Case No. D31/92

Profits tax – leasing of computer equipment – whether equipment capital assets or stock in trade.

Panel: Anthony F Neoh QC (chairman), Eric Lo King Chiu and Frank Wong Kuen Chun.

Dates of hearing: 4, 5, 6 and 7 November 1991.
Date of decision: 16 October 1992.

The taxpayer was a computer equipment leasing company and computer equipment sales company. With regard to those items of equipment which the taxpayer leased, the taxpayer claimed and was allowed depreciation allowances for tax purposes. The taxpayer maintained that where computer equipment was leased and then sold at a profit the sale was a sale of a capital asset and not subject to profits tax. The Commissioner argued that the taxpayer carried on one business only which was the sale of computer equipment and that leasing of equipment did not change its nature into becoming a capital asset.

Held:

The taxpayer was carrying on only one business. It was a matter of indifference to the taxpayer whether the equipment was hired to a customer or sold outright. The computer equipment leased out did not represent capital assets and accordingly the profit on its sale was taxable under section 14 of the Inland Revenue Ordinance.

Appeal dismissed.

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

Cases referred to:

Commissioner of Taxes v Nchanga Consolidated Copper Mines [1984] AC 948
John Smith & Son v Moore [1921] 2 AC 13
Simmons v IRC [1980] 2 All ER 798
Federal Commissioner of Taxation v Cyclone Scaffolding [1987] 19 ATR 673
Gloucester Railway Carriage and Wagon Co Ltd v the Commissioner of Inland Revenue [1925] 12 TC 720
The Rees Roturbo Development Syndicate Ltd v the Commissioner of Inland Revenue [1928] 13 TC 366
Memorex v Federal Commissioner for Taxation [1987] 19 ATR 553

Federal Commissioner for Taxation v GKN Kwikform Services [1991] 21 ATR 1532
Federal Taxation Commissioner v Myer Emporium Ltd [1987] 163 CLR 199

D J Gaskin for the Commissioner of Inland Revenue.
Denis O'Dwyer of Ernst & Young for the taxpayer.

Decision:

Determination appealed against

1. X Ltd ('the Taxpayer') appeals against the Commissioner's determination, given in writing on 9 July 1991 ('the determination') to the following effect, namely that:

(1) Profits tax assessment for the year of assessment 1981/82 showing net assessable profits of $2,687,456 (after set off of loss brought forward of $5,840,236) with tax payable thereon of $443,430 be increased to assessable profits of $15,480,054 with tax payable thereon of $2,554,208.

(2) Profits tax additional assessment for the year of assessment 1982/83 showing net additional assessable profits of 19,130,040 with tax payable thereon of $3,156,456 reduced to additional assessable profits of $13,352,654 with tax payable thereon of $2,203,187.

(3) Profits tax assessment for the year of assessment 1983/84 showing net assessable profits of $5,700,854 with tax payabale thereon of $940,640 be reduced to assessable profits of $5,163,113 with tax payable thereon of $851,913.

(4) Profits tax additional assessment for the year of assessment 1983/84 showing net additional profits of $396,994 with tax payable thereon of $65,504 be increased to additional assessable profits of $6,798,365 with tax payable thereon of $1,121,730.

(5) Profits tax additional assessment for the year of assessment 1984/85 showing net additional assessable profits of $1,096,295 with tax payable thereon of $202,874 be annulled.

2. The Commissioner sets out his computations at pages 22 to 26 of his determination. It is not necessary to set out these computations. This appeal, turns upon only one point of principle, namely, whether computer equipment forming the subject matter of various equipment leases represented 'capital assets' or stock in trade. If the answer is the former, as the Taxpayer contends, then gains derived from their sale are not taxable, if the answer is the latter, as the Commissioner contends, then the gains are taxable.

Undisputed factual background

3. The following paragraphs set out the factual background, which is undisputed. The Taxpayer was incorporated, under a former name, as a private company in Hong Kong in 1971. In 1979 it changed to another name and in 1987, it adopted its present name. At all material times, the Taxpayer has been a wholly-owned subsidiary of a company incorporated in USA.

4. At all material times, the Taxpayer has, in its returns, disclosed the nature of its business as '… the sale, rental and maintenance of computer hardware …'. The memorandum of association of the Taxpayer states that the 'objects for which the Company is established are: (1) to establish, promote and carry as the business of … buying, hiring, leasing, installing, servicing, maintaining, repairing, dealing in and engaging in all offered commercial activities with respect to the following products … (iv) computers and peripheral equipment information handling and retrieval system …'.

5. On divers dates the Taxpayer submitted its profits tax returns which disclosed the following assessable profits/(losses):

Year of Assessment	Assessable Profits (Losses) US$
1980/81	(2,235,323)
1981/82	947,296
1982/83	4,271,354
1983/84	650,457
1984/85	2,292,082

6. In arriving at the profits/(losses) disclosed above, the Taxpayer:

(a) claimed depreciation allowances on all items of computer equipment other than those it held for 'direct sale'. Those 'non-direct sale' items including leased assets and assets for own use were always included as fixed assets within the Taxpayer's balance sheets;

(b) treated the sales proceeds on the sale of computer equipment (other than 'direct sale' items) in accordance with the provisions of Part VI of the Inland Revenue Ordinance;

(c) treated the profits on disposal of the computers on leases as capital profits;

(d) returned the profits on the sale of 'direct sale' items as trading profits.

