Case No. D19/85

Board of Review:

William Turnbull, *Chairman*, R. J. McAulay C. H. Wong, *Members.*

14 October 1985.

Profits tax—cessation of manufacturing business—whether surplus on disposal of trading stock assessable—Section 15C of the Inland Revenue Ordinance—whether compensation payment for breach of contract allowable—Section 15D(2)—redevelopment of property—whether property dealing business commenced.

The Appellant was a company incorporated in Hong Kong which previously carried on business as a textile manufacturer on the land and building owned by it. In 1976, the Appellant ceased the manufacturing business. On the cessation, it derived profits from the sale of raw materials and paid compensation to its customers for breach of contracts. It then proceeded with the redevelopment of the land by the demolition of the old premises and the erection of flatted factory units. The project was financed by funds borrowed from bankers as well as deposits from purchasers on the presale of certain units. Two new objects were introduced into the Appellant's Memorandum of Association in April 1977. In May 1977, the Appellant launched a sales promotion campaign in respect of the redevelopment which was eventually completed in 1979.

The Commissioner decided that the Appellant was assessable to tax on the surplus from the sale of raw materials and that the compensation payments were not deductible expenses. He further decided that the Appellant had commenced a property dealing business with effect from 28 May 1976, the date of the Appellant's resolution for cessation and redevelopment.

The Appellant appealed on the grounds that—

(1) the surplus on the sale of raw materials arose only when the contracts were not fulfilled, hence the compensation payment should be allowed; alternatively the surplus should not be taxed;

(2) the intention of the redevelopment was retention of the building for rental purposes. It did not have sufficient power to deal with property prior to the amendment to the Memorandum of Association.

Held:

(1) The surplus arising on the sale of raw materials was correctly charged to tax in accordance with section 15C; the compensation payment which arose when the business ceased was not an allowable deduction in terms of section 15D.

(2) The Commissioner's determination that the Appellant carried on a property dealing business with effect from 28 May 1976 was upheld as the Appellant failed to produce satisfactory evidence to the contrary.

The case was remitted to the Commissioner to agree a value of the land as at 28 May 1976.
(*NOTE:* The Decision of the Board of Review is subject to confirmation on appeal to the Court.)

Luk Nai Man for the Commissioner of Inland Revenue.
A. A. Iles of Pacific Services Taxation Ltd. for the appellant.

Reasons:

The Appellant is a company incorporated in Hong Kong which previously carried on business as a textile manufacturer. The Appellant owned a piece of land ("the land") which its used for the purpose of its textile manufacturing business.

The Appellant in 1976 decided to cease business in manufacturing textiles, demolish its factory premises on the land, and redevelop the land. This appeal is in two separate parts. One part relates to the computation of profits tax on the value of the stock of raw materials remaining when the manufacturing ceased and the other part relates to whether or not the Appellant made taxable profits from its real estate.

The Appellant ceased textile manufacturing in June, 1976. When it ceased its manufacturing operations it had certain stocks of raw materials and also had certain contracts with its customers for spinning and weaving. As a result of the termination of its business the Appellant was not able to fulfill its contractual obligations to its customers in relation to spinning and weaving and was obliged to pay compensation for breach for contract.

The Commissioner decided that the Appellant was liable to pay tax on the surplus which arose when the raw materials were sold and that the compensation payments were not expenses of the Appellant Company which could be deducted from its assessable profits but were capital payments incurred by the Company to enable it to cease its manufacturing business. The Appellant appealed against this decision of the Commissioner claiming that either the compensation payment should be allowed as deductions from the taxable surplus arising from the sale of raw materials or alternatively if the compensation payments cannot be deducted then the surplus on disposal of the raw materials should not be subject to tax.

The representative for the Appellant argued that the raw materials and the contracts for spinning and weaving were inextricably interconnected. He said that the raw materials were acquired specifically to perform these spinning and weaving contracts and that the raw materials could not be sold unless the spinning and weaving contracts were cancelled. That being the case, there could be no surplus on disposal of the raw materials unless compensation was paid to the customers who had the spinning and weaving contracts to which the raw materials related. Accordingly the compensation payments must be allowable expenses against the surplus proceeds arising on the disposal of the raw materials. The argument is logical and if there were any equity in taxation law we would have much sympathy for the Appellant. Unfortunately for the Appellant the Inland Revenue Ordinance and previous decisions do not support the Appellant's argument.

