Case No. D32/85

Board of Review:

H. F. G. Hobson, *Chairman,* Alexander S. K. Au and James Yuen-wo Chu, *Members.*

12 December 1985.

Profits tax—Section 14 of the Inland Revenue Ordinance—commitment to purchase property under construction—whether profit on resale a capital gain.

The Appellant was the chairman and managing director of two associated textile manufacturing companies. Both companies held substantial properties in the New Territories and were engaged in projects of redevelopment for the years 1976 to 1984. In mid-1978, the Appellant made a commitment to purchase on completion of construction a property at a price of $27M. After 22 months, the property was sold at a profit of $19M which the Assessor had assessed and the Commissioner had confirmed to tax under Section 14 of the Inland Revenue Ordinance. The Appellant appealed on two grounds:—

(1) The original intention to purchase the property was for capital investment to support development projects of the two companies; the subsequent resale was due to unforeseeable circumstances that part of the development projects was shelved in view of the prolonged negotiation and change of market conditions.
(2) Previously he had not purchased any property other than his residence.

Held:

(1) On the facts, the Appellant's motive in purchasing the property was a belief in the substantial appreciation of value upon resale.
(2) The isolated transaction having the ingredients of property trading was an adventure in the nature of trade.

Appeal dismissed.

Cases referred to:—

1. Leeming v. Jones 15 TC 333.
2. C.I.R. v. Dr. Chang Liang-jen, 1 HKTC 975.
3. Balgownie Land Trust Co. v. C.I.R., 14 TC 684.
4. Rees Roturbo etc. v. Ducker, 13 TC 366.
5. Williams v. Davies, 26 TC 371.

Luk Nai Man for the Commissioner of Inland Revenue.
Henry Litton, Q.C. for the Appellant.

Reasons:

This Appeal is concerned with a commitment made in mid-1978 by A, the Appellant Taxpayer, to purchase, on completion of construction, B at a price of HK$27,022,940 and the resale thereof some 22 months later at a profit of HK$19,708,050 which the Revenue had assessed and the Commissioner had confirmed to tax under s. 14.

The Appellant was represented by Mr. Henry Litton, Q.C. who submitted that the profit was derived from the sale of a capital asset. The Revenue was represented by Mr. LUK Nai-man, Senior Assessor (Appeals).

The Appellant formulated tow grounds of appeal which may be paraphrased as follows:—

1. The Revenue had failed to take into account that the Appellant's original intention was for capital investment and to support the large scale development project of C and its parent D—the disposal was due to unforeseen circumstances and that the profit was a capital gain.
2. The only other property the Appellant had owned was purchased in 1962 and used since then as his family residence.

BACKGROUND

The Appellant Taxpayer, with two others who do not reside in Hong Kong and were referred to as "sleeping partners", incorporated D in 1957 and in the same year that company bought a large tract of land in Tuen Mun which was exchanged with the Hong Kong Government for 550 000 s.f. of land comprising E having 451 700 s.f. designated for industrial use and F and G in DD 131 of about 100 000 s.f. designated for residential purposes.

D is a "verticial" manufacturer, from raw textiles through to apparel manufacturing and marketing. These functions were carried out in factory premises erected on E. Upon F and G were erected dormitories for the Company's staff.

In 1964 A and his two sleeping partners bought C which had about 40 000 s.f. at H upon which it had its manufacturing facilities. Subsequently C issued shares to D. A is the Chairman and Managing Director of both companies—neither of the sleeping partners is a director of C. We are unsure whether they were in fact directors of D but assume they were not since it was said not only that they lived outside Hong Kong and only came here for periodic shareholders meeting but also that they were content to leave management matters to A.

C became a public and quoted company in 1970.