7. Up to 20 November 1986 the assessor had issued assessments/loss advices reflecting the following position:

Year of Assessment	Assessable Profits/(Losses)	Date(s) of assessment Loss Advices
1980/81	(HK$11,276,587 that is US$2,234,492)	9/1/1984 & 17/11/1986
1981/82	HK$5,585,806 that is US$977,035	9/1/1984 & 17/11/1986
1982/83	HK$26,689,555 that is US$4,271,354*	9/1/1984
1984/85	HK$17,893,826 that is US$2,292,082	3/2/1986

[* A revised computation showing assessable profits of HK$26,727,558 that is US$4,277,756 had been proposed by the Taxpayer, but no revised assessment had been issued at the time of the determination.]

Apart from a few minor, agreed adjustments the assessments/loss advices were basically in accordance with the returns lodged.

8. From about 1986, the assessor had been corresponding with the tax representative as to the nature and extent of the Taxpayer's computer business, and the manner in which the related transactions had been reflected in the accounts. In relation to the income derived by the Taxpayer from its sales and hire of computer equipment, the tax representative described the modus operandi as follows:

(a) an end-user would approach the Taxpayer with a view to acquiring suitable computer hardware, or the Taxpayer would decide to acquire equipment for its own use;

(b) prior to placing purchase orders, the Taxpayer would enter into an agreement with the customer either to buy outright or hire the equipment in accordance with the customer's financial needs;

(c) prior to conclusion of rental contracts, the Taxpayer would carry out feasibility studies to determine the type of computer equipment that best suits the customer's needs. Upon completion of successful feasibility studies the Taxpayer would procure the computer hardware by entering into purchase agreements with its overseas suppliers;

(d) upon initial acquisition by the Taxpayer, the computer equipment is entered into a common account, labelled 'Rental Machines' – which is a misnomer in that all items, whether for hire, sale or own use are included therein. In fact, not all the computer hardwares held in the account are for 'rental purposes' as the account is effectively a control account only;

(e) the Rental Machines (R/M) account is subdivided into:

(i) 'R/M Awaiting Installation' where all additions will come through this account including those ordered for direct sale;

(ii) 'R/M Revenue Producing' where the equipment is rented to customers;

(iii) 'R/M Idle' where the equipment is off-rented from customers and temporarily not in use;

(f) the tax representative has provided to the Commissioner a schedule of movements in the account from the years of assessment 1980/81 to 1984/85 (Contained in Appendices A1 to A5 of the determination), wherein the column (A) 'Machines for Direct Sale' represents the R/M Awaiting Installation as described in (e)(i) above. The additions will then be 'reallocated' to the subdivided accounts which are represented by columns (B), (C) and (D) depending on the usage of the machines at the time they were ordered for;

(g) it is the Taxpayer's practice not to order any equipment for stock purposes and the aforesaid treatment would be consistently maintained by the Taxpayer.

9. The tax representative provided the following breakdown of the Taxpayer's turnover.

Year of Assessment	Direct Sales US$	Sale of rental/idle machines US$	Hiring income US$	Maintenance Income US$	Total turnover US$
1980/81	11,994,617	99,778	1,167,575	1,661,483	14,923,453
1981/82	13,274,432	8,000	1,928,302	3,008,988	18,219,722
1982/83	10,481,569	4,444,151	1,925,608	3,189,024	20,040,352
1983/84	5,100,810	9,876	2,616,207	3,974,237	11,701,130
1984/85	6,225,534	188,670	2,333,752	4,500,895	13,248,851
1985/86	20,275,601	-	2,362,885	5,351,029	27,989,515

10. In particular, the assessor queried the Taxpayer concerning certain items sold in the years of assessment 1982/83 and 1984/85 resulting in substantial surpluses, over and above the original cost to the Taxpayer, such surpluses having been claimed by the Taxpayer to be capital in nature. In schedule 4A to the 1982/83 return (copy attached as Appendix B1 to the determination) the three items are shown as '1 x 1100/80', '1 x UTS 400', and '1 x DCP 40' respectively and in schedule 8 to the 1984/85 return (copy attached as Appendix B2 to the determination) the item concerned is listed as '1 x DCP/40'.

11. The items referred to in the preceding paragraph were the subject of various agreements, details of which are set out in the following paragraphs.

Agreement with H Ltd

12. In late 1978 the Taxpayer entered into an agreement (copy attached to the determination as Appendix C1) with H Ltd which had a preamble which read:

> ‘ WITNESSETH:
>
> WHEREAS H Ltd has expressed the intention of acquiring a computer system which will enable it to process its 1981 workload and of having all its existing programs converted to the new system.
>
> AND WHEREAS [Division U], a division of the Taxpayer, is developing a new computer system, presently known with the code name of ‘B’ which system is considered suitable for H Ltd.
>
> AND WHEREAS [Division U] is willing to undertake the conversion of H Ltd’s program and to install, until ‘B’ becomes available and is ordered by H Ltd, a CPU System and ancillary equipment.’

