

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D37/96

**Profit tax** – sale of exchanged land – whether capital gain or a transaction amounting to an adventure in the nature of trade.

Panel: Ronny Wong Fook Hum SC (chairman), David A Morris and Nigel A Rigg.

Date of hearing: 17 May 1996.

Date of decision: 16 August 1996.

The taxpayer acquired a piece of land on 1 September 1983 which was exchanged with Government for another piece of land in 1987. At the same time the taxpayer placed advertisement offering the sale of the exchanged land, but it was unsuccessful. Later the exchanged land was developed as a factory building in 1989. The taxpayer successfully pre-sold the entire building to another company by placing advertisement in newspaper. The taxpayer claimed that the land was kept as long term investment and the profit on sale of the exchanged land should not be subject to profit tax. However, the Commissioner was in the view that there was a change of intention while the taxpayer was applying for land change.

Held:

Placing advertisements for sale in newspaper by taxpayer indicated that the exchanged land did not form part of long term activities of taxpayer and constituted an intention to trade. Further the taxpayer did not have sufficient fund, or did not arrange any finance, to redevelop the exchanged land as long term investment, any presale or intention of presale of building, or even in part, could embark an adventure in the nature of trade at the outset.

**Appeal dismissed.**

Cases referred to:

Wing On Cheong Investment Co Ltd v CIR High Court [1987] 90-035

Simmons v IRC [1990] 1 WLR 1196

Overseas Textiles Ltd v CIR High Court [1987] 90-042

Wong Ki Fong for the Commissioner of Inland Revenue.

Chris Liu of Messrs Chris Liu & Co for the taxpayer.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Decision:

### The Facts

1. Since 1 August 1968, Madam A had been the sole proprietress of 'the Firm'. The Firm's main activity was in the manufacture and sale of wooden doors and building materials. For the purpose of its business, the Firm used a piece of land, No 1. No 1 was repossessed by the Government due to the change of land usage and the Firm was compensated in cash instead of land.
2. As from 1983, the Firm began to use No 2 for its operation.
3. The Taxpayer was incorporated on 6 May 1983. Its principal activity is property investment. Madam A and her husband Mr B were its shareholders and directors from incorporation up to 1989/90.
4. On 1 September 1983, the Taxpayer purchased No 3 ['the Original Lot'] at a consideration of \$1,000,000. The Original Lot was agricultural land with a short-term waiver for non-agricultural use. This purchase was financed by director's advance. Before the acquisition of the Original Lot, the Firm had been in production of wooden door at No 4, a rented premises adjacent to the Original Lot. The Firm was expanding and required more space for production and storage.
5. The Taxpayer let the Original Lot to the Firm for its use as workshop and commenced to receive rental from the Firm from 1 December 1983.
6. From December 1984, the Firm also used No 5 for its operations. No 5 is of an area of about 16,500 square feet.
7. The Government wrote to the Taxpayer in October 1985 offering land exchange for the Original Lot as part of its scheme to develop the area as an industrial estate. The Government indicated that the building covenant for the new grant would normally confer a 2 to 5 plot ratio. In order not to disrupt existing business operations, the Government would be prepared to consider reducing the building covenant to allow a plot ratio as low as 1. The Taxpayer was invited to indicate the type of development it had in mind for the purpose of the land exchange. In response to this offer, the Taxpayer appointed an architect on 1 November 1985 to apply to the Government for a land exchange to permit the Original Lot to be used for industrial and/or godown purposes. The Original Lot was eventually surrendered by the Taxpayer on 23 June 1987 in exchange for No 2 ['the Exchanged Land']. The Exchanged Land is of an area of 11,000 square feet.
8. The Taxpayer made 2 payments of premiums in respect of the Exchanged Land: \$846,000 in mid 1986 and \$988,000 in June 1987. The Taxpayer also submitted building plans in respect of the Exchanged Land which were approved by the Building Authority on 8 June 1987. Those building plans envisaged the construction of a factory

## INLAND REVENUE BOARD OF REVIEW DECISIONS

building consisting of Ground to 5th floors together with a Flat Roof. A staff canteen, a kitchen and a sizeable round-about for loading and unloading can be found in the Ground Floor plan. The rest of the plans gives little indication that the proposed factory building was designed for any specific trade.

9. When first incorporated, the authorised and issued share capital of the Taxpayer were \$1,000,000 and \$2 respectively. During the year ended 31 March 1986, the issued share capital was increased to \$1,000,000. It is not clear whether such increase was related to the land exchange.

10. In January 1986, the Firm started using No 6 as its workshop. The area of No 6 is 29,000 square feet. From July 1987, the Firm further used No 7 for its operation. No 7 is of 10,000 square feet.

