Case No. D3/86

Board of Review:

H. F. G. Hobson, *Chairman,* Anthony F. Neoh and Benny Wong Man Ying, *Members.*

28 April 1986.

Profits Tax—Date of Commencement of business in relation to development of vacant sites and eventual sale of buildings erected thereon.

In May 1965 the Appellant was granted by the Government two plots of land in exchange for a large tract of agricultural land in the New Territories including a small area where the appellant was running a factory. Both new instruments of title contained building covenants calling for the erection of buildings before 31 March 1968. The buildings were restricted to residential purposes, save for the ground floors which could also be used for commercial purposes. Specifically both lots could not be used for industrial purposes and no factories were permitted. In both cases extension of time for erecting the buildings was granted. After completion the units were sold.

The Assessor considered that the engagement of an architect to draw up development plans was the critical date for determining when the plots were converted into trading stock and he therefore adopted 3 September 1970 as the critical date. The Appellant contended that the change from investment to trading occurred much later in May 1971 in respect of the first plot and 20 September 1972 in respect of the second plot when the site clearance and foundation work began. The Assessor accepted the valuations adopted by the Commissioner of Rating and Valuation as at 3 September 1970 and did not accept the valuations made by professional valuers in May 1971 and September 1972. If the latter valuations were taken the profits assessable would have been much smaller. The Appellant appealed.

Held:

The date of commencement is the date upon which the intention began to translate into an activity which could be characterised as trading. The appellant became committed to trading both lots, whether by developing or reselling undeveloped, not later than 3 September 1970.

Appeal dismissed.

Cases referred:

Board of Review Case No. D3/80.
Birmingham & District Cattle By-Products Co. Ltd. v. I.R.C. (12 TC 92).
Cannop Coal Co. Ltd. v. I.R.C. (12 TC 31).
Pilkington v. Randall (42 TC 662).

Luk Nai Man for the Commissioner of Inland Revenue.
A. L. Brown of Price Waterhouse for the Appellant.

Reasons:

1. This appeal is concerned with the date or dates upon which B commenced business or businesses in relation to the development of two vacant sites namely lots X and Y and the sale of units in the buildings erected on those sites. The commencement date as found by the then Commissioner of Inland Revenue was challenged by the Appellant.

Mr. Anthony Brown of Price Waterhouse appeared for the Appellant, Mr. Luk Nai-man, Senior Assessor (Appeals) represented the Revenue.

2. C, a nephew of the Appellant and his secretary for over 30 years, gave viva voce evidence under oath and explained that the Appellant, in his eighties, was unable to attend the hearing due to the poor state of his health, the nature of which was explained to us by C. This explanation for B's absence was not challenged by the Revenue and we saw no reason to doubt it.

3. Having heard C's testimony, seen certain documentary evidence and in the light of Mr. Brown's acceptance of the Facts as set out in the Commissioner's Determination, we find the following as the factual background upon which this Decision is founded.

4.1 The Appellant was born in Mainland China where before he came to Hong Kong he had a bristle treatment factory and sold its product mostly to the U.S.A. This business of B was a substantial enterprise, he owned the factory and his own residence in Chung King and another in N. China.

4.2 With the Communist takeover he came to Hong Kong where, on the 3 June 1948, he bought a large tract of land in the New Territories at the heart of which was a small area of 5 045 sq. ft. designated for industrial building, the use of the surrounding land of 179 790 sq. ft. was confined to agricultural use.

4.3 A bristle treatment factory was established on the industrial area but by 1950 U.S.A. had introduced an embargo on imports from China.

4.4 B went to the U.S.A. in 1950 and stayed there until 1960. When he returned to Hong Kong though he continued to make trips to the States where in 1962 he bought a large tract of commercial forest land in Florida, 95% of which he still owns.

4.5 In 1964 the Government resumed a strip of the Appellant's land which included the area on which the factory was built. The remaining agricultural land was of no use for the Appellant's manufacturing business, moreover he was aware that a new highway (which eventuated as Lung Cheung Road) was planned to run through it, he therefore approached the Government to effect an exchange of that land for something more desirable. On the 26 May 1965 by two separate instruments the Appellant was granted X, with an area of 1 470 sq. ft. as compensation for the 1964 resumption of the lot upon which his factory lay and exchanged the remaining land for Y, having an area of 14 900 sq. ft. Both instruments of

title contained building covenants calling for the erection of buildings before the 31 March 1968: the requisite minimum expenditure for X was $59,000 and for Y was $600,000.