13. The agreement referred to above [‘the H Ltd Agreement’] included the following provisions:

(a) Clause 2 – that the H Ltd Agreement would subsist for a minimum period of 60 calendar months, with provisions for extension and termination as set out in clause 23;

(b) Clause 3.1 – the Taxpayer would commence, upon signing of the agreement to convert all of H Ltd’s programs so as to make them compatible to run on the computer equipment to be supplied by the Taxpayer;

(c) Clause 4.1 – prior to 31 December 1979 the Taxpayer would submit the computer equipment to an ‘Acceptance Test’;

(d) Clause 8 – the Taxpayer would provide, during the period of the agreement, a ‘preventive and remedial maintenance service’. Service, after expiration of the agreement would be provided by the Taxpayer under its then current terms and conditions;

(e) Clause 14.1 – H Ltd to pay to the Taxpayer an amount of US$700,000 for the conversion effort undertaken;

(f) Clause 14.4.5 – H Ltd to pay to the Taxpayer, monthly in advance, lease and maintenance charges fixed from time to time in accordance with the agreement;

(g) Clause 14.10 – all payments under this clause to be made in HK dollars at the rate of US$1 = HK$4.615;

(h) Clause 16 – H Ltd could, at any time, exchange any piece of equipment for another unit subject to certain provisos;

(i) Clause 16.6 – read as follows:

'Notwithstanding the provisions of this clause H Ltd shall have the option at any time after the Acceptance of the Equipment to exchange under an extended term lease or a sale agreement the 1100/12 CPU and memory for [B System] (CPU memory and necessary associated features), subject to its final public announcement by [Division U] and availability thereafter. The range of B systems will provide significantly increased price/performance over the current 1100/10 range.

16.6.1 [Division U] is not in a present position to commit to a firm price and/or a firm delivery date. However, announcement for B will take place no late than June 1979. The contracted purchase prices or monthly lease charges for the substituted B item will be determined on the basis of the same relationship to the published list prices or monthly lease charges for B as exists between the prices or monthly lease charges in the equipment schedule and the current published list prices or monthly lease charges for the 1100/12 items to be replaced as shown in the equipment schedule always provided that if H Ltd opts to lease B it shall sign a new lease agreement with a term equal to the terms of this agreement.'

(k) Clause 22 – title and risk to the equipment, aids programs (except H Ltd's 'converted' programs) to remain at all times with the Taxpayer and at the termination of the agreement the equipment was to be returned to the Taxpayer.

14. The computer equipment under the H Ltd Agreement was included in an 'Equipment Schedule' which described each item and allotted to each item amounts described as 'Monthly Lease Charge (US$)', 'Monthly Maintenance Charge (US$) and Purchase Price (US$)'. Minor amendments to the 'Equipment Schedule' were made by way of Amendment No. 1 to the agreement, dated 21 September 1979 (copy attached as Appendix C2 to the determination).

15. The H Ltd Agreement was substantially amended by Amendment No. 2 thereto (copy attached to the determination as Appendix C3) dated 3 October 1980. This amendment, inter alia, reflected the replacement of the 1100/12 CPU and equipment with

the 1102/82 CPU and equipment as envisaged in the preamble to the original H Ltd Agreement. Amendment No. 2 reflected the following changes to the original agreement:

(a) the agreement would continue for a period of 84 months from the 'Ready for Use' date of the 1100/82 CPU and certain ancillary equipment as set out:

(b) a new clause 11.7 was added to the original agreement which read, in part as follows:

> 'For the duration of THE AGREEMENT as amended hereby or for a period of seven years from the Ready for Use date of the equipment listed in items 1-9 of schedule 4 of this amendment in case H Ltd opts for purchase as mentioned in clause 14.13(sic) hereafter H Ltd shall not be charged with licence fees for the operating system OS1100…'

(c) Clause 14 of the old agreement was entirely replaced and clause 14.12 of the replacement read as follows:

> 'In the event that H Ltd decides to purchase the equipment in schedule 6 at any time after the Ready for Use Date of the equipment listed in items 1-9 of schedule 4 of this amendment, Division U shall sell this equipment subject to a separate sales agreement for a sum of US$4,316,288, decreased by an amount defined as conversion credit. Conversion credit shall be calculated as 75% of the paid-up monthly lease charges between the Ready for Use Date of the equipment item 19 as listed in schedule 4 of this amendment and the date of purchase up to a maximum of US$438,383.00. The resultant net purchase price shall be paid by H Ltd to Division U in U.S. dollars.'

(d) the resultant equipment reflected by the original agreement as amended was set out in schedule 6 to amendment No. 2.

16. In a letter dated 28 June 1982 from the Taxpayer to H Ltd (copy attached as Appendix D1 to the determination), the Taxpayer noted H Ltd's confirmation, on 18 June 1982, of a decision to '… convert the lease on the installed equipment to a contract for outright purchase at a total price of US$4,000,000.'

17. On 20 July 1982 the Taxpayer and H Ltd entered into a 'Conversion Sales Agreement' (copy attached as Appendix D2 to the determination) to formalise the purchase by H Ltd of all the equipment listed in schedule 6 to the amendment No. 2. The 'Conversion Sales Agreement' contains a clause 2 to the effect that: 'The agreement shall become effective on the date it is accepted by Division U'.