11. On 17 September 1987, the Taxpayer placed advertisements in a newspaper for 10 days from 18 September 1987 to 27 September 1987 offering the Exchanged Land for sale. The Exchanged Land was described as suitable 'for heavy industry, especially warehouse or cold storage.' There was however no sale of the Exchanged Land in 1987.

12. By a loan agreement dated 23 September 1987, Bank C extended a building loan in favour of the Taxpayer for \$8,890,000 secured by the Exchanged Land. The loan was repayable 3 months after issuance of the occupation permit or before 31 December 1988. A building mortgage was duly executed on 23 February 1988. Advances were made in favour of the Taxpayer between 15 February 1988 and 7 December 1988. A total of \$8,783,149 was advanced in its favour.

13. Development of the Exchanged Land took place during 1988 and 1989. The total development cost was \$10,326,913. Occupation permit for the developed property was issued on 4 April 1989.

14. On 10, 13 and 15 June 1988 and 24, 27 and 29 June 1988, the Taxpayer advertised in the same newspaper offering to sell either the whole of the development or units of factory building on a floor by floor basis. By an agreement for sale and purchase dated 20 October 1988, the Taxpayer sold the Exchanged Land together with the building to be erected thereon in accordance with the approved building plans to Company D, an investment limited, for \$25,500,000. The sale was completed on 1 June 1989, shortly after issuance of the occupation permit.

15. By letter dated 22 August 1989, Company E, solicitors, wrote on behalf of the Taxpayer offering to purchase No 5 for \$3,890,000. As pointed out in paragraph 6 above, the Firm had been using No 5 since December 1984. This written offer was not accepted by the owner of No 5.

16. On 16 July 1990, the Taxpayer purchased No 8 ['the No 8 Property'] for \$5,066,137 and let it to the Firm. No development was carried out by the Taxpayer in respect of the No 8 Property.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

17. The Taxpayer through its tax representatives stated that:
- a. there were no directors' minutes as the 2 directors were not familiar with such formalities. There was also no feasibility study or financial analysis as the Taxpayer was not experienced in real estate business and there was no financial expert in the company.
  - b. before redevelopment on the Exchanged Land, the Firm had 2 main production workshops at:
    - i. No 5 and
    - ii. No 7 and No 6.
  - c. the Firm planned to return No 5 to the landlord in December 1989 upon completion of the redevelopment on the Exchanged Land.
  - d. '[The Taxpayer] had the initial plan of retaining G/F to 3/F for use by [the Firm] and to sell 4/F and 5/F to cover the loan. The total proceeds on sale of the two floors was roughly estimated at \$8,952,236 (\$450 per square feet x 9946.93 x 2). However, this was a very rough estimation and there were many factors hindering their final decisions to sell.' Those factors included the Firm's trading position; the Taxpayer's financial position and the market price for units in the redevelopment.
  - e. 'The advertisement put up on 18 September 1987 was merely [the Taxpayer's] tentative idea of testing the market value of [the Exchanged Land]. The information obtained was useful to our client in seeking alternate options in case if the bank loan was not granted. It so happened that the bank confirmed the loan on 23 September 1987. [The Taxpayer] implemented its plan of redevelopment after the bank loan was available and took no further steps to sell the vacant land'.
  - f. The Taxpayer changed its plan because:
    - i. it was advised by estate agent that it was much harder to sell the redeveloped property by units than by the building as a whole;
    - ii. the costs of relocating the Firm's equipments from No 5 was prohibitive and
    - iii. the Taxpayer reached oral agreement with the owner of No 5 for purchase of the same but that owner reigned on the oral agreement and rejected the offer from Company E of 22 August 1989.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

18. The issue before us is whether the Taxpayer is assessable for profits tax in respect of the profit on sale of the Exchanged Land.

### **The Commissioner's determination**

19. The Commissioner was prepared to accept that the Original Lot was the Taxpayer's capital asset at the time of its acquisition in September 1983. The Commissioner was however of the view that there was a change of intention on the part of the Taxpayer on 1 November 1985 when the Taxpayer appointed its architect to apply for land exchange.

20. For the following reasons, the Commissioner concluded that in November 1985 the Taxpayer commenced a property dealing trade or business:

- a. Within 3 months after obtaining the grant for the Exchanged Land, the Taxpayer advertised to sell it as undeveloped land.
- b. When the building was under construction, the Taxpayer again put up advertisements to sell either the whole of the building or units therein on a floor by floor basis.
- c. The entire building was sold before completion of the construction.
- d. The Taxpayer did not arrange any long term financing to enable it to hold the developed property as a capital asset.
- e. There is little documentary evidence to support the intended use of the developed building as workshop of the Firm.