4.6 Whilst the exchange negotiations were initiated by the Appellant, the resumption was a unilateral matter.

4.7 The Special Conditions to the instruments of grant and exchange restricted both X and Y to residential purposes, save for ground floor (or floors) which could also be used for commercial purposes. Specifically the lots could not be used for industrial purposes and no factories were permitted.

4.8 The Appellant obtained three one year extensions of the building covenants attaching to X, the last deadline being the 31 March 1973 by which time a building had been erected thereon—the occupation permit being granted on the 31 January 1973. No penalties were charged for the extensions.

4.9 Similarly extensions were granted as regards Y the first three of which were the same free extensions as applied to X but three additional extensions were given at substantial premia ($225,330, $443,400 and $375,500) down to a final date of 30 September 1975.

4.10 The first manifestation—quite apart from the obligations imposed by the building covenants—that the Appellant was actually considering how he would develop the lots was in March 1964 when he engaged an architect, D, to prepare plans for an 8-storey Chinese style tenement building on Y.

4.11 In that year there were serious runs on various local banks and the Appellant was unable to raise a bank loan to finance the development of Y.

4.12 After this set back and before the expiry of the original building covenant on 31 March 1968 the cultural revolution made itself felt in no uncertain manner—it is not surprising therefore that the first one-year extension of the building covenant was granted for both lots free of any penalty. B himself left Hong Kong before the 1967 riots broke out here and remained in the U.S.A. until his return about April 1969.

4.13 Following D's departure from Hong Kong also about 1967, the Appellant—having obtained a second free one-year extension—engaged another architect, E, in November 1969 to prepare preliminary sketch designs for a 6-storey building on Y. These plans however were never used because on D's return to Hong Kong in 1970 he was re-instated by the Appellant on the *3 September 1970*—as architect for *both* lots—and so far as E's plans for Y were concerned they were by then considered too modest, commercial confidence being once more in the ascendancy. It will be noted that a third free extension of 3 years was obtained thereby putting the new deadline for both lots at 31 March 1971. This second

engagement of D was a formal contractual one, specifying fees, the stages at which they became payable and the obligations to be carried out by D.

The Commissioner considered that "the engagement of the architect (D) to draw up development plans was the critical date for determining when the plots were converted into trading stock" he therefore adopted 3 September 1970 as the critical date.

The words quoted by the Commissioner refer to plans which ultimately resulted in definitive drawings for the buildings which eventuated, not from the earlier plans by D in 1964 nor the sketch drawings of E in November 1969.

4.14 On the 28 August 1980 the Appellant procured the incorporation of F of which he was the major shareholder the others being his wife and daughter, a minor percentage being held by C. C said that the reason behind the incorporation of F was that the Appellant did not want to show his name to the public.

4.15 C said that site clearance of and foundation work for X began on the 12 May 1971.

4.16 By an Agreement dated the 31 December 1971 the Appellant appointed F as his agent in connection with both lots. Relevant extracts read as follows:—

> "Whereas, Owner desires to employ an agent to develop said building lots including designing, constructing, selling, managing and other relative works …"
>
> "(1) That Agent shall act and do any and all things solely for the Owner to develop said building lots for the utmost benefit of the Owner."
>
> "In consideration of its services, the Agent is to be paid a lump sum of HK$140,000 annually retroactive from the 1st day of January 1971, and for all preliminary expenses paid by the Agent before that date will be reimbursed by the Owner."

4.17 As to the retroactive aspect C was sure that fees were indeed paid by the Appellant back to 1 January 1971. Though C mentioned a refund of expenses it is not clear whether the Appellant or F paid those stage fees, if any, due to D by the Appellant prior to the 1 January 1971 in respect to X. Evidence was not given as to when D's preliminary sketches and layouts were approved by the Appellant thereby entitling D to be paid his first fee nor when he submitted general building plans to the Building Authority entitling D to his second fee. All we do know is that by the 9 December 1970 building plans for X had been approved by the Building Authority but the "consent date" for those plans was the 31 August 1971 according to an undated PWD form BA 14(S). We are uncertain what this signifies but Mr. Brown accepted the Commissioner's findings in which it is stated that the general plan of construction was approved by the Building Authority on 9 December 1970.

