade. Hence any surplus realized was subject to profits tax under section 14 of the IRO.

67. The success of the Transfer Mechanism in achieving stamp duty savings hinges on the recognition of the legal separate existence of corporate entities and concepts embodied in the Beautiland case. We see no reason why we should abandon these concepts directly or indirectly to ignore the corporate entities when considering the question of Hong Kong profits tax.

No profit from the trade (second issue)

68. We now turn to the question whether there was any taxable profit despite our conclusion on trade. The Taxpayer framed two issues for our consideration in this appeal. We have dealt with the first issue of trading or adventure and concern in the nature of trade. The second issue was, in the wording as framed to us:

> If prima facie the facts could give rise to a finding of 'trade', whether, in computing the profits of such trade, one should deduct the value of the assets given to Company J which enabled the (Taxpayer) to realize the same on the disposal (with the consequence that there is no assessable profit).

69. The manner in which this second issue was framed presupposed that there should be no distinction between the shareholding of a company and the assets of that company. The assets virtually 'gifted' (except for the transfer of one share at par) to Company J was 50% of Company G and indirectly 50% of the Site. The Company G shares became the assets of Company J. The second issue, as framed, then presupposed that it was the Company G shares that were realized by the Taxpayer. But the item that was realized by the Taxpayer, legally and based on the Disposal Agreement, was the J Share. Another way of looking at this is that nothing was given to the Taxpayer which is the entity that we should be looking at. The 'gift' was to Company J. We have referred to this when we set out our views on the work done/value added badge of trade. For the same reasons as we have set out in our decision on whether there was a trade, we are of the view that there must be a distinction in the surface transaction represented by the sale of the J Share (which was properly documented by the Disposal Agreement and which to all intent and purpose is legally enforceable) and the underlying transactions represented by the effective transfer of control and the beneficial interests of 50% of Company G and the Site.

Considerations on the second issue

70. We will address the second issue assuming that the beneficiary of the gift was the Taxpayer and that the presuppositions in the second issue were valid.

71. The entire premise on which the Taxpayer's submission on this issue rests was the Taxpayer's statement of the principle to be derived from Sharkey v Wernher, the expansion of the

Sharkey principle and its application in reverse. In essence, the Taxpayer's application of the principle was that in tax calculations there should be the determination of a taxpayer's 'true' profit from his trade and that the true value of a stock in trade at the commencement of trade has to be deductible in computing any trading profit.

The Sharkey principle

72. The facts of Sharkey v Wernher are well known. In brief, a horse breeder cum racer, who bred for herself and for others, took horses bred by her to race. The taxpayer's stud farm was deemed a trade by statute and taxable while the taxpayer's racing activities was recreational and not taxable. After going through the entire appellate process where the various courts' judgments yo-yo'ed between favouring HM Inspector of Tax and the taxpayer, the House of Lords, in a majority decision, decided that the market value of the horses should be accounted for in the calculation of the stud farm's taxable profits.

73. The principle that can be derived from Sharkey v Wernher is not without controversy. There is the wide concept, as submitted to us by the Taxpayer, that the principle is as wide as the need to determine the true profit and that value has to be deducted in computing any trading profit. There is then the difficult question of what is 'true' profit and what is the 'value' that should be deducted. There is the narrow concept that confines Sharkey only to a situation where a taxpayer appropriates the taxpayer's own trading stock for self use, the taxpayer must account for it in the taxable trading business at a value which is the market value of that trading stock.

Its expansion

74. The narrow concept Sharkey principle was regarded as having been expanded by the English Court of Appeal in Petrotim Securities Ltd v Ayers (1963) 41 TC 389 to a situation where instead of appropriation of own trading stock for self use, it applied to disposals at undervalue as well. Petrotim was not cited to us in argument but an English High Court decision, Ridge Securities Ltd v IRC (1964) 44 TC 373, decided subsequent to the Petrotim case, was. In Ridge Securities, Pennycuick J at page 397 stated '*If a trader starts a business with stock provided gratuitously, it would not be right to charge him with tax on the basis that the value of his opening stock was nil.*'

75. Ridge Securities involved the acquisition of a number of companies and a series of complicated financial transactions where the taxpayer asset-stripped the companies and used dividends and debenture interest methods to off-take the profits earned by the acquired companies when their assets were sold. One of the transactions considered in the case, as obiter, was the purchase of a war loan from one subsidiary to a fellow subsidiary at an undervalue which was then sold at ten times the undervalued transfer price. One of the arguments put forward by the taxpayer was that the fellow subsidiary would have to pay tax on the profits from this sale. Hence the fellow subsidiary had a profit chargeable with tax to support the payment of a dividend payment to its

parent, the taxpayer, under a deduction of tax. The opposing argument was that the fellow subsidiary should account for the real value of war loan (which was the price at which it was sold to the third party) with the result that there would have been no profit chargeable to tax to support the payment of the dividend under a deduction of tax. Pennycuike J agreed with the opposing view.

