Case No. D19/90

Profits tax – redevelopment of property – whether profit subject to profits tax or a capital gain on disposal of capital asset.

Panel: William Turnbull (chairman), Christopher Chan Cheuk and Richard Lee.

Dates of hearing: 26, 27 and 28 February 1990.
Date of decision: 25 June 1990.

The taxpayer owned certain valuable property which it had owned for a number of years. The taxpayer entered into a joint development agreement with a property developer to redevelop the property. After completion of the redevelopment the property was sold to another company. The question to be decided was whether or not this was the realisation of a capital asset or an adventure in the nature of trade.

Held:

The taxpayer had embarked upon a joint venture for the development of its property and was not just realising a capital asset. Accordingly the profit was subject to profits tax.

Appeal dismissed.

[Editor's note: The taxpayer has filed an appeal against this decision.]

Cases referred to:

Simmons v IRC [1980] 1 WLR 1196
Ransom v Higgs [1974] 1 WLR 1594
West v Phillips [1958] 38 TC 203
BR 19/85, IRBRD, vol 2, 182
BR 65/87, IRBRD, vol 3, 66
Wrigley v Ward [1967] 44 TC 491
Overseas Tanker v Stoker [1989] 1 WLR 606
California Copper Syndicate v Harris 5 TC 159
Federal Commissioner of Taxation v Whitfords Beach Pty Ltd 12 ATR 692
Federal Commissioner of Taxation v Myers Emporium Ltd 18 ATR 693
CIR v Waylee Investment Ltd [1990] HKLR 107
Beauchamp v Woolworth Plc [1989] 3 WLR 1

Burrel, Webber, Magness, Austin and Austin v Davis 38 TC 307

P F Feenstra for the Commissioner of Inland Revenue.
Robert G Kotewall QC instructed by Johnson Stokes & Master for the taxpayer.

Decision:

This is an appeal by a corporate taxpayer against two profits tax assessments which brought into account for profits tax certain profits or gains made or realised by the Taxpayer on the sale of a redeveloped building. The facts are as follows:

1. The Taxpayer was a Hong Kong incorporated company. At all relevant times, the ultimate holding company of the Taxpayer was A Limited, a limited company incorporated in Hong Kong.

2. The Taxpayer declared the nature of its business as 'real estates' in its profits tax returns for the years of assessment up to and including 1982/83. In its 1983/84 and 1984/85 profits tax returns, the Taxpayer's business was described as 'ownership and development of commercial property for letting'.

3. The Taxpayer acquired a valuable property ('the first property') in early 1970s. Later, the first property was exchanged for other valuable property in the same area ('the second property').

4. In the Taxpayer's balance sheet as at 31 March 1977, the second property was shown at a value of $205,000,000 with $1,000,000 allocated to the buildings and $204,000,000 to the land. This valuation was based on a professional joint valuation by two firms of valuers which reflected the redevelopment potential of the whole of the second property at that time. The second property comprised two adjacent sites on which stood two old buildings.

5. The directors of the Taxpayer on 11 May 1977 resolved that the second property would be held for redevelopment in five years subject to market conditions at that time. It was at this board meeting that it was resolved that the second property would be revalued as set out in the preceding fact.

6. By letter dated 12 March 1979, a real estate developer ('the developer') proposed to the Taxpayer through its parent company, A Limited, to redevelop the second property on a joint venture basis on certain terms and conditions which included assessing the value of the second property at $360,000,000. On 16 March 1979, the directors of the Taxpayer held a meeting to consider the proposal put forward by the developer and it was resolved that the proposed joint development would be approved subject to the price for the second

property being agreed at $363,800,000 and that such agreed price would be higher than a joint valuation to be prepared by the two joint valuers who had previously valued the property. The directors of the Taxpayer at their meeting on 16 March 1979 considered a detailed draft reply dated 15 March 1979 to the developer's proposal and this was duly approved and sent to the developer.

7. On 21 March 1979, the joint valuers advised the Taxpayer that the current open market value of the second property was $280,000,000 assuming immediate vacant procession and not taking into account any compensation for obtaining vacant procession. At that time the existing two old buildings standing on the second property were let to tenants so that vacant procession was not immediately available. This valuation was substantially below the value proposed for the joint venture redevelopment.