The Inland Revenue Ordinance makes specific provision for how trading stock is to be handled on the cessation of the trade or business. Section 15C of the Ordinance reads as follows:—

> "Where a person ceases to carry on a trade or business in the Colony the trading stock of the trade or business at the date of cessation shall be valued for the purpose of computing the profits in respect of which that person is chargeable to tax under this Part as follows:—
>
> (*a*) in the case of any such trading stock:—
>
> (i) which is sold or transferred for valuable consideration to a person who carries on or intends to carry on a trade or business in the Colony; and
>
> (ii) the cost whereof may be deducted by the purchaser as an expense in computing the profits from such trade or business in respect of which such purchaser is chargeable to tax under this Part, the value thereof shall be taken to be the amount realized on the sale or the value of the consideration given for the transfer;
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> (*b*) in the case of any other such trading stock, the value thereof shall be taken to be the amount which it would have realized if it had been sold in the open market at the date of cessation."

This section is clear and specific. The raw materials are to be valued for the purpose of computing taxable profits at either their realized value or their realizable value as the case may be. Apparently in the present case the raw materials were actually sold and accordingly there is no argument as to their value.

There can be no doubt that the value of the raw materials must be brought into account when computing the profits in respect of which the Appellant is chargeable to tax. There is no substance in the argument put forward on behalf of the Appellant that such raw materials should be considered to be of a capital nature and not of a trading or business nature.

The Appellant's representative argued at length that the nexus between the raw materials and the compensation payments for breach of spinning and weaving contracts was such that the compensation payments must be allowable expenses. We are unable to accept this argument. There may or may not have been such a nexus but that is not to point. The material question to be answered is whether or not the payments of compensation were deductible from the profits of the manufacturing business previously carried on by the Appellant or whether they were, as decided by the Commissioner, of a capital nature not related to the business previously carried on by the Appellant. Section 15D(2) of the Inland Revenue Ordinance is the relevant Statutory Provision and reads as follows:—

> "Where a person who has ceased to carry on a trade, profession or business in the Colony pays any sum which, if it had been paid before such cessation, would have been deductible in computing the profits of the trade, profession or business in respect of which the person is chargeable to tax under this Part, then to the extent to which the sum

> has not already been deducted in computing such profits, that sum shall be deducted in ascertaining his profits for the year of assessment in which the cessation occurred."

In our opinion the Commissioner was right in disallowing the compensation payments from the taxable profits of the Appellant because the payments were not incurred in the course of the trade or business previously carried on by the Appellant. When a person ceases to carry on business a number of expenses arise out of the fact that the business had ceased. A well known example of this would be payments to employees in the form of severance pay or compensation for loss of employment or ex gratia rewards for past services. Such payments are not deductible against previous taxable profits and likewise we hold in this case that the compensation payments made by the Appellant which were in nature of damages for breach of contract caused by the termination of the business of manufacturing are not deductible against the profits of the trade or business previously carried on by the Appellant. It may be that the Ordinance is unfair in this regard but this is not a matter for the Board to consider. Our duty is to apply the terms of the Ordinance which does not allow deduction of termination expenses.

Accordingly the first of the two grounds of appeal of the Appellant fails.

The second part of the appeal relates to whether or not the Appellant carried on a property dealing business when it redeveloped its land and sold units in the new flatted factory building.

The Commissioner decided that the Appellant was carrying on business as a property trade and dealer when it redeveloped its property and sold units in the new premises at a profit. The Appellant appealed against this decision on the basis that the Appellant was doing no more than to realise to the best of its ability the land which it owned and which was a capital asset. A subsidiary question arose regarding the date which the Commissioner decided was the commencement date of this property trading business.