Its application in reverse

76. There are those who consider that the Sharkey principle applies in the reverse as submitted to us by the Taxpayer. If the Sharkey principle is said to work where there was a change of the nature of the asset from trading (stud farm) to investment/capital use (racing), it would work also in the reverse, that is, when a capital asset is appropriated to trade.

77. Analyzing the Taxpayer' s submission on the second issue, it seems to us that another, though different, type of reverse application would arise. If the Revenue can tax notional gains when a taxpayer converts trading stock to capital assets, why can' t the taxpayer claim a tax deduction when capital asset, which has been converted to trading stock, is then sold? In the tax calculation of profit, the market value of the capital asset at the time of change of intention (provided there has been capital gains) should be taken into account in addition to the initial acquisition costs.

78. In either reverse application scenarios, this concept of the Sharkey principle would involve a change of intention between the time of acquisition of an asset and prior to its disposal from one intention into the other. It cannot be said that there is any change of intention in the facts of this appeal and the Taxpayer has not presented its appeal on this basis.

Application of Sharkey in Hong Kong

79. Sharkey, in its expanded form, has been applied by the Revenue in Hong Kong in change of intention situations. A taxpayer having acquired an asset with an intention to trade then subsequently changed the intention to hold the trading stock for investment purpose. The Revenue deems a notional disposal of the trading stock by the taxpayer to himself and taxes the taxpayer for the difference in the cost of acquisition and market value as at the time of change of intention.

80. Differently composed Boards of Review have at different times expressed their distaste for the application of Sharkey in Hong Kong. Attempts to expand on its application have been disapproved of and rejected by the Board usually on the ground that it does not apply to facts under appeal.

81. There has never been any authoritative judgment in the Hong Kong courts on the application of the Sharkey principle in Hong Kong. Quitsubdue is a recent case decided in Hong Kong which touches on Sharkey but did not form part of its ratio decidendi. The Board in Quitsubdue found that there was a change of intention of the taxpayer from trade to investment but that Sharkey was not applicable to enable the Revenue to charge a tax on the notional profit as the

taxpayer had not disposed of the asset. The High Court felt that there was no change of intention and that the taxpayer had acquired the asset as a fixed asset. Yuen J in Quitsubdue was of the view that Sharkey did not apply (at page 49 : *'I take the view that the principle in Sharkey v Wernher [1956] AC 58, 36 TC 275 does not apply generally or in the circumstances of this case.'*) Yuen J's reasoning was based on the principle that a man cannot trade with himself as espoused in the Irish case of Dublin Corporation v M'Adam 2 TC 378. She stated: '*If he cannot trade with himself, it must follow that he cannot make a profit out of trading with himself. The charge on profit in s.14 of the Inland Revenue Ordinance (Cap 112) is a charge on real profit. So, it follows that a person cannot be charged with profits tax on 'self-trade' as it does not exist.*' Yuen J was sympathetic to the dissenting views of Lord Oaksey in Sharkey who agreed with the English Court of Appeal.

82. In addition to the rationale expressed by Yuen J in Quitsubdue, we find it difficult to apply English tax decisions which are decided on differently worded tax statutes. Given the strict approach to interpretation of tax statutes, unless the English tax statute in question is the same or so materially similar, it would be difficult to apply English cases or cases of other common law jurisdiction to Hong Kong, or at any rate, to accurately extract principles applicable to Hong Kong. What can be included as 'assessable profit' under the charging provision of the IRO is more clearly defined in subsequent sections 15 to 15E. And what can be deducted from the assessable profit are found in sections 16 to 16E of the IRO. Further, if one were to apply the principles of interpretation of tax legislation of the need for a clear intention to impose a tax and the resolutions of ambiguities in favour of the taxpayer, it would be difficult to argue that the Hong Kong legislature has imposed a tax on a notional income (based on market value) which a taxpayer should have received when the taxpayer appropriated his/her own stock in trade for self use or converted a trading asset into an investment asset.