8. In mid-1979, the directors of the Taxpayer met to consider a draft joint venture agreement between the Taxpayer and X Limited, a company formed by the developer, and other third parties for the purpose of the redevelopment. The board of directors resolved to approve the joint venture agreement.

   The development agreement between the Taxpayer and X Limited was then executed.

9. In January 1982, a proposed price list for the pre-sale of the new building to be erected on the second property ('the new building') was drawn up and in September 1982, a revised price list was finalised between the Taxpayer and X Limited.

10. In January 1982, a third party company indicated to the Taxpayer that it wished to purchase two floors of the 'high zone' office accommodation in the new building. On the same day, the Taxpayer advised X Limited that it was its intention to retain the entire 'high zone' office accommodation of the new building.

11. In August 1982, the second property was made available by the Taxpayer to X Limited for the redevelopment. The new building was completed in two stages with the issue of a temporary occupation permit in December 1983 and a final occupation permit in June 1984.

12. In January 1983, the Taxpayer wrote to X Limited and confirmed an earlier discussion that Y Limited, which was another company in the A Limited company group or one of its subsidiaries, would purchase the entire office tower comprising the third to twenty-third floors of the new building. At the same time, the Taxpayer waived its rights under sub-clause 12(D) of the development agreement to retain 50% of the commercial and office units in the new building.

13. Y Limited nominated a wholly owned subsidiary of itself to purchase the entire office tower of the new building as previously negotiated. All of the other units of the podium were sold to third parties or associated companies of the Taxpayer and the earliest was sold in December 1982.

14. In its tax returns for the years of assessment 1983/84 and 1984/85, the Taxpayer claimed that the profits which arose on the disposal by it of the new building constructed on the second property were of a capital nature and not subject to profits tax. This was at first accepted by the assessor, but after receiving further information, the assessor was of the opinion that the Taxpayer had embarked on a trading venture with X Limited and that the profits which the Taxpayer made from the redevelopment of the second property were subject to profits tax and proceeded to assess the same accordingly.

15. The Taxpayer objected to the two assessments which assessed the profits on the redevelopment. In his determination dated 24 June 1988 the Commissioner upheld the decision of the assessor and the Taxpayer duly lodged notice of appeal to this Board against the Commissioner's determination.

At the hearing of the appeal, the Taxpayer was represented by Counsel and called to give evidence an ex-director of the Taxpayer who had been a director of the Taxpayer from the time of its incorporation up to October 1985. He had also been a director of A Limited and of Y Limited at all relevant times. His evidence established the following additional facts to our satisfaction:

1. It was the policy of the A Limited group of companies that trading companies would not hold real estate properties. For this reason, the Taxpayer was used for the purpose of acquiring the first property which was used by A Limited for its offices and by a subsidiary of A Limited which carried on a tertiary business ('the business').

2. At all times it was the intention of the Taxpayer to redevelop the first property but this could not be done unless and until suitable alternative accommodation was found for the business.

3. In 1971, an offer was made to purchase the first property from the Taxpayer but it was rejected because an alternative site could not be found for the business.

4. The A Limited group actively looked for alternative accommodation for the business and were successful in so doing in 1972, but it was not until 1977 that new premises were available for occupation by the business.

5. In the early 1970s there were rumours and threats that a third party would try to obtain control of the A Limited group of companies but the takeover bid was unsuccessful.

6. It was in the light of this background that an approach was made by the developer to the Taxpayer with a view to entering into an arrangement with the Taxpayer, not only for the joint redevelopment of the second property, but also other properties owned within the A Limited group. It was seen by the A Limited group as a means of stopping future takeover bids by third parties.

7. After the signing of the development agreement but before completion of the new building, the property market in Hong Kong collapsed. It was for this reason that the A Limited group of companies made arrangements for a company within its group to acquire all of the development from the Taxpayer save and except for those parts of the podium which were sold to third parties or associated companies.