Whether or not the Appellant was carrying on business as a property developer and trader is a matter of fact and it is necessary to consider the totality of facts in order to arrive at a proper determination.

The facts can be briefly summarized. The Appellant owned the land which was clearly a capital asset. All of the shares in the Appellant Company were sold by the previous owners who had been operating the textile factory to new owners who were well known property developers in Hong Kong. At a Board meeting held on 28 May 1976 and following the change of ownership the new directors formally resolved to cease trading in textiles and passed the following resolution:—

> "We informed the meeting since the directors are unfamiliar with the textile trade, it would be beneficial to the Company to cease business as such and to utilise the land more advantageously by erecting a flatted factory thereon for rental. It was resolved that the Company will cease business on the 3 June 1976 and that architects will submit plans for redevelopment as soon as possible."

The Company ceased business in June 1976 and proceeded to erect a flatted factory on the land but instead of retaining the building for rental purposes proceeded to sell the premises. Demolition of the old factory building commenced on 12 January 1976. The redevelopment was completed in stages with the entire development being completed during the year ended 31st March 1979.

The redevelopment of the land was financed by means of money borrowed from the Appellant's bankers and in addition certain units in the new flatted factory building were pre-sold and moneys obtained from purchasers.

The first sales of units in the building seem to have taken place actually or prospectively in March 1977 when certain deposits were received by the Appellant Company or its agents and sales continued thereafter. In May 1977 the Appellant through its agent embarked upon a major sales promotion campaign and a press release described the development in the following terms:—

> "Named the KTIC, the project will include units as small as 912 square feet. With a total of 1.8 million square feet, the estate is by far the largest industrial development ever undertaken in Hong Kong."

The project was stated to be a $300,000,000 property development offering the main in the street a chance to buy his own factory. The press release went on to say:—

> "So huge is the complex's scale that Central Enterprises' architects have created some new real estate superlatives. They calculated that 50,000 people a day will visit the factories and have provided 300 carparks and 36 lifts—4 of which will each be capable of carrying 70 people."

On 14th April 1977 the Memorandum of Association of the Appellant had been amended by adding two new objects as follows:—

> "(*a*) To purchase, take on lease or in exchange, or otherwise acquire, develop and deal for investment only in any freehold or leasehold land and nay kind of real or personal property and any land and here-ditaments of any tenure and messages and tenements and any estate for interest and any rights, easements or privileges to or in connection with any such lands or hereditaments, messages or tenements in Hong Kong or elsewhere.
>
> (*b*) To acquire, develop and turn to account for resale any property and land purchased or acquired by or in which the Company is interested and develop for resale any property or land whether belonging to the Company or not."

The Commissioner decided that the Company carried on a property dealing business commencing around 28 May 1976 and that the profits or gains on the sale of units in the flatted factory building were liable to be assessed to profits tax. It is from this decision that the second part of this appeal is made.

Whilst each case must depend and be decided upon its own particular facts it is useful to look at previous cases which have been determined.

The starting point of any review of the law must be Hudson's Bay Company v. Stephens (1909) 5 T.C. 424. In this case the tax payer was a company which had acquired certain lands which were disposed of from time to time and it was held that the profits arising from the disposals were not taxable as trading profits. In West v. Phillips (1958) 38 T.C. 203 the tax payer owned certain houses which were not trading stock but which were long term investments. As a result of a change in market circumstances the tax payer sold the houses at a profit and it was decided that the profits arising on the sale were not taxable. In Taylor v. Good (1974) IWLR 556 an individual acquired a large country house at an auction and having realized it was not practical to live in the house he proceeded to obtain planning permission and having obtained the same then resold the property at a substantial profit. It was decided that the tax payer had done no more than realize a capital asset and had not embarked upon an adventure in the nature of trade.