83. This reasoning is best expressed by Mr Henry Litton (formerly a Chairman of the Board of Review and subsequently Litton PJ) in D41/91, IRBRD, vol 6, 211. This passage was quoted in a tax book called 'Taxation of Property Transactions in Hong Kong' (at page 67). He said:

> '*It is worth emphasizing that, under the scheme of the Income Tax Acts in the United Kingdom, there is no statutory equivalent to section 61 of the Inland Revenue Ordinance* [an anti-avoidance provision aimed at sham transactions]. *The position in Hong Kong is therefore quite different. We find it difficult to see any justification for the Commissioner in Hong Kong exercising some "common law" power to disregard a transaction, outside the scope of s 61 of the Ordinance, by invoking a "principle espoused" in Sharkey v Wernher and Petrotim Securities Ltd v Ayres decisions under a tax regime wholly different from that of Hong Kong. Indeed, we question whether the Commissioner has the power to apply the "principle espoused" in Petrotim Securities Ltd v Ayres at all, when the Inland Revenue Ordinance in Hong Kong makes express*

provisions which seem to be aimed at a very similar situation. If in truth what the Commissioner is saying is that the sale to Madam A was a sham, a device in order to disguise the fact that the taxpayer was simply giving its property away to a director, this could have been stated in plain terms, and there was no need to invoke any so-called "principles" stated in English cases.'

It could well be argued that D41/91 was made on the basis that Sharkey would not be applicable only where the transaction under tax scrutiny may be subject to challenge as a sham under the anti-avoidance provision of section 61 of the IRO. But we doubt whether the Board would have reached a different conclusion since the transaction under scrutiny in D41/91 was, in that Board's view, not a sham under section 61 of the IRO.

84. We believe that there is a legal basis to state that, if Sharkey is applicable, the Hong Kong judicial approach is to subscribe to the narrow concept of Sharkey. And this is the legal basis which we adopt in looking at the second issue.

85. The facts of this appeal are distinguishable from Sharkey in a number of ways:

a. The tax provisions considered in Sharkey were different.

b. In this appeal, we are not dealing with an entity trading with itself or appropriating trading stock for own enjoyment.

c. In Sharkey, there was no disposal to a third party, there was no document in the nature of the Disposal Agreement and there were no transfers of underlying assets between fellow subsidiaries. All these were present in this appeal.

d. In Sharkey there was a change of intention from trading to investment whereas no such change of intention occurred in this appeal. If it could be said that the J Share was capital asset (which we have concluded was trading asset), then its subsequent sale was also an realization of a capital asset. No change of intention is involved. It could not be and has not been argued that while the Company G shares were capital asset, its nature changed to trading when the J Share was acquired for the purpose of disposal to Company C.

86. While there was a disposal to a third party in this appeal (and the reason that the Board in Quitsubdue rejected Sharkey was there was no disposal), Sharkey must be applied in the reverse in this appeal if the Taxpayer were to succeed on the second issue. We believe that there is no legal basis in Hong Kong to say that Sharkey works in reverse in Hong Kong. And if it does work in reverse, there was no change of intention in this appeal (change of intention being the basis on which the reverse principle is applied).

87. We were referred by the Taxpayer to the several cases to support its stance on the application of Sharkey to this appeal:

a. First, there was the Ridge Securities case already mentioned above. We are of the view that Ridge Securities is not binding on us or applicable to this case. The issue of whether the fellow subsidiary would be taxed on the basis of having acquired the war loan at the undervalue or at the market value was not the issue decided in Ridge Securities. The tax statute under consideration was completely different from those under consideration in this appeal. Moreover the direct recipient of the gift or undervalued asset (being the fellow subsidiary) sold the war loan. In this appeal the direct recipient of the gift was Company J which did not sell the Company G shares.

b. Another English High Court case cited to but not binding on us was Bath and West Counties Property Trust Ltd v Thomas (1977) 52 TC 20. In Bath, land previously sold with a right to re-purchase was re-purchased by the taxpayer with the intent that it would be on-sold to a third party at a profit. The on-sale occurred and a profit was realized. An issue in the case was whether the right to re-purchase should be taken into account in the calculation of the profits made by the taxpayer in the on-sale to the third party. The Court held that the cost to the taxpayer of re-acquiring the land had two elements: the actual price paid and the value of the right to re-purchase. Hence the value of the right to re-purchase must also be deducted in the profits tax computation. There was no question that at the time when the taxpayer re-purchased the land, it had a trading intention and the land was re-purchased with the intention to sell. In Bath, there was no value added or work done. The taxpayer had a right to re-purchase the land and it was exercising that right to re-purchase with an intention to trade. But then again it could be argued in this appeal that no value was added because the Taxpayer indirectly held the Company G shares (through Company H) before the injection into Company J. This approach fails to take into account the concept of separate corporate entity. Further it is an attempt to apply Sharkey in reverse, which as we have considered as without legal basis.