4.18 On the 12 November 1971 G was engaged as contractor for X but he was dismissed on 4 January 1972 as the Appellant was most dissatisfied with him. He was however paid for excavation and preliminary works. We need not concern ourselves with these dates

because Mr. Brown puts the critical date for the change of character of the land at X from investment to trading as having occurred in *May 1971*, the date upon which physical activities started (see 4.15 above).

4.19 In the event a six-storey building known as H comprising 5 floors of residential units and ground floor devoted to shops, was erected on X; the occupation permit date was 31 January 1973.

4.20 The first sale of units in H occurred in August 1972. It is not disputed that that sale and subsequent sales of residential units in that building were in the nature of trading activities.

4.21 Turning now to Y, as mentioned at 4.9 three extensions of the building covenants had been obtained for premia. C said that B was nervous of actually committing himself to development and had approached others at various time between *January 1972 and January 1973* with a view to selling this lot undeveloped but B was not satisfied with the price. Whether and just how a sale could be arranged before development bearing in mind that the Particulars and Conditions of Exchange contained a prohibition against assignment is not clear as no evidence was led on the point. However during this one year period the development of X was completed and unit sales had commenced. The suggestion that B was nonetheless willing to sell Y implies an ambivalent attitude as regards development but not as regards an ultimate intention to sell. On the *20 September 1972* the Appellant engaged I as construction manager for Y—consequently we have reservations as to the actual period during which the Appellant was attempting to sell Y at what he considered an acceptable price. Be that as it may the Appellant, according to C, engaged I rather than let out the whole project to a single contractor because he was by then very skeptical of contractors. Mr. Brown argued that the *20 September 1972* is the critical date for the commencement of business for Y which he contended should be viewed as a distinct business activity to that of Lot X.

4.22 C produced a schedule showing the dates upon plans concerning Y where produced, refused and/or approved by the Building Authority. These show tentative plans were submitted on the 4 September 1970 i.e. one day after D was re-instated as architect for both lots (see 4.13 above). On the 22 October 1970 general plans were submitted but refused on the 23 November 1970; new plans were submitted on the 19 December 1970 and approved on the 7 January 1971. These general plans envisaged a 24 storey building with a car park basement and went through various modifications. Then on the 20 August 1973 new plans for a 24 storey building with a commercial basement were submitted which were approved on the 17 September 1973.

Original caisson plans were at first refused then new plans were submitted on the 24 May 1971 and approved on the 12 July 1971. In consequence of the Kotewall Road disaster in the summer of 1972 the Appellant consulted experts in the field of geotechnical matters; this led to revising the caisson dimension by 15% and reinforcing rods. New plans were submitted apparently on the 28 March 1973 and approved on the 30 May 1973, with

additional plans submitted on the 14 November 1983 which were approved on the 13 December 1973. Again all the dates after 20 September 1972 tend to be immaterial background, Mr. Brown having accepted that by the 20 September 1972 the character of Y had changed (4.21 above).

4.23 The building on Y was completed in 1975, the Occupation Permit being issued on the 12 November 1975. The building was called J, it comprised a ground floor and basement for commercial use with two tower blocks above of 22 stories each with 4 flats per floor per block.

4.24 The Appellant obtained a construction loan for Y on *9 September 1972* i.e. a few days earlier than the date suggested by Mr. Brown. A subsequent loan was obtained: later in 1975 both these loans were consolidated at a figure of $7,300,000.

4.25 Sales of J flats began in 1975/76: we are unsure whether any were effected before the Occupation Permit date but the point seems immaterial.

4.26 C's evidence concerning B's intention with regard to the units in the newly constructed buildings was this:—

> As regards H—X—he wanted to sell all flats but to keep two shops. For J—Y—which unlike H, had been financed by bank loans he wanted to sell enough to clear the bank loans, the remainder including the shopping area he would retain for investment income. In keeping with this last intention the Appellant stopped selling flats after the bank loans had been redeemed: however he resumed selling after a two year pause because he began to believe that he would be wiser to transfer his "investment" to higher class properties in K.

4.27 Eleven flats were purchased by the Appellant in K over the two tax years 1978/79 and 1979/80 and let out. Notwithstanding C's evidence the Commissioner's Facts disclose that these purchases were mainly financed by bank loans.