18. In relation to the computer equipment sold to H Ltd referred to above:

(a) the items sold at a consideration of US$4,000,000 originally cost the company US$2,278,112.88 and US$361,055 as reflected in Appendix B1 and supplied schedules (copies of which are attached as Appendices D3 and D4 to the determination), and

(b) the proceeds of US$4,000,000 were treated by the Taxpayer as consideration for the sale of capital assets and, to the limit of original cost, deducted for depreciation allowance purposes against the 30% 'Pool' purportedly pursuant to section 39B(4)(e) of the Inland Revenue Ordinance (see Appendix D5 to the determination).

Agreement with Bank Y

19. On 14 January 1982 the Taxpayer entered into an agreement (copy attached as Appendix E1 to the determination), numbered DCF/40/CHB/81/319, with Bank Y ('the Bank'), which included, inter alia, the following particulars:

(a) the Taxpayer would rent to the Bank, for a period of five years, the computer equipment listed in the 'equipment schedule' set out on page one of the agreement;

(b) the equipment schedule described each of the items and allocated thereto amounts, designated in US$, described as 'Purchase Price', 'Base Monthly Maintenance Charge' and 'Monthly Lease Charge';

(c) the term of the agreement would be automatically extended from year to year unless terminated by written notice by either party;

(d) title and risk in the equipment was to remain vested in the Taxpayer whilst the agreement was in force, and the equipment was to be returned to the Taxpayer after termination of the agreement.

20. On 16 March 1982, the Taxpayer entered into a further agreement (copy attached as Appendix E2 to the determination), with the Bank, which included the following details:

(a) the Taxpayer would rent to the Bank, for a period of one year, the computer equipment set out in Annex I to the agreement;

(b) identical terms to those mentioned at terms (b), (c) and (d) in the preceding paragraph existed;

(c) Annex II to the agreement granted an option to the Bank to purchase part or all the equipment. Paragraph (a) of Annex II was in the following terms:

> 'The Customer may, whilst this Agreement is in effect, opt to purchase the equipment at a 'Conversion Price'. In this event, the customer shall send not less than 30 days prior written notice of its desire to exercise the option and upon expiry of such notice Division U (provided all charges under this Agreement have been paid to date) shall enter into its standard form of Conversion Sale agreement with the Customer.'

(d) the 'Conversion Price' was stated to be the total 'Purchase Price' listed in the agreement less certain credits. The computation of the 'Conversion Price' is set out in paragraph (c) and (d) of Annex II to the agreement.

21. On 1 October 1982, the Taxpayer entered into a third agreement (copy attached as Appendix E3 to the determination) labelled as a 'Sales Agreement' with the Bank. This agreement reflected the following:

(a) the agreements referred to the preceding two paragraphs would be superseded by it, such that the items included in those agreements would now be sold;

(b) items already installed for use as at 1 October 1982 would be sold to the Bank at a net purchase price of US$382,655;

(c) items to be delivered and installed ready for use by 31 March 1983 would be sold for a net US$2,221,141, and

(d) a further 91 items, already hired under ten other hire agreements may have those agreements terminated by the Bank at any time after June 1983 by giving not less than 30 days prior notice to the Taxpayer.

22. In relation to the computer equipment sold to the Bank as set in the preceding paragraph:

(a) the items sold at a consideration of US$382,655 originally cost the Taxpayer US$202,970 as indicated by Appendix B1 to the determination and a supplied schedule (a copy of which is attached as Appendix E4 to the determination);

(b) the sales proceeds of US$382,655 as mentioned paragraph 20(b) above were treated by the Taxpayer as consideration for the sale of capital assets and, to the limit of original cost, deducted; for depreciation allowance purposes, against the 30% 'Pool' purportedly to section 39B(4)(e) of the Inland Revenue Ordinance (see Appendix D5 to the determination); and

(c) the profits on the sale, for US$2,221,141, of the computer equipment as indicated in paragraph 20(c) above were returned by the Taxpayer as trading profits and profits tax was paid by the Taxpayer thereon.

<u>Agreement with K Ltd</u>

23. On 4 February 1983, the Taxpayer entered into an agreement (copy attached as Appendix F1 to the determination) with another company ('K Ltd') which included the following terms:

(a) the Taxpayer would rent to K Ltd, for a period of seven years, certain computer equipment set out in five 'equipment schedules' labelled therein as schedules 'A' to 'D2' inclusive;

(b) the equipment schedules described each of the items and allocated thereto amounts, designated in US$, described as 'Purchase Price', 'Monthly Maintenance Charge' and '5-year Monthly Lease Charge';

(c) the term of the agreement would be automatically extended from year to year unless terminated by written notice by either party;

(d) title and risk 'shall at all times be vested in Division U';

(e) all but two of the items set out in equipment schedule 'A' had already been delivered and installed, but, as at the date of the agreement the balance of the equipment had not so been delivered or installed; and

(f) Appendix I to the agreement contained clause 16 which read as follows:

> 'The customer may elect any time to purchase any or all units of equipment listed in the Equipment Schedule under a separate sales agreement with purchase prices and terms and conditions agreed between the parties.'