c. The Board of Review in D26/84, IRBRD, vol 2, 139 (cited to us as authority in support of the application of the expanded Sharkey principles) confined the English extension of the Sharkey principle in Petrotim to a situation where there was a disposal between associated parties at substantially below market rate. That Board considered that Sharkey applied in Hong Kong but it was of the view that its scope should not be extended and great caution should be exercised in attempting to invoke it. In the injection of Company G into Company J, there was a ‘disposal’ of some sort at substantially below the market rate (the disposal was not a straight forward transfer or sale at undervalue). The transferee in the ' disposal' (Company J) was an associated party. But unlike D26/84 where the disposal to the subsidiary was due to the execution of a corporate reorganization plan and that was the end of the matter, in this appeal there was another disposal, and a clear disposal to another party not within the same group, which was the heart of the matter.

d. D35/96, IRBRD, vol 11, 504 was also cited to us by the Taxpayer. The case was not decided on any Sharkey principle. Sharkey v Wernher and Petrotim Securities Ltd and Ayres were referred to only in the submissions of the Revenue. The relevance of D35/96 appeared to be a mere example of the Revenue' s application of the Sharkey-Petrotim principles in the profits tax assessment of the taxpayer who objected to the assessment. But the assessment was settled prior to a determination of the objection by an agreement on what should have been the value of the asset transferred.

88. To summarize, if Sharkey applies in Hong Kong, like the Board in D26/84, we will not extend its operational scope. For the reasons given above, we agree with the Revenue and have come to the view that Sharkey does not apply to the facts of this appeal even if somehow the corporate veil can be ignored. The value of the ' gift' to Company J could not be accounted for in the calculation of the Taxpayer' s profit. We would confine Sharkey to the barest of principles which can be said to have arisen from it or from its extension in Petrotim (assuming that Petrotim applied in Hong Kong).

Alternate view of second issue/value as at commencement of trade

89. The Taxpayer submitted that there was an alternative way of looking at the Taxpayer' s second issue which was basically that the Taxpayer had not commenced to trade until the Taxpayer was in a position to trade it. And the Taxpayer was not in a position to trade until Company J became the owner of the 50% Company G shareholding. A 1919 English High Court case, The Birmingham & District Cattle By-Products Co Ltd (1919) 12 TC 92, was cited to support this proposition.

90. The Birmingham & District Cattle By-Products Co Ltd (1919) 12 TC 92 was a case decided in 1916 and in the context of the unique provision in the English (No.2) Finance Act 1915. The Court had to decide between two scenarios; each of which depended on a different date of commencement of business. If the taxpayer commenced business on its incorporation date in June 1913, then the pre-War (World War I) standard to be used for computing the taxpayer' s excess profits duty should be based on the accounts of the taxpayer for the period commencing on the date of incorporation. If the taxpayer is deemed to have commenced business on 6 October 1913 (which was the date of commencement of business as resolved by the directors and the date when the taxpayer took delivery of raw materials to turn out its product), the standard to be used for

computing the taxpayer's excess profits duty was to be a statutory percentage on the average amount of the capital employed during the accounting period. The tax provision under consideration in that case was unique as it appeared to be applicable only during the crossover period when the United Kingdom was entering into a state of war. The English (No.2) Finance Act 1915 was vastly different from the IRO. While Birmingham & District does not apply to this appeal, it shows that under certain circumstances, the date when a business commences may be important. It also highlights that the date of commencement of a business may not be as clear cut as is generally thought. Having looked at the case, we are not entirely in agreement with the view of Rowlatt J in that case that the date of delivery of raw materials was the date when trading began and ignoring other material prior dates such as entering into contracts to sell the products or contracts to purchase raw materials and purchasing plant and machinery; activities which the learned judge relegated to 'preparation' for trade. If delivery of raw materials was the trade commencement date, surely the date when the finished products were produced and in a physically ready state to be sold would have been a more relevant event.

91. A commencement date for trade on its own has no relevance to the alternate second issue. In Birmingham & District there were already in existence commonly acceptable deductions which could be taken into account if these deductions fell within the meaning of trade or after commencement of trade. In this appeal, the deduction which is sought to be added back into the value of the trading stock is one which depended on an extension of the application of Sharkey (the further reverse application mentioned above).

92. Despite the Taxpayer's contention that the alternative view is not affected by the applicability of the Sharkey principle in Hong Kong, it was still required for the argument to succeed. Since we do not consider that Sharkey applied to this appeal, the alternative view is not accepted.