The relevane of these cases to the present appeal lies in demonstrating what a tax payer can do in order to realize the best price for a capital asset owned by him. It is clear from these cases and other similar cases that the owner of real estate can undertake considerable work in relation thereto in order to realize the best possible value of his asset. A land owner in order to sell land can build roads and lay out the land in order to divide it into separate lots. Likewise an owner of houses or flats can redecorate premises and set up a sales organization for the purpose of selling the various units. However it is equally clear from the decided cases that if the facts show that the tax payer has embarked upon a venture in the nature of trade or has commenced trading in real estate, then the profit arising from such activities is correctly taxable. To ascertain on which side of the borderline any particular case falls is a hard practical matter of fact and it is necessary to look at all of the relevant facts.

It was submitted on behalf of the Appellant that the original intention of Appellant was to redevelop the land with a view to retaining the new factory building for rental purposes. The basis of this argument was the inclusion in the relevant board resolution of the words "for rental" In his determination the Commissioner expressly rejected this argument and found that there was no evidence to suggest that the Appellant ever made the slightest effort to rent out the premises.

The Appellant's representative submitted that the Commissioner was wrong in his determination but did not call any evidence to explain why the Appellant did not proceed with its stated intention of renting the flatted factory building. Neither Mr. Benoni Wu nor any of the other directors appeared to give evidence before the Board. The onus of proof in an appeal is clearly placed upon the Appellant by section 68(4) of the Inland Revenue Ordinance. In the course of the hearing it was suggested to the Appellant's representative that the Appellant might wish to call evidence to be given by its directors but the Appellant decided not to do so. If the true intention of the Appellant was to redevelop for rental

purposes in May 1976 it was most definitely no longer the intention of the Appellant to develop for rental purposes in May 1977. That is when a press conference was held to launch the sale of the new flatted factory. There is no evidence whatsoever of any change of intention between 28 May 1976, being the date of the Board resolution, and May 1977. In the absence of any further evidence or any explanation the only conclusion to draw is that the Appellant had no real intention to build a new flatted factory for rental purposes.

The Appellant's representative further submitted that by amending its object clauses on 14 April 1977 the Company did not regard its previous objects as wide enough to permit property dealing and that the Company by its very action in passing the amendment considered that any suggestion of dealing in property was ultra vires. Whilst we agree that if the Company did not have power in its object clauses to carry on business as a property developer then whatever it did prior to the 14 April 1977 can only have been of a preparatory nature as otherwise it would have been ultra vires and void. However it is for the Appellant to satisfy this Board that the objects of the Company prior to their amendment on 14 April 1977 did not permit the business of property dealing. It is not enough to show that the objects were amended on 14 April 1977. What this Board has to be satisfied is what was the position prior to that date. In his determination the Commissioner stated that he was of the opinion that prior to the amendments the object clauses were already wide enough for the Company to undertake a property dealing business. The Appellant's representative submitted that this was a debatable point but did not adduce any arguments to rebut the Commissioner's opinion. Accordingly the Company has not satisfied us that its objects before their amendment on 14 April 1977 were not wide enough to permit property dealing and for the reasons set out in the preceding paragraph we hold that the Company commenced its property trading business on 28 May 1976.

In the course of the hearing of the appeal both the Appellant and the Commissioner reserved their rights to submit evidence and argue the value of the property on whatever date the Board might decide the Appellant commenced business. Having determined that the Appellant commenced its property trading activities on 28 May 1976, the matter must be referred back to the Commission to agree with the Appellant on the value of the property as at that date of bring this appeal back to the Board of Review if the value cannot be agreed.

To summarize the foregoing this Board now orders as follows:—

1. That part of the Appellant's appeal which relates to the inclusion by the Commission of the value of the raw materials existing at the date of cessation of the manufacturing business and the disallowance of payments of compensation for breach of spinning and weaving contracts is dismissed and the decision of the Commissioner upheld.

2. That part of the Commissioner's determination in finding that the Appellant had been carrying on a property dealing business when it redeveloped its property and sold flatted factory units in the new building is upheld.

3. The determination by the Commissioner that the date of commencement of the property dealing business was 28 May 1976 is upheld.

4. The case is referred back to the Commissioner to agree a value of the land as at 28 May 1976 or failing agreement have this appeal set down before the Board of Review to enable the Board of Review to establish the value of the land as at the 28 May 1976.