The shareholdings of the two companies at the relevant time were:—

—D:

The Appellant	30%
I	40%
J	23%
Other small shareholders	7%
	100%

—C, the public company:

D	74%
The Appellant	12%
Public	14%
	100%

It follows that the Appellant though not the largest individual shareholder in D nonetheless to the extent of 34% his was the largest personal interest in C—technically he could, of course, be outvoted by his partners in D and hence be outvoted in C.

In 1976 A and his partners decided that D's Tuen Mun property should be redeveloped—initially planning 8 flatted factory blocks on E and 16 low-rise residential blocks on F and G.

In October 1977 the Board of C resolved to redevelop in Kwai Chung property and to buy a property in Texaco Road to which the manufacturing would be moved to enable H to be vacated. That move was effected in 1977.

The redevelopment of the D's E, F and G was to be a far bigger undertaking, involving staggered development, with the idea that upon completion of the first industrial block D's own manufacturing would be relocated into it to minimize disruption of manufacturing processes.

C and D had administrative offices in Central — the offices were separate and autonomous though both were in Prince's Building. These offices engaged in buying raw materials. D's principal bankers were Hong Kong and Shanghai Banking Corporation whereas C's was Chartered Bank.

D's original architect who had proposed an 8 block layout for E was later replaced by K who more readily appreciated that each intended new block would itself have to conform to

the plot ratio applicable to the entire Lot to avoid difficulties that non-conformity with covenants would pose with purchasers or other subsequent assignees. The plot ratios problem evidently requiring K to confer with many government departments and consequent revisions and discussions consumed far greater time than the Appellant had originally envisaged. By the time the difficulties were reaching resolution A and his partners had had a significant change of heart as to the kind of redevelopment by D which they then felt to be marketable. By the end of 1979 they had concluded that the market for industrial premises was poor due to over supply—actual or anticipated. C redevelopment was by that time in practical terms a fait accompli, the Texaco Road move having been accomplished, the buildings formerly on H demolished and a contractor had been engaged. In early 1980 C created a subsidiary to which it passed the title to H.

D redevelopment was not off the drawing board by the end of 1979. A and his partners therefore decided to let K pursue his work—he had to be paid in any case—but nonetheless to put the project "on ice". In 1982 however the Government gazetted the zoning of area no. 9 which included D's property as industrial, this led to objection by D, a Town Planning hearing in 1984 and negotiations with the authorities for a comprehensive scheme of redevelopment of C's property to provide for building residential properties on E (except for an area to re-house the factory premises).

EVIDENCE

A gave viva voce evidence, much of it is covered above and that portion is not disputed by the Revenue.

A related that when he and his two sleeping partners decided to commit D and C to redevelopment they were concerned that estate agents standard commission was two per cent which would, on the basis of their then estimate of total sales of $1.5 billion, amount to $30 million. (When cross examined A said that even with tough bargaining he would not get down to one per cent then; in 1983 negotiated a rate of 1% with L to handle the sale of C's subsidiary's Kwai Chung property). It was this concern, A said, which prompted him to look for office accommodation in Central, which he said would be staffed by some 40 to 50 person, to co-ordinate the redevelopment work of C and D and conduct sales.

A tried to get a floor in World Wide House when it came on the market in 1977 but he was told by the developers they had all been sold. He therefore moved quickly in August 1978 when he learnt from those same developers of sales of units in B, then under development, and promptly paid a $100,000 as a good faith deposit, signing the formal Agreement in September 1978 at a price of some $27 million. That Agreement provided for instalment payments in 1980 he had paid 20%, the balance being paid out of the resale price which was $46,731,400.00.

A said it was his original intention to "inject" the B property into C "in due course according to the original cost" in order to bolster the market price of C's shares then inactive

and quoted at about 54 cents. However he acknowledged that he did not discuss the idea with the Board of C nor with his sleeping partners to put it in his own words "it was none of the latter's business, they did not know of it, it was a personal venture." He did say he discussed it with his partners at an AGM meeting of D late in 1978—i.e. well after he'd committed himself to purchase—but the precise nature of that discussion was not clear form A's testimony: he said that there was no discussion as to rent or period of lease—presumably meaning a possible lease by D from C. He had no discussions with the Directors of C even after the B purchase.