93. The two Board of Review decisions cited to us (D12/80, IRBRD, vol 1, 380 and D49/92, IRBRD, vol 8, 1) in support of the alternative second issue was more connected with Sharkey rather than the date of commencement of trade and the need to use the market value of a stock in trade as at commencement of trade. The two cases illustrate that the Revenue had been, and probably still is, applying the Sharkey principle in reverse, which must now be doubted due to Quitsubdue. In these two cases, the dispute was over whether there was any change of intention from investment to trade and if there was, when this change of intention took place. No change of intention is at issue in this appeal. We are unable to find any assistance from these two decisions relevant to the alternative second issue.

Cases where tax computation included true value

94. Undoubtedly section 14 of the IRO is a charge on 'real profits' as Yuen J commented in Quitsubdue. But as Lord Racliffe stated in Sharkey (at page 82), the metaphysical distinction of what is 'real' does not assist to solve the problem. Would the correct book keeping entry of the Taxpayer in recording the purchase of asset (Company J) at almost no cost and selling

it two days later at $141,000,000 be any more real than notionally crediting back to the Taxpayer a value that increases the Taxpayer's cost of selling that asset? With this in mind, we now consider two further cases referred to us by the Taxpayer in this appeal.

95. In Wing Tai Development Co Ltd v CIR (1979) 1 HKTC 1115, which went up to the Court of Appeal, one can see the attempt to reach a proper value for calculation of assessable profits tax with interesting discussions on the burden of proof in section 68(4) of the IRO. The taxpayer had received shares of a company about to be listed as part of the consideration in the sale of a single asset property owning company. The Board found, on the facts of that case, that the taxpayer had embarked on a venture to trade when it had agreed to accept the shares to be listed as consideration and this was not challenged on appeal. The issue was which value should be used as the cost value of these shares when they had to be sold at a profit. Bearing in mind that the onus of proof was on the taxpayer, the Board was satisfied that the true value of the shares was in excess of their par value. Yet the Board was not satisfied with the evidence presented by the taxpayer on what should have been the correct value of the shares. The Board decided that the onus of proof was not discharged and confirmed a profits tax assessment based on the cost value of the shares being their par value. The Court of Appeal was of the view that the Board, having been satisfied that the par value of shares was not the correct value, should have made a finding on the true value of the shares however difficult it might be.

96. The facts of Wing Tai are different from those of the present case. Wing Tai was a case where in the sale of the property owning company, the vendor/taxpayer and the purchaser had agreed on the value of the property (and hence the value of the property owning company) and then agreed that that value was to be paid partly in cash and partly in shares of a company about to be listed. The vendor and purchaser were contemplating a value of the shares to be listed which exceeded the value that was used to calculate how much was to be satisfied in cash and how much was to be satisfied by the par value of the shares to be listed. The question was finding (however difficult it might have been) the contemplated value of the subject matter of the taxable transaction (viz the shares to be listed). Probably the parties themselves had no specific value in mind except that, given the securities market at the time, the shares to be listed would be oversubscribed and would be definitely above their par values. The subject matter of the taxable transaction in the present appeal is the J Share. There was no doubt as what the value of the J Share was. We are unable to find any assistance from this authority.

97. Likewise, we find no assistance in BR2/77, IRBRD, vol 1, 263. It was a decision where the Board had to reach a conclusion on the correct value of the subject matter of the taxable transaction for tax computation purpose. The taxpayer acquired shares of public companies in exchange for issuing new listed shares of its own. The taxpayer had booked the share exchange transactions in its books at the par value of the shares acquired and the par value of its own exchanged. It was obvious that the par value was not the true consideration contemplated by the parties to the share exchange transactions. The decision of the Board to ignore the par value and use market value comes as no surprise. The 'costs' of the shares for accounting purpose must be

different from the 'cost' for profits tax purpose. (What was perhaps more interesting about this case was the Board's choice of the 'real' value, although the Board did not seem to have addressed this in detail. The Board chose the 'real' value to be the market value of the listed shares issued by the taxpayer rather than the market value of the listed shares acquired by the taxpayer in exchange.)

Conclusion

98. From the facts as agreed and the facts found by us and after consideration of the legal issues and submissions of leading counsel for both parties, to whom we are most grateful for their very capable assistance, we have concluded that we should look at the Transfer Mechanism principally as an acquisition and disposal of shares of a company and ignore its underlying transactions. This means that the acquisition and disposal of the J Share was an adventure and concern in the nature of trade. We have also concluded that Sharkey v Wernher does not apply to this appeal. Hence for the purpose of calculating the assessable profit realized on the disposal of the J Share, there is no legal basis to treat the initial value of the J Share as being equal to the price at which it was sold to Company C.

99. In the circumstances, we dismiss the appeal and confirm the Determination.