### **The Taxpayer's Grounds of Appeal**

21. The Taxpayer maintains that the Exchanged Land was not trading stock and the profit derived was capital in nature not susceptible to profits tax.

22. Apart from the points referred to in paragraph 17 above, the tax representatives further contended that:

- a. the Commissioner failed to take into account the 'planned machine lay-out' on the architectural plans for the proposed redevelopment;
- b. the building mortgage from Bank C was for limited duration as the bank 'would not consider long-term financing until the building was completed'.
- c. the sale of the Exchanged Land was after conclusion of the oral agreement with the owner of No 5 for its purchase.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Oral evidence of the Taxpayer

23. Madam A gave evidence before us. It is a matter of regret that the tax representatives did not prepare a proof of her evidence. The facts in this case are not easy to grasp. Without proper preparation, confusing questions were put to Madam A which did little justice to her veracity.

24. Madam A told us that:

- a. She advertised in September 1987 because of her fear that she might not be able to obtain any loan in support of the redevelopment. Her friend warned her that in the absence of any bank loan, the Government might resume the Exchanged Land.
- b. The loan from Bank C was of limited duration as that was the normal duration for building loan.
- c. In May 1988, the owner of No 5 expressed willingness to sell at \$3,800,000. This was above the market price. The Taxpayer was prepared to buy at this price as there would be savings in the Firm's relocation expenses which would amount to \$1,000,000. The owner wanted to wait till the expiration of the then tenancy to see if higher price could be achieved. The Taxpayer subsequently increased its offer to \$3,890,000 but the owner refused to sell. Madam A maintained that oral agreement was reached with the owner for the purchase of No 5.
- d. The Taxpayer intended to sell merely 2 floors in the redevelopment on the Exchanged Land to repay Bank C. The Taxpayer was however advised by its architect that in the then market conditions it would be difficult for the Taxpayer to sell these 2 floors.
- e. The advertisements in June 1988 did not produce any interested buyer for units in the redevelopment. She was however approached for sale of the entire development which she did in the belief that the Firm would not require the redeveloped premises in view of her oral agreement to purchase No 5.

25. No evidence was called before us as to how the Taxpayer responded to the Government's offer of 23 October 1985. In particular, we do not know the plot ratio for the Exchanged Land and whether that plot ratio was tailored to the needs of the Firm.

### The Law

26. The issue is whether as from November 1985, the Taxpayer was engaged in a trade or adventure in the nature of trade. This is a question of fact to be decided upon the totality of evidence.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

27. In Wing On Cheong Investment Co Ltd v CIR High Court [1987] 90-035 the taxpayer was engaged in securities trading and other activities but had not traded in property. It bought various pieces of properties between 1968 and 1971. In 1972 it took steps to redevelop its property at Fa Yuen Street. The occupation permit for this Fa Yuen Street redevelopment was issued in 1974. Advertisements were placed for the letting of units in the new building but the taxpayer company had difficulties in attracting stable tenants. In 1974, the taxpayer company commenced redevelopment of its Queen's Road West property. The board of directors of the taxpayer company met in May 1976. They resolved to sell some of the units in the Fa Yuen Street building in order to discharge mortgage debts that were coming due or were overdue. As a result most of the units in the Fa Yuen Street property were sold in 1976/77. Upon completion of the redevelopment at Queen's Road West, the taxpayer company sold units in the new building. Most of the units were sold during 1977. The Board of Review found that the taxpayer initially acquired the properties as investment properties but those properties became trading stock in May 1976 when its directors decided to sell units in the Fa Yuen Street building. On appeal before Godfrey J (as he then was), the Learned Judge was of the view that:

*'There is, as it seems to me, no evidence to support the conclusion that the appellant did in fact take a decision on 1 May 1976 (or for that matter on any other date before the sales in question) to turn the properties to account by way of trade. It is not enough to say (true it is) that the purchase, development and sale of property is characteristic of property trading. The error of law lies in the application of the generalisation to the facts of the instant case, in which the properties were acquired as investments. Certainly there were sales of the properties; but as Lord Salmon succinctly pointed out in Simmons v IRC [1990] 1 WLR 1196 at 1203*

*An investment does not turn into trading stock because it is sold.'*

The Learned Judge reversed the decision of the Board of Review. The Learned Judge took the view that the taxpayer was not trading, but was selling unwanted investment properties in order to raise money.