A was unable to explain how C could buy the B property, even for the original price, when its own asset value at that time was only $17 million: even if transferred against an issue of shares to A such an issue would seriously deplete the percentage of shares in public hands—from 14% to about 6%. In cross examination A on this aspect A said "it was only an idea (to inject B into C), was unsure how I'd do it and whether the other directors would agree." It should be noted that some of these directors were non-executive outsiders recommended by the Chartered Bank, C's bankers.

A said he was in a financial position to buy the B property, as at that time he had over $15 million credited to him in the shareholders loan account of D and the latter had the finances (in excess of $45 million) to redeem that obligation, the accounts produced bore this statement out and were not challenged by the Revenue.

In support of his testimony that so far as he was concerned A had earmarked the B property for C an interior design plan was produced. A admitted however that no charge was made for this, the designer only charging if the plan was implemented. We do not look upon his piece of extrinsic evidence as any no more than indicative of the fact that the injection of the B property into C was one possibility (but not one for which he held out any real prospects) which had exercised A's imagination in October 1978 when the plan was originally drawn. However the fact that it was revised in January 1980, i.e. after it was decided to put the redevelopment of E on ice tends to undermine even that small merit—particularly as A himself said that C's own development would not justify such huge (20 000 sq.ft.) office premises.

As to the relationship of A and his sleeping partners, Mr. Litton submitted it was reasonable to assume that they had confidence in A's management abilities, the sleeping partners being only concerned with policy matters. Bearing in mind the 30 years of association we think that is a reasonable inference. We are however puzzled as to why A did not take these partners and dominant shareholders into his confidence as early as 1977 when he was looking for office space in World Wide House or again in 1978 before he purchased the B property, if indeed A did sincerely wish to pass the ownership to C. His assertion that the purchase of the B property was none of the business of his partners is of course at variance with the fact that they, as indirect shareholders in C (having a collective interest of

about 46%), would in financial terms be even more interested in seeing the B property injected at cost (assuming the market to be still on the rise) than A with his total of 34%. To this must be added the fact that he never once spoke to the other C directors, who as non-executive outsiders would look to the interest of minority shareholders, at any time before or during the 22 months during which A held an inchoate interest in B. However bearing in mind both the improbability of the non-executive disapproval of a plan that would result in the diminution of the minority's percentage of the equity and the fact that the argument that cost of estate agents commissions would exceed the cost of B could well be a highly questionable when account it taken of the staff, rent, and other substantial overheads and even highly unfavourable in total terms we do not therefore believe A's explanation for acquiring the B.

A did not put forward any other long term plans. Since A seeks to bring the B transaction within the first parenthesis of s. 14 ("sale of capital assets") we believe the onus is upon him.

CONCLUSION

We therefore have reached the conclusion that A's motive in buying the Admiralty property was a strong belief (correct as it happened) that it would appreciate in value substantially whereupon he would sell it. We do not think he had any belief that he could arrange a sale to C otherwise we think he would have explored the prospect seriously. As it was he bought quickly against his own estimation of the ability to realize a profit. We accept that A did not advertise the sale—it was he who was approached, but that comes as no surprise to the Board when the prevailing market was a sellers' market the like of which had not occurred before in Hong Kong: buyers and estate agents were aggressively knocking on the door of the owners of all the popular properties—we think there is no gainsaying that.

LEGAL CONSIDERATIONS

We now turn our attention t the effect of the law on the foregoing conclusions. The relevant portion of s. 14 reads as follows:

> "S. 14 Profits tax shall be charged … on every person carrying on a trade, profession or business … in respect of his assessable profits arising in or derived from the Colony … from such trade, profession or business (excluding profits arising from the sale of the capital assets) …"

Mr. Litton submits that the purchase and sale of the B property by A was not by way of a trade, profession or business, the profit was merely the realization of a capital asset. In this regard he invites us to consider the badges of trade for he argues that none of these indicia is applicable to A's activities.