Counsel for the Taxpayer submitted that the 50% share of the development profits received by the Taxpayer would only be subject to profits tax if it was profit from a trade or adventure in the nature of trade carried on by the Taxpayer. He pointed out that the Taxpayer had never been in the trade or business of buying and selling property and had never traded in property. He pointed out that since the beginning the Taxpayer had been in the business of owning and letting commercial property. He drew our attention to the fact that the Taxpayer had entered into the development agreement not as a normal commercial transaction but so as to ensure the survival of the A Limited group because of the takeover threats.

He submitted that the sale was the sale of a capital asset. He submitted that the development agreement was no more than the means whereby the Taxpayer realised its capital asset. He submitted that the development agreement did not convert a capital asset into a trading activity or an adventure in the nature of trade. He submitted that it is well established law that the mere realisation of non-trading assets will not convert them into a trading transaction. He submitted that the Taxpayer had done no more than to realise a capital asset to the best of its ability to realise the best price.

Counsel for the Commissioner submitted that the development agreement went far beyond the mere realisation of a capital asset. He pointed out that the development agreement valued the land considerably in excess of its market value at the time but the Commissioner had accepted this value for assessment purposes. He pointed out that the development agreement was an adventure in the nature of trade and that any profits which the Taxpayer realised after the execution of the development agreement in excess of the value placed on the land by the development agreement must be taxable.

Counsel for the Commissioner took us through the development agreement and pointed to the many powers and rights reserved to the Taxpayer which clearly demonstrated

that the Taxpayer was not a mere passive seller of property but an active participant in the joint development. He pointed out that the development agreement envisaged the sale of the entire new building. It had been submitted that it was the intention of the A Limited group to retain half of the new building within the group as the corporate headquarters of the group. However, Counsel for the Commissioner pointed out that a sale by the Taxpayer, albeit within the group, was still a sale by the Taxpayer the profits from which would be taxable in the hands of the Taxpayer. Only if the Taxpayer had retained the property for itself would the Taxpayer not be taxable. Any sale by the Taxpayer, whether to an associated company or not, was a taxable transaction.

In the course of their submissions, Counsel referred us to the following cases:

Simmons v IRC [1980] 1 WLR 1196

Ransom v Higgs [1974] 1 WLR 1594

West v Phillips [1958] 38 TC 203

BR 19/85, IRBRD, vol 2, 182

BR 65/87, IRBRD, vol 3, 66

Wrigley v Ward [1967] 44 TC 491

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Beauchamp v Woolworth Plc [1989] 3 WLR 1

Burrel, Webber, Magness, Austin and Austin v Davis 38 TC 307

With due respect to Counsel for the Taxpayer, we are unable to agree with his submissions in this case. The facts are quite clear to us. The Taxpayer was originally a property investment company and continued to be a property investment company until it entered into the development agreement with X Limited. When the Taxpayer entered into the development agreement, it went far beyond the mere realisation of a capital asset. The Taxpayer took upon itself significant risk and the hope for significant additional profit. It received a credit in the development agreement for a sum which was then in excess of the

market value of the second property. It agreed to future delivery of the second property when vacant procession could be obtained. It is impossible to construe the development agreement as a sale and purchase agreement for the second property with the price capable of being adjusted upwards if the property was worth more at the date when it was delivered to X Limited. Bearing in mind that the Taxpayer had relied extensively upon joint professional valuations of the second property one would have expected to find a clause to say that a third joint valuation would take place when the property was delivered to the purchaser and in the event of the value exceeding the agreed price then the price would be adjusted upwards. There is no such provision in the development agreement nor any similar provision. What we have is a standard type of joint venture development agreement under which the developer is entitled to be repaid his development costs out of the proceeds of sale of the new building. The value attributed to the land is not payable to the Taxpayer in advance of and in priority to all other liabilities as would be the case if this were a sale but is deferred to certain other payments. The protection of the Taxpayer lay in the fact that the Taxpayer could cancel the agreement and take back the second property if it wished during the course of the development period.

The development agreement demonstrates that it is clearly a joint venture development agreement and not a sale and purchase agreement.

On the evidence and facts before us we have no hesitation in finding in favour of the Commissioner and upholding the assessments appealed against.