4.28 In the tax year 1979/80 according to the Facts 5 flats were purchased in L and 2 sold within a year. C's evidence was that 7 were bought and 3 sold within the year. In any event a profit of over one million dollars was made on these sales. C said the reason for the sales was that after the purchases B became concerned about the effect of a projected low cost housing project, of which there was some physical evidence, would have on the value of the L flats.

4.29 Over a period the Appellant sold all of the units in J despite the avowed intention merely to sell sufficient to redeem bank finance and also sold all units in H notwithstanding the intention to retain two shops.

4.30 The Appellant also eventually sold all the L and the K flats.

5. Mr. Brown filed 31 grounds of appeal. Thankfully we were not taken through them Mr. Brown being content to rely on the following contentions. So far as X and Y were concerned it was acknowledged that the Appellant did engage in trading but each development was a distinct business neither of which commenced until the Appellant engaged a contractor to actually embark on the task of translating plans into reality (respectively May 1971 for X and September 1972 for Y). Mr. Brown's argument does have some pungency at least so far as Y is concerned because plans existed from as far back as 1964. Mr. Brown in effect argued that the mere drawing up of plans cannot be the criterion for determining change from investment to trading, especially so where, as here, the plans were subsequently changed both substantially and over a long period.

Furthermore, Mr. Brown argued, it is wrong to choose the date upon which an intention is formed; vide Butterworths U.K. Trade Guide (Third Edition):—

> "Thus the mere formation of an intention to commence trading is not the moment of commencement, nor is the incurring of capital expenditure for the purpose of preparing to trade."

This editorial view was based upon Birmingham and District Cattle By-Products Company Ltd. v. IRC (12 TC 92) and Cannop Coal Co. Ltd. v. IRC (12 TC 31). In both these cases the Courts disregarded activities preliminary but essential to the ultimate trading activities concerned.

Mr. Brown then referred to the Irish tax case of H.A. O'Loan v. Mr. J. Noone & Co. where the court ignored the act of the taxpayer entering into agreements preparatory to engaging in coal mining.

From the findings in those cases Mr. Brown draws the inference that "business begins when the profit producing operations commence in fact and not when preparations and plans are made to start business later." He also referred us to the Board of Review case D.3/80 in which the Board found that the commencement date for the business of the Stock Exchange there referred to was not the date of incorporation but the subsequent date of authorization by the Government.

Mr. Brown then reverted to a fundamental matter of interpretation, Section 14 charges profits tax "on every person *carrying on* a trade …". How could it be argued that the Appellant was "carrying on business" on the 3 September 1970 since the plans had to be approved by the Building Authority before the "business could begin to be carried on since if the Authority found them impracticable, unsafe or contravening regulations they could not be put into effect." Moreover , Mr. Brown's argument proceeds, specific piling and caisson plans would need to be approved before work could commence. In short the general plans being liable to potential modification or rejection were but one step in a long process which could only be said to crystallize when a contractor was engaged. That "intention" is but one badge of trade, it is not the particular one from which a commencement date should be determined.

We were much impressed by Mr. Brown's arguments on the commencement date aspect of the case.

Mr. Brown then argued that the two developments were distinct business, ergo they had their own distinct commencement dates. He reasoned that the Appellant, a reluctant developer (at heart a land holder, as witness the Florida land and his earlier holding of the land which was exchanged for Y), chose to develop the smaller plot X because it offered less risk and even that was fraught with hesitations on the Appellant's part. The Appellant explored in 1971 and 1972 the possibility of selling Y undeveloped, these attempts continued even after the Appellant finally committed himself to the X development which, Mr. Brown submitted, goes to show that the Appellant's attitude towards the two plots was at that time different. There was no train of development so, Mr. Brown contend separate commencement dates would reflect the realities.