In support of Mr. Litton's argument he drew the Board's attention to the House of Lords case Leeming v. Jones (1930).

In that case, which was concerned with an isolated property sale transaction, Rowlatt J., who dealt with the case stated in first instance, referred the matter back to the Commissioners for further findings of fact remarking that he "would not like to say there was no evidence" that the four appellants had been carrying on a trade and pointing out that "even with regard to isolated transactions there are several cases in the books where they have been held to afford an income which is taxable." The Commissioner then found that the transaction concerned was not a concern in the nature of trade: Rowlatt J. accordingly found for the Taxpayer. The Revenue appealed to the Court of Appeal which upheld Rowlatt J. The Commissioners then took the issue before the House of Lords and lost. From our reading of this case it would seem that despite the fact that it dealt with a single transaction nonetheless it was open to the Commissioners to find, if they so believed with reasonable supporting evidence, that it was in the nature of trade. For example per Lord Hanworth M. R. before the Court of Appeal:—

> "Now upon those facts I agree with the learned Judge that there was evidence of trading, and evidence of trading even though this one enterprise in relation to the two properties might be called an isolated transaction in the sense that these four persons were not constantly employing themselves in the buying and selling of properties; but having regard to the two properties, the expenses incurred and the negotiations involved, it appears to me that there was clear evidence for submission to the Commissioners of trading."
>
> "It was necessary for them to determine the facts and the summation of the facts, and Mr. Justice Rowlatt, in calling their attention to the several points which I have read out, indicated, I think, to them that it was quite possible for them to find that this was an adventure in the nature of trade."
>
> "Now Mr. Justice Rowlatt, and I think this Court, might perhaps have taken the course of saying that having regard to what he had called attention to in this case, the particular facts, of organising the speculation, of maturing the property, and the diligence in discovering a second property to add to the first, and the disposing of the property, these ought to be and there must be a finding that it was an adventure in the nature of trade; but Mr. Justice Rowlatt withheld his hand from so doing and I think he was right, for however strongly one may feel as to the facts, the facts are for the decision of the Commissioner."

Mr. Litton specifically refers us to the following passage in Rowlatt J.'s judgment:—

> "Now what is the dividing line between the case of a man buying and selling in an isolated transaction and buying and selling in transaction which is also isolated but which can be said to yield to taxable income?
>
> I venture to refer, with respect, to what the Lord President, Lord Clyde, said in the case of The Commissioners of Inland Revenue v. Livingston. He is dealing with this very point

> and he says this "I think the test, which must be used to determine whether a venture such as we are now considering is, or is not, in the nature of trade, is whether the operations involved in it are of the same kind, and carried on in the same way, as those which are characteristic of ordinary trading in the line of business in which the venture was made." "

The Revenue have not sought specifically to distinguish the law upon which the decision of the Leeming case is founded from our own law. As a generality the local cases suggest that if long term investment is negatived—and hence the profit is not a capital gain—then provided there is some indicia of trade the Board of Review will be inclined towards holding that the profit it from a trade, profession or business.

Mr. Litton adopts the principle enunciated by Lawrence, L.J. in the Court of Appeal and quoted by Lord Buckmaster in the House of Lords viz:—

> "It seems to me in case of an isolated transaction of purchase and resale of property there is really no middle course open. It is either an adventure in the nature of trade, or else it is simply a case of sale and resale of property."

Mr. Litton also drew our attention to C.I.R. v. Dr. Chang Liang-Jen HKTC p. 975, we do not however propose to deal with that case as we think the facts are so entirely different as to offer little guidance for the isolated transaction confronting us. We would however remark that the words quoted at p. 1004 from C.I.R. v. Fraser "It would be extremely difficult to hold that a single transaction amounted to a trade but it may be much less difficult to hold that a single transaction is an adventure in the nature of trade." may be opposite.