28. In Overseas Textiles Ltd v CIR High Court [1987] 1 HKRC 90-042 The taxpayer owned the land which was clearly a capital asset. The entire shareholding in the taxpayer was sold by the former owners who operated a textile factory, to the new owners who were Hong Kong property developers. A board meeting following the transfer of ownership was informed that since the directors were unfamiliar with the textile trade, it would be beneficial to the company to cease business as such and utilise the land more advantageously by erecting a flatted factory on it for rental. It was resolved that the company would cease business and that architects would submit redevelopment plans as soon as possible. The company duly ceased business and erected a flatted factory on the land. Instead of retaining the building of rental purposes the company proceeded to sell units in it. The Commissioner and the Board of Review found that there never was any intention to retain the factory building for rental purposes and that the taxpayer had

## INLAND REVENUE BOARD OF REVIEW DECISIONS

embarked upon a venture in the nature of a trade. Their decisions were upheld by Nazareth J on appeal.

29. We also find assistance in the following analysis in the article Tax on Land Held for Investment ? Mere Sale is Not a change of Intention by Mr A Halkyard in [1989] 19 HKLJ 215-217

*'The final issue which is relevant ... is whether profits on the sales of units in a redeveloped property (which was originally acquired as a capital asset), such sales being made to finance the cost of the redevelopment, are subject to profits tax. In this regard, two separate fact situation must be considered.*

*The first is where the redevelopment was undertaken at the very outset, with the expectation that units would have to be sold because the owner had insufficient funds to complete the project without preselling. In this case, it would seem clear that the profits on any sales would be taxable on the basis that the owner has entered into an adventure in the nature of trade. The reason for this is that the owner could only undertake the redevelopment (albeit of a capital asset) by embarking upon a trading venture by, from the very beginning, committing certain units with the view to their immediate resale. Notwithstanding that the remaining units continue to be held for investment purposes, it is submitted that a redevelopment even in part with the intention of resale is the very essence of trading.*

*Turning now to the second situation, the facts need only slightly to be changed. If during the course of the redevelopment the taxpayer discovered that presales were necessary, say because interest rates had risen and it had become too much of an economic burden to continue to hold all of the units, then the sale of units to alleviate this problem does not of itself amount to trading ...*

*In essence, the difference between these two fact situations is one of intention at the time the development is undertaken. In the first situation, the owner intends to embark upon a trade of selling units at the time the redevelopment is commenced; in the second, the intention at the time of the redevelopment was for long-term investment and is not altered by a subsequent decision to sell part of the property.'*

### **Our Decision**

30. We are not persuaded that when the Taxpayer instructed architect to negotiate with the Government for the Exchanged Land, it intended to let the land so granted for the operations of the Firm. We have pointed out above the lack of evidence that links the Firm's needs with the land exchange. The approved building plans are equivocal and lends little weight to the contention that those plans were tailored to the Firm's needs. The so-called 'planned machine-layout' are handwritten Chinese characters which do not form part of the original plans. The Firm was then using No 5 and No 7/No 6. The Exchanged

## INLAND REVENUE BOARD OF REVIEW DECISIONS

Land was advertised for sale in September 1987 as suitable 'for heavy industry, especially warehouse or cold storage'. Madam A's explanation that those advertisements were placed pursuant to advice from her friends to forestall Government resumption further demonstrates that the Exchanged Land was not essential to the Firm's needs.

31. An important plank of the Taxpayer's case hinges on the oral agreement to purchase No 5. The argument is that this purchase of No 5 frustrated the investment intention in relation to the Exchanged Land. We have considerable reservation on whether there was in fact a concluded oral agreement as opposed to mere eagerness on the part of the Taxpayer. The advertisements in 1988 were for the entire development or individual units therein. The agreement for sale and purchase of the Exchanged Land was made on 20 October 1988. Sale of the Exchanged Land was completed before the solicitors letter offering to purchase No 5 on 22 August 1989. There can be little doubt therefore that the Exchanged Land was sold in the absence of any binding agreement for the purchase of No 5. This also suggests that the Exchanged Land did not play any significant role in the long term activities of the Firm.

32. Assuming we be wrong in relation to the Taxpayer's intended use of the Exchanged Land, it is clear on the evidence before us that the Taxpayer did not have any fund of its own to redevelop the Exchanged Land. We find that sale of units in the proposed new building was from inception very much an integral part of the redevelopment in order to finance the same. This therefore is not a case where sales were prompted by unanticipated economic burden in the course of the redevelopment.

33. For these reasons, we are of the view that this case falls within the first of the 2 categories referred to in Mr Halkyard's article. The Taxpayer did embark upon an adventure in the nature of trade when it instructed its architect in November 1985. The eventual sale was the result of such trading activities.

34. We confirm the assessment on the Taxpayer.