24. On 16 October 1984 the Company entered into a further agreement with K Ltd (copy attached as Appendix F2 to the determination) whereby K Ltd purchased all but one of the items set out in schedule D1 to the hire agreement as set out in paragraph 23 above. The items sold at a consideration of US$164,159 were originally acquired at a cost of US$74,583 as reflected by Appendix B2 to the determination.

25. As a result of his discovery of the foregoing, the assessor did on divers dates (no doubt, exercising powers conferred by section 60 of the Inland Revenue Ordinance) revise certain loss computations and raised assessments/additional assessments on the basis that the computer equipment and related feasibility and modification costs were not the Taxpayer's capital assets, that the Taxpayer was not entitled to depreciation allowances thereon and that the surpluses on disposal (difference between sales proceeds and original costs) were chargeable to profits tax. We have not set out the assessments in detail as they have been superseded by the Commissioner's determination which is summarised in paragraph 1 above.

<u>Grounds of the Commissioner's Determination</u>

26. The Commissioner, in essence, based his determination upon the following grounds:

(a) that the Taxpayer carried on a single business comprised of both selling and hiring computer equipment.

(b) that although the equipment in question was initially leased, the agreements either contained options allowing the lessees to purchase at some future date or it was implicit in all hiring situations that the Taxpayer would sell if approached, and that this point is emphasised by the fact all leasing documents set out in each case the prices at which the lessee might purchase the goods.

(c) that the extent and nature of the large systems, backed up no doubt by compatible and suitable software provided by the Taxpayer, would lead to the conclusion that at some point the systems would be purchased in order that he hirer would have the comfort of not being left in a situation, however unlikely, of having his operations dependent on a finite lease with no legal title.

(d) that the Taxpayer could not have formed the primary intention of leasing when from the very beginning it had granted explicitly or implicitly an option to purchase to the lessee.

(e) that in considering all the facts, the profits/losses made on the sale/disposal of computer hardware were incidental and relevant to the one business of dealing in computer equipment dominated by, and predominantly targeted towards, selling, and that the computer items do not meet the definition of 'capital expenditure' in section 40 of the Ordinance on the basis that such definition does not allow '… any expenditure which is allowed to be deducted in ascertaining for the purpose of Part IV the profits of a trade or business carried on by that person'.

(f) that, however, the items specifically acquired for 'own use' did constitute capital assets of the Taxpayer and that depreciation allowances should be granted.

(g) that as the Taxpayer had provided no authority to support its claim that depreciation allowances claimed in previous years could not be subsequently adjusted, there was no reason to depart from the clear power given by section 60 of the Ordinance to raise the assessments under consideration.

The Taxpayer's case

27. In this appeal, the Taxpayer, ably represented by Mr O'Dwyer of Messrs Ernst & Young, advanced the following arguments:

(1) that the question as to whether the Taxpayer had one or two business is not decisive;

(2) that in the computer world, expensive equipment has a propensity of becoming quickly obsolete, and so, the fact that a particular system can be sold at a handsome profit does not mean it must be a trading asset.

(3) that the accounting treatment of the assets in question (which were leased out) was in accordance with accepted principles, approved by auditors, and depreciation allowances for tax purposes were claimed and given;

(4) that the Inland Revenue Department had not fully considered the implications;

(5) that the Department's stance will deprive taxation policy of certainty in that the Department was seeking to revise history by retrospection on a haphazard basis;

(6) that there is no dispute that depreciation can be given only on such assets which are acquired for the purpose of producing chargeable profits, and the corollary, that no depreciation allowances can be given on trading stock;

(7) that leases given by the Taxpayer in the appeal were in the nature of 'Hire Purchase Agreements', as defined in section 40 of the Ordinance, and in those cases where the leases do not contain an option to purchase at a stated or ascertainable price, the provisions of section 37A of the Ordinance cannot be applied to the lessees until the equipment is bought, if ever a sale takes place, and thus the assets must remain as capital plant and machinery in the ownership of the lessor until the happening of such an event which may never take place;

(8) that in any event, even if there is an option to purchase, no depreciation allowance can be given to the lessor until the conclusion of the sale, which may never take place;

(9) that accordingly, the end result is that the policy behind Part VI of the Ordinance, which is to encourage the acquisition of plant and machinery by giving tax relief in the form of depreciation allowance, cannot be attained since the allowance is only made after the equipment is sold, an event which may never happen.

28. Evidence on behalf of the Taxpayer was given by Mr X, the contract and pricing director. Mr X had been employed by the Taxpayer for 15 years and was familiar with the contracts forming the subject-matter of this appeal. The Board regards Mr X as a truthful witness and insofar as it considers his evidence relevant, accepts the following statements made by him:

(1) That the Taxpayer kept a separate rental/maintenance contract register, in respect of equipment which was leased out.

(2) That in relation to the H Ltd contract:

(i) H Ltd chose leasing because initially, it had another machine (that is the B model) in mind. They also had at that time budgetary constraints and further wanted to test the equipment before they decided to purchase. Thus, they decided that there should first be leasing before purchase.

(ii) The original equipment supplied was a stopgap pending the availability of the B model.

(iii) Eventually, the Taxpayer and H Ltd re-evaluated the position and H Ltd decided upon a system bigger than the B system.

(iv) Included in the second amendment was an option to purchase which was requested by H Ltd.