Mr. Litton's next authority was Balgownie Land Trust Co. v. C.I.R. (14 TC 684) where the Scottish Court of Session upheld the taxation of profits made from property sales. It is not so much the circumstances of that case with which Mr. Litton is concerned as the following passage by the Lord President:—

> "A single plunge may be enough provided it is shown to the satisfaction of the Court that the plunge is made in the waters of trade; but the sale of a piece of property—if that is all that is involved in the plunge—may easily fall short of anything in the nature of trade. Transactions of sale are characteristic of trade, but they are not necessarily distinctive of it; much depends on the circumstances."

However we have also noticed the following earlier passages:—

> "One of the most familiar problems under Case I of Schedule D of the Income Tax Act, 1918, is to decide whether a person who makes a profit on a transaction (or on several transactions) which is of the kind into which a trader might enter in the course of his business, is or is not carrying on a trade, so as to subject the profit to Income Tax."

AND:—

> "This is so notwithstanding the definition of "trade" in Section 237 of the Income Tax Act, 1918, as including "every … adventure … in the nature of trade". And yet that definition makes it plain that even the profit of an isolated transaction—if it constitutes an adventure in the nature of trade—may be brought within Case I of Schedule D of the Income Tax Act."

S. 12 of our Ordinance defines "trade" as including "every trade …, and every adventure and concern in the nature of trade. "Mr. Luk for the Revenue drew our attention to the following passage from SILKE on South African Income Tax (8th Edition) at P. 197, "As regards the term "Venture" the Special Court has held that it refers to a transaction in which a person risks something with the object of making a profit, i.e. a financial or commercial speculation". Mr. Luk also asked us to note the remarks or Rowlatt J. at p. 379 in Rees Roturbo etc v. Ducker (13 TC 366)" … What is meant by the phrase "capital asset" is that this is an asset which represents fixed capital as opposed to circulating capital, that is to say, that this is an article which is possessed by the individual in question, not that he may turn it over and make a profit by the sale of it to his advantage, but that he may keep it and use it and make a profit by its use."

Whilst the case of Williams v. Davies (26 TC 371) was referred to by Mr. Litton it really is one which turns on its own facts and of little direct guidance.

We therefore propose to examine whether in or view there is anything in the circumstances surrounding A's purchase and sale of the B property which is indicative of the transaction being in the nature of trade.

During the material time speculation in the Hong Kong property market, particularly so the commercial buildings in Central, was so optimistic as to be blind to the future, many commercial units and even blocks changing hands rapidly. We only have evidence that A was committed to one property, however it is our view that he intended to sell that property at a profit; he certainly had no intention in the bullish climate of the day of waiting to let it. Granted A used his own money to finance the initial instalments but then on his own evidence he had ample funds to do so, so the lack of banking accommodation in his case is not a "badge" of any consequence. We accept that he did no work on making the property more attractive, but then how could he have done so whilst the building was still in the course of construction—the same remark applies to "incurring expenses chargeable against profits."

We also accept that there is no evidence that he made the resale approach, rather that he like many other "owners" (including in that phrase buyers under agreements for sale and purchase) was approached by Estate Agents—but again in our view that badge, in the climate of the day for this type of property, was not then a prerequisite to "trading". We do however consider that that A's transaction was one which had all the only ingredients needed to qualify as trading at that time and for that property, namely a commercial property in the course of construction being purchased on instalments in a frenetic market. Such ingredients made up the recipe for property trading by others who were then habitually engaging in buying and reselling of commercial units in Central by way of trade: the only

distinction is that A was only concerned with one property. As that consideration, i.e. an isolated property, is not negatived by an intention to hold long term we are of the opinion that the profit from A's transaction was an "adventure … in the nature of trade."

Accordingly this appeal is dismissed.