

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D31/87

Board of Review:

William Turnbull, *Chairman*, Woo Man-sing, Manuel and James W. Sweitzer, *Members*.

29 September 1987.

Profits tax—whether resulting profits and losses on the sale of shares subject to profits tax.

The Appellant company was a family company formed in December 1957 and managed conservatively. The Appellant company had a substantial portfolio of Hong Kong quoted shares. Each year the company would buy and sell shares in the Hong Kong market and the profits or losses on such sales were shown in the accounts of the company as trading profits and losses and were offered to the Inland Revenue Department for the purposes of profits tax. Each year dividends were paid by the company to members of the family and with the exception of 1974 which was a bad year in the stock market dividends were increased each year. The Appellant company contended that profits and losses on the sale of shares had been incorrectly treated in the accounts of the company and by the Commissioner and the company should not be subject to profits tax. The Appellant further contended that it was not engaged in share trading because it was a family company endeavouring to increase its net worth by investing in the stock market without the intention of distributing any gains which it might make. The audited accounts of the Appellant company, however, showed that the company carried on a business of buying and selling securities at frequent intervals.

Held:

The Appellant company was trading in shares. Frequent switching of shares is the hallmark of a share trader.

Appeal dismissed.

Wan Tsang Yuk-ling for the Commissioner of Inland Revenue.

David K. W. Cheng of Messrs Hodgson Impey Cheng for the Appellant.

Reasons:

The Appellant Company was a family company formed in December 1957. Miss L appeared and gave evidence before the Board. She said that her father founded the family company which was formed for the benefit of himself and the members of his family who comprised Miss L, her brothers and sister-in-law and children and grand-children of the founder and nieces and nephews. Up to 1972 decisions appear to have been made by the father. He died and subsequently the family members led by Miss L tried to follow his instructions and objectives which were to manage the Company conservatively and try to increase dividends. Each year dividends were paid by the Company to members of the

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family and, with the exception of 1974 which was a bad year in the stock market, dividends were increased each year.

During the years in question the Company had a substantial portfolio of Hong Kong quoted shares. Each year the Company would buy and sell shares in the Hong Kong Market and the profits or losses on such sales were shown in the accounts of the Company as trading profits and losses and were offered to the Inland Revenue Department for the purposes of Profits Tax.

The submission made on behalf of the Company was that the profits and losses on the sale of shares had been incorrectly treated in the accounts of the Company and by the Commissioner of Inland Revenue. In fact the profits and losses were capital profits and losses not subject to Profits Tax. Miss L in evidence said that the policy of the Company was to switch investments depending upon the fundamentals of the quoted public company. The main thrust of the submissions on behalf of the Appellant Company were that investments were held for long periods of time and proceeds from investments were substantially re-invested including realized gains. Switching of securities took place to protect the Company's capital and increase the fundamental value of the Company rather than to create money for distribution to shareholders. However Miss L did agree in cross-examination that the dividends distributed by the Appellant Company were paid out of the proceeds of sale of investments as well as dividend income and interest and any other sources of income of the Appellant Company.

In deciding this case we wish to remove two fundamental mis-apprehensions.

The representative for the Commissioner submitted that the onus of proof in an appeal coming before this Board is upon the Appellant. This is clear law and is set out in section 68(4) of the Inland Revenue Ordinance which states "the onus of proofing that the assessment appealed against is excessive or incorrect shall be on the appellant". The Commissioner's representative went on to say that this onus of proof is "heavy one". With due respect we do not agree with this last statement. An onus of proof is no more than that. The onus is upon the appellant to substantiate its case. The position can be likened to the position of a plaintiff in civil proceedings. The onus of proof is upon the plaintiff to prove his case but it goes no further than that. By virtue of the uncontroverted facts of a particular case it may be difficult for either the Appellant, or indeed the Commissioner, to substantiate a submission or to seek to draw inferences from the fact. This is however different from saying that there is a heavy onus of proof.

In the submissions made on behalf of the Appellant Company there seemed to be a fundamental misunderstanding of the meaning of share trading. It was submitted that the Appellant Company was not engaged in share trading because it was a family company endeavouring to increase its net worth by investing in the stock market without the intention of distributing any gains which it might make. Again with due respect we cannot accept this submission. A company may well wish and is entitled to distribute immediately to its shareholders' capital gains which it has made upon the realization of a capital asset and

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conversely it may wish and is entitled to retain and re-invest profits which have arisen from trading activities. No inference can be drawn one way or the other and the nature of a transaction is not changed because it is, or is not, distributed to shareholders. A company which operates a retail shop or wholesale trading business cannot avoid the payment of profits tax by not distributing its trading profits to its shareholders.

Having clarified these two misunderstandings we now briefly turn to the relevant facts.

The audited accounts of the Company showed that the Company carried on a business of buying and selling securities quoted on recognized exchanges in Hong Kong. This is strong evidence to show that the Company and its management and auditors were of the opinion that it was trading in shares. Miss L on behalf of the Company said that this was an error and that for many years she had been arguing with the auditors that they were wrong. The auditors were not called to explain the alleged error in their ways. However notwithstanding this we are prepared to approach the subject with an open mind, and look at the other facts objectively.

Miss L said that she switched investments to protect the company's capital. In giving evidence frequent reference was made to switching investments and the representative for the Company submitted the following statement which summarizes this point (we quote from the written submission without editing):—

“In nowadays, quoted shares are popular investment in view of their very fast capital appreciation, readily saleable and massive information available. Just as the value of quoted shares can go up very fast, it can come down with equal speed. The share market is therefore very volatile and require extreme cautions and cares; otherwise, the value of the share investment may be completely diminished.

In nowadays, rarely a shrew investor will acquire a quoted share and hold on for a long term for its income. He will watch the stock market carefully and realise the shares when the price is right or to switch to other shares or other kind of investment with better potential for a quick capital appreciation. Once this policy of shares switching is adopted, it is inevitable that transactions of this kind will be frequent and the value is large. This is the characteristics of quoted shares and the continued switching of the shares is the practical method to hedge against any loss in nowadays and if any investment manager is not doing that he is considered to be not discharging his duties properly.”

With due respect to the Company's representative and the Company's witness we are forced to the conclusion that the Company was trading in shares. Frequent switching of shares is the hallmark of a share trader and nothing else. On the basis of the Company's own submission and evidence we find without hesitation in favour of the Commissioner that the Company was trading in shares and that the resulting profits or losses must be taken into account when determining the Company's profit for Profits Tax purposes.

The representative of the Company drew attention to the fact that the Company had held shares for many years before making sales. We agree that this would indicate that the shares

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were bought for long term investment purposes but it is not conclusive. If the Company had set aside such investments as long term investments or if the Company had not indulged in switching of investments at frequent intervals we would then agree that the gains would be of a capital nature. However those are not the facts. We are confronted with only one portfolio of shares and evidence that the Company adopted a policy of switching investments at frequent intervals. It is not what a company might have done which can be the basis of a decision of this Tribunal. We must decide in accordance with the actual facts. In the present case the actual facts are that this Company had only one portfolio of shares and this portfolio was a trading portfolio and nothing else. It may well be that the Company could have regulated its affairs differently but that is not for us to speculate.

For the reasons given we find in favour of the Commissioner and dismiss this appeal.