(v) H Ltd later bought the system because they had faith in the equipment and budgetary constraints no longer applied.

(vi) H Ltd bought the installed system at US$4,000,000.

[Note: The Board notes that a purchase price was indicated in all H Ltd's contracts].

(3) That is in relation to the Bank contract:

(i) the original contract with the Bank was a standard form contract which did not initially contain an option of purchase, which was included by an amendment, two months later.

(ii) the equipment was sold nine months after the original contract when the Bank wanted to and did buy all the equipment outright.

[Note: The Board notes, however, that a purchase price was indicated in the first contract between the Taxpayer and the Bank].

(4) That the original contract with K Ltd did contain a clause stating that K Ltd may elect at any time to purchase any or all of this equipment listed.

[Note: the Board again notes that a purchase price for each item of equipment was shown in all the relevant contracts signed between the Taxpayer and K Ltd].

(5) That the inclusion of a purchase price whether or not there was an option to purchase, was standard corporate practice and that such practice indicated that the Taxpayer was willing to sell the equipment leased to the lessee at a certain price.

(6) That the decision to lease or sell was a matter of negotiation between the customer and the Taxpayer, and decision to agree to lease was generally exercised by the general manager of the Taxpayer.

(7) That there was no differentiation in marketing the equipment for sale or lease, that is, the equipment was marketed by staff of the marketing department and it was only after negotiation with the customer that either leasing or outright sale was decided upon.

(8) That the only segregation in administration between leasing and sales, lay in the keeping of separate registers for leases and sales.

Conclusions of the Board

29. Section 14 of the Inland Revenue Ordinance ('the Ordinance') provides that '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) …' (our emphasis). The question for determination is whether, as the Taxpayer contends, the computer equipment forming the subject matter of this appeal represent capital assets.

30. Authorities have been helpfully cited to this Board by both sides. From these authorities, the Board has gleaned the following propositions with which it would guide itself in the determination of this appeal, namely:

(1) Professor Whitman's two tests

That although there is no single satisfactory test as to what constitutes a 'capital asset', guidance might be had to two tests formulated b Professor Whitman, both tests having been approved by Lord Radcliffe in Commissioner of Taxes v Nchanga Consolidated Copper Mines [1984] AC 948, namely:

(i) Assets which from part of the permanent structure of the business and are means whereby profit are earned represent capital assets which should be contrasted with transactions relating to the subject-matter of the trade and which are trading, as opposed to capital assets;

(ii) An asset which is retained in the business with the object of producing profits is fixed capital (or a capital asset), whereas an asset is part of circulating capital of the business if it is required in the ordinary course

of trade, and is sold. Put another way by Lord Haldane in John Smith & Son v Moore [1921] 2 AC 13:

> 'Adam Smith Second Book of Wealth of Nations described fixed capital as what the owner turns to profit by keeping it in his own possession, circulating capital as what he makes profit by parting with it and letting it change masters. The latter circulate in this sense.'

(2) The requirement of intent

It is clear that the above two tests require intent on the part of the person carrying on the business. The basic question to ask is whether the asset in question was acquired with the intention of disposing at a profit or was it acquired as a permanent investment (that is to be retained in the business for the purpose of providing profit to the business), see: Simmons v IRC [1980] 2 All ER 798 per Lord Wilberforce.

(3) Is hiring out part of the adventure in form of trade?

Whilst the first two propositions are proposition of law, the final question is one of fact and it involves a determination as to whether the assets hired out were assets which the Taxpayer have deliberately retained as a permanent part of the business for the purpose of generation of profits. In coming to this determination of fact, the Board must look at the whole of the evidence including, of course the Taxpayer's accounting treatment of its hiring and outright sale activities (see: Federal Commissioner of Taxation v Cyclone Scaffolding [1987] 19 ATR 673).

31. In making findings of fact, decided cases often do not greatly assist. At the most, they offer some degree of guidance. Thus, we hope that Counsel for both sides will not consider it discourteous of us if we did not deal with in full the passages in decided cases that they have diligently researched and read to us. However, as will be apparent in our analysis of the facts below, we have derived a degree of assistance from the cases cited.

32. One first concern is whether we can regard the hiring part of the Taxpayer's business to be a separate business. On considering the whole of the evidence, we believe, and so find as a fact, that the hiring of computer equipment is an integral part of the Taxpayer's business, namely, that it is not a separate business. We have come to this conclusion on the basis that the only indicia of separation lies in keeping separate registers of the equipment sold and equipment hired out and the keeping of a rental account, whereas, from an operational point of view, the whole purpose of the Taxpayer's business was to market computer equipment (which is imported by it and for which it carried no stock) to Hong Kong customers by a single sales force working in the marketing department and it was only when the transaction was consummated that a contract of sale or hire was entered into. On the evidence, there was no deliberate allocation of assets for hire and assets for

sale. The aim was to turn the import of computers into profit and sale or hire was merely a step in the process. The Taxpayer's mode of operation reminds this Board of the words (which we adopt) of the Commissioners for Special Purposes of the Income Tax Acts in Gloucester Railway Carriage and Wagon Co Ltd v The Commissioner of Inland Revenue [1925] 12 TC 720: 'In our opinion we must have regard to the main object of the Company which is to make a profit in one way or another out of making wagons and rolling stock. We are unable to draw the very sharp line which we are asked to draw between wagons sold, wagons let on hire purchase and wagons let on simple hire, nor do we consider that this very sharp division in fact exists.'