6. The Revenue, represented by Mr. Luk Nai-man, Senior Assessor (Appeals) approached the question of commencement date rather differently. Mr. Luk urged that the date should be the date upon which the two lots became stock-in-trade of the Appellants business, which should be taken to be the date upon which the Appellant changed his intention and decided to develop the two lots. He cited Pilkington v. Randall (42 TC 662) in response to the cases cited by Mr. Brown as showing (*a*) that the date of formation of an intention could be taken as the commencement date and (*b*) that date could embrace subsequent activities. We feel that it must not be forgotten that whereas part of the Appellant's original holding was so to speak taken from him the remainder could have been retained. The motive in seeking an exchange was that the land without the core factory area would be of no use to the Appellant through which he knew a road would be built. Now the Appellant did *did* swop for land which, like his then holding, could be allowed to remain fallow (as for instance Letter B) but for land which had to be developed. If he had made no swop at all presumably in due course he would have been compensated when there was a resumption for road works. The exchange with the concomitant building requirement was in first step on the road which in this case eventuated in the erection of a building. But if the units in buildings had not been sold but had been simply left empty or let out, the characterization of the Appellant as a holder of property would not have changed, but change it did for the Appellant did build for resale and has conceded that he did engage in trade. The first visible evidence of a "trade" would be the first contracts to sell flats in H(X) that did not occur until August 1972, 5 months before the Occupation Permit. Those sales however were not more than the culmination of activities making the sale possible. The question remains therefore which of those earlier activities, taking an objective view of the evidence before us—including the hearsay evidence by C as to the state of mind of the Taxpayer—represented the crossing of the Rubican?

7. We are of the opinion that the Appellant became committed to trading both lots, whether by developing or reselling undeveloped, not later than the 3 September 1970. We reach this view for the following reasons—

7.1 The suggestion that the Appellant was at heart a land holder does not entirely mesh with the fact that he was under no compulsion to exchange the agricultural land surrounding his factory for Y. No evidence was led that he intended to do anything at all with this land. Why should he not have kept it until very many years later it was also resumed was not made clear to us.

7.2 Nor was evidence adduced as to why he exchanged his former land for land he was required to developed—as opposed to other land for agricultural purposes, assuming such a possibility existed.

7.3 We believe therefore that he quite deliberately chose to embark on a policy which would result in either his building properties or selling undeveloped, if such were legally possible, if that were a profitable alternative as far back as when the swop was arranged. That may be said to be the "intention badge of trade".

7.4 Whilst various events, such as bank runs and drops in property values, led to hesitation and postponement, none provoked abandonement as for instance surrendering the land to the Government.

7.5 As to the date upon which intention began to translate into an activity which could be characterized as trading, we do see the force of Mr. Brown's argument but so far as X is concerned we think that the formal engagement of D in September 1970 to draw plans for both lots is not inappropriate bearing in mind that J was incorporated in August 1970 to shield B from public view when engaging in the development: though the shield was not put formally in place until December 1971 it was retroactive to 1 January 1971 and included reimbursement of expenses prior to that date.

7.6 We think the December 1971 Agreement, with its retroactive nature coupled to its reference to both plots, is of evidentiary value in indicating that Y had become treated as trading stock by the 3 September 1970.

7.7 Whilst we were much impressed by Mr. Brown's arguments in the light of the foregoing we considered that they were insufficient to displace the Appellant's onus of proof.

8. We now pass to the subsidiary question of whether any non-residential units in H or the surplus of units in J constituted investment stock.

8.1 The evidence given by C was that the commercial units in H were retained for rental and were not sold until 1982 i.e. 9 years after that building's occupation permit. Nonetheless these units were included in original sales brochures and price lists and had been shown in B's accounts in stock-in-trade: subsequently they were shown as fixed assets but no direct evidence was forthcoming upon which we could reasonably conclude that the two units concerned were thenceforth to be treated as investments.

8.2 The surplus units in J were likewise advertised for sale (both residential and commercial though the latter did not indicate a specific asking price). C said this was to give prospective buyers an unrestricted choice; i.e. the surplus units being determined by subsequent events, rather than re-determined. For two years none of these units were sold but when sold the proceeds were catergorized in exactly the same manner as those units which had been admittedly sold for trading.

8.3 We are of the view therefore that there is insufficient cogent evidence to upset the Commissioner's finding on this issue.

9. Finally as to flats purchased in K and L these were bought with the proceeds from H and J sales and were themselves held for a relatively short period before they were resold. Again we are of the opinion that we have heard nothing of a sufficiently convincing nature to lead us to upset the findings of the Commissioner on this particular aspect.

This appeal is therefore dismissed. We feel that we should mention that Mr. Brown's presentation of his arguments and documentary evidence, in what proved to be factually a complicated case, was exemplary.