33. In the Gloucester Railway case, the taxpayer was formed to manufacture, buy, sell, hire and let out, wagons and rolling stock. In the books of the taxpayer, wagons built to be let on hire were capitalised at a sum which included an amount added as profit on the manufacture and year by year an amount was written off the value for depreciation. In 1920, following a decision to cease letting wagons on hire, the taxpayer sold off the entire stock of wagons. The Special Commissioners finding that the surplus on sale represented trading profits was upheld by the House of Lords wherein, Lord Dunedin, giving the only judgment at the House, stated: 'The Commissioners have found and I think it is the fact – that there was one business. A wagon is none the less sold as an incident of the business of buying and selling because in the meantime before sale it has been utilised by being hired out.'

34. On the evidence of the present case, this Board finds as a fact there was only one business of turning computers to profit whether it be by way of sale or hiring.

35. Mr O'Dwyer submits that a finding of one business is not decisive. He asks this Board to consider the question of intent more thoroughly, and in particular, he relies upon the following facts:

(a) The fact that the Taxpayer had followed consistent accounting principles and depreciation allowance for tax purposes had been claimed and given on the assets which were leased out.

(b) The fact that assets were leased out for usually long periods.

36. It is a trite proposition in tax law that one looks to the substance and not to the form of accounts. As the Commissioner has stated in his determination (see: Fact(9)), the assessor had prior to 1986 begun to ask questions as to the nature and extent of the Taxpayer's computer business and had entered into correspondence with the tax representatives. It was upon reconsideration of the facts so provided that new assessments were raised. That is exactly the sort of situation for which section 60 of the Ordinance was enacted. The fact that assets were leased for long periods is but one factor in ascertaining whether the assets were capital in nature. One must look to the whole of the evidence. In the Gloucester Railway case, wagons were let for various terms of 10 years and under down to yearly agreements which were customarily continued from year to year, yet the Special

Commissioners (who were upheld by the House of Lords) found on the whole of the evidence that such assets were not capital in nature.

37. Accepting Mr O'Dwyer's invitation to look further into the evidence, we find further proof that the one continuing thread in the evidence was the Taxpayer's intention to bring the importation and distribution of computers into profitable account whatever the form of the transaction.

38. Between the years of assessment 1980/81 to 1985/86, the Board notes that hiring income represented only a minor proportion of the total income of the Taxpayer. According to the Taxpayer's only witness, its contract and pricing director, whether a piece of equipment was hired or sold outright was a matter of negotiation between the Taxpayer's representative and those of the customer. We find as a fact that it was a matter of indifference to the Taxpayer whether a piece of equipment was hired or sold, what mattered was that a contract for the equipment was entered into with the customer. Our finding is reinforced by the fact that the Taxpayer carried no stock and each system was only imported after a feasibility study of the customer's requirements. Further, in all contracts for hire we have seen, a sale price was listed in respect of each item of equipment. The Taxpayer's witness tells us that it is standard corporate policy to include a list price in all contracts for hire and that such practice indicated that the Taxpayer was willing to sell the equipment leased at a certain price. This indicates to us that the clear object of the Taxpayer's business was to distribute the equipment it had imported, and the decision to hire initially was an expedient based on the customer's requirements. Yet, at all times, the Taxpayer was ready and willing to sell whether initially or at some time in the future.

39. The tax representative's letters to the assessor further revealed to us that whilst the existence of a purchase option does not intend to guarantee any subsequent outright purchase, 'it is not uncommon that the option to purchase is exercised, even if the clause does not exist' (see: tax representative's letter of 2 February 1990, page 11 of Exhibit IRD-1). In another letter (dated 6 July 1990, at page 15 of Exhibit IRD-1), the tax representative said:

> 'Our client agrees to your suggestion that it is commercially realistic to assume that all of the rented computer equipment was at all times available for sale to the hirer. It would not be commercially realistic to refuse to sell a rented equipment even if the hirer requested to buy. However, we emphasize that the sales of the leased equipment were all initiated by the lessees and our client conducted no positive action to sell the equipment. It should not be inferred that our client had a primary intention to sell the equipment at the time of negotiating the leas agreements because the option to purchase (in cases where there was an option) was included to provide some flexibility to the hirers only.'

40. Considering the three specific contracts whose basic terms are set out in paragraphs 12 to 23 above, it is clear to this Board and we so find as a fact, that in all three

cases, it was clear that the Taxpayer and the customer contemplated the possibility of a sale in the future.

41. The H Ltd contract in its preamble was explicit in stating that H Ltd wished to acquire the B system then under development. The oral evidence given to us was that H Ltd wanted first a stopgap before the B system was supplied, and when the final system (which was a bigger system than the B system) was supplied, it wanted to test the system before committing itself to the purchase. Further, when the original contract was signed H Ltd had budgetary constraints. When the final system was eventually supplied and successfully tested, and when the budgetary constraints no longer applied, H Ltd made good its intention to purchase the system. The term of the initial hire being 60 calendar months was no doubt designed to allow time for the development and supply of the B system. In particular, clause 16.6.1 refers to the fact that the Taxpayer was not then in a position to give a firm price/delivery date for the B system. When the second amendment was entered into, the new system had been installed and to formalise H Ltd's intention to purchase the system, an option to purchase was included in the amended agreement.

42. In relation to the Bank contract, the original contract, pursuant to standard corporate practice as confirmed by the Taxpayer's witness, contained a price list of the various items of equipment hired. Two months later, an option to purchase was included in an amendment contract covering the same equipment. 7 months later, the option was exercised. This series of events is entirely consistent with the view, which we take, that from the time the equipment was supplied, a sale at some time in the future was contemplated.

43. The K Ltd contract for hire contained an option to purchase from the very beginning, as to which, see clause 16, reproduced at paragraph 22(f) above. Whatever the legal effect of such a clause, it is clear that a future sale was contemplated.

44. But it is argued on behalf of the Taxpayer that subsequent sale is no more than a mere possibility, and in any event, the Taxpayer has no control over the matter, a subsequent sale being invariably requested by the customer. We do not believe that this is an obstacle in the way of the Commissioner's determination. The crux of the matter lies in identifying the business of the Taxpayer. This Board has identified the business of the Taxpayer as the importation and distribution of computer equipment for gain. As the possibility of sale is contemplated in all hire contracts (it is being standard corporate practice to include list prices in all hire contracts), it cannot be argued that possible sale is not part of the normal business of the Taxpayer.

45. As Lord Buckmaster in his judgment in The Rees Roturbo Development Syndicate Ltd v the Commissioners of Inland Revenue [1928] 13 TC 366 observed (which observations we adopt mutatis mutandis for the purpose of this appeal and would suggest that these observations apply a fortiori to the facts of this appeal):

> 'Turning to the findings of the Commissioners, I find that they set out in detail the circumstances connected with the working of this Company, and, in

> particular, the reports, which begin in 1907 and continue down to 1918. These reports show that the directors were contemplating from the earliest the possibility of the sale of some of these patents. It is quite true that they preferred not to sell them if a sale could be avoided, but the statement in paragraph 11 of the case is quite plain, that "the possibility of the sale of" the Taxpayer Company in respect of such interest as it possessed "in the foreign patents". It is one of the foreign patents with which this appeal has to do, and the agreements, which are set out, showing the way in which the foreign patents in the case of France and of Canada have also been dealt with, so that that statement was not a statement of a mere accidental dealing with a particular class of property, but that it was part of the Company's business which, though not of necessity the line on which it desired its business most extensively to develop, was one which it was prepared to undertake.'

46. Another way of putting the question is whether the sale constitutes part of the whole scheme of the Taxpayer's activities (see: Federal Commissioner for Taxation v Cyclone Scaffolding [1987] 19 ATR 673). The scheme, as we have found it to be, is the importation and distribution of computers equipment for gain. The evidence clearly points us to the fact that eventual sale is no less a part of the scheme since such possibility has been contemplated from the beginning. As stated by the tax representatives, 'it is not uncommon that the option to purchase is exercised even if the clause does not exist'. Certainly in the three specific contracts forming the subject matters of this appeal, the possibility of sale is contemplated by both the Taxpayer and the customer. When the sale eventually took place, it was expected. The sale after a period of leasing is therefore but the culmination or the final act in a scheme of turning the importation and distribution of computer equipment to profitable account. It is part of the ordinary incidence of the business of the Taxpayer (see: Memorex v Federal Commissioner for Taxation [1987] 19 ATR 553 and Federal Commissioner for Taxation v GKN Kwikform Services [1991] 21 ATR 1532). As was said by the Australian High Court in Federal Taxation Commissioner v Myer Emporium Ltd [1987] 163 CLR 199:

> 'Because a business is carried on with a view to profit, a gain made in the ordinary course of carrying on the business is invested with the profit-making purpose, thereby stamping the profit with the character of income.'

We adopt the above formulation of principle and find that the income on the disposal of the hired equipment represents income of a revenue nature, in other words, we do not accept that the assets hired out represent capital assets.

47. We next deal with Mr O'Dwyer's submissions relating to problems associated with lessees. These submissions are summarised in paragraph 26(7) to (9) above. Mr Gaskin accepted that the leases under appeal may be said to fall within the definition of 'Hire Purchase' agreements under the Ordinance or at common law and agreed that there may be computational problems. However, he does not consider that such computational problems are insurmountable and suggested, for example, that a monthly 'lease' amount might be in reality a composite reflection of principal costs and an interest element. In any

event, as we are dealing with the Taxpayer's tax position and not that of the lessees, we shall, therefore, leave that question to be dealt with between the Commissioner and the lessees concerned with the comfort of the knowledge that the Commissioner does not consider the computational problems insurmountable.

48. In conclusion, the Board summaries its conclusions as follows:

(a) that sale and hiring of computer equipment make up a single business of importation and distribution of computer equipment;

(b) that the computer equipment leased out do not represent capital assets;

(c) that the sale of such equipment represents income incurred in the ordinary course of the business of the Taxpayer, which is taxable under section 14 of the Ordinance.

(d) that consequently, the appeal fails and the Board confirms the Commissioner's determination.