Case No. D39/12

Profits tax – gain on disposal of listed shares – whether long term investment – section 14(1) and 16(1) of the Inland Revenue Ordinance ('the IRO').

Panel: Cissy K S Lam (chairman), Shirley Fu Mee Yuk and James Todd Wood.

Dates of hearing: 12 and 14 September 2012.
Date of decision: 27 November 2012.

The Appellant carried on trade and/or business as a licensed investment adviser and provided initial public offering ('IPO') advisory services to Company B Group and Company H Group under Company B Agreement and Company H Agreement respectively wherein share options were granted to the Appellant.

The Appellant duly exercised the respective options and eventually sold the relevant shares at substantial profits.

The Appellant contended that the gains on disposal of the relevant shares were gains arising from the disposal of 'long term investments' and hence were not chargeable to profits tax.

The Appellant further contended that it would have suffered a loss should IPO issue prices be adopted in deriving the gains on disposal of the relevant shares.

Held:

1. The respective options granted to the Appellant were part and parcel of the Appellant's remuneration for the services it rendered.

2. The gains on disposal of the relevant shares were profits arising in or derived from the Appellant's trade and/or business within the meaning of section 14(1) of the IRO.

3. The relevant shares were purchased with an intention to sell upon the IPO of the relevant group. Such an intention is clearly not an intention to purchase or hold the relevant shares as capital assets.

4. The profits arising from the sale of the relevant share were not profits arising from the sale of capital assets.

5. The Appellant paid nothing for the relevant shares. It would be a futile exercise to use the IPO issue prices to recalculate the notional profits and losses.

Appeal dismissed.

Cases referred to:

Simmons v IRC [1980] 1 WLR 1196
Lee Yee Shing v CIR [2008] 3 HKLRD 51
Nice Cheer Investment Ltd v CIR HCIA 8/2007
Nice Cheer Investment Ltd v CIR CACV 135/2011

Cheung Ivan T Y Counsel instructed by Starkings International Limited for the Taxpayer.
Mike Lui Counsel instructed by Winnie W Y Ho, Senior Government Counsel of the Department of Justice for the Commissioner of Inland Revenue.

Decision:

1. The Appellant was incorporated in Hong Kong as a private company in 1994. At all relevant times, the Appellant was licensed under the Securities and Future Ordinance and its predecessor, the Securities Ordinance, to carry on the following regulated activities:

Type 4: Advising on Securities

Type 6: Advising on Corporate Finance.

2. The Appellant closed its accounts on 30 June annually.

3. The Appellant submitted its Profits Tax Returns for the years of assessment 2000/01 to 2004/05 together with the corresponding audited financial statements and proposed tax computations ('the audited accounts'). The relevant entries are summarized in Table 1 below.

Table 1

	2000/01	2001/02	2002/03	2003/04	2004/05
For the year ended	30-6-2000	30-6-2001	30-6-2002	30-6-2003	30-6-2004
	$	$	$	$	$
Turnover – Project success fees	3,000,000	4,055,467	-	2,000,000	695,360
– Advisory fees	2,032,314	2,562,100	300,000	885,000	1,220,000

	2000/01	2001/02	2002/03	2003/04	2004/05
For the year ended	30-6-2000	30-6-2001	30-6-2002	30-6-2003	30-6-2004
	$	$	$	$	$
Total	5,032,314	6,617,567	300,000	2,885,000	1,915,360
Less: Direct expenses	(3,116,157)	(1,287,604)	(1,507,167)	(1,341,142)	(893,200)
Gross profit/(loss)	1,916,157	5,329,963	(1,207,167)	1,543,858	1,022,160
Add: Other income					
Dividend from listed shares	319,000	-	-	-	-
Rental income	-	-	-	-	60,000
Gain on disposal of listed shares	123,693	2,279,550	0	7,455,339	2,315,682
	2,358,850	7,609,513	(1,207,167)	8,999,197	3,397,842
Less: Expenses	(3,080,503)	(1,745,552)	(1,526,229)	(1,324,854)	(1,027,426)
Profit/(loss) before taxation	(721,653)	5,863,961	(2,733,396)	7,674,343	2,370,416

4. The item 'Gain on disposal of listed shares' is highlighted because this is the item in issue. Except for the year of assessment 2000/01, this item was deducted in the calculation of the assessable profits/adjusted loss in the audited accounts.

Table 2

	2000/01	2001/02	2002/03	2003/04	2004/05
For the year ended	30-6-2000	30-6-2001	30-6-2002	30-6-2003	30-6-2004
	$	$	$	$	$
Profit/(loss) before taxation	(721,653)	5,863,961	(2,733,396)	7,674,343	2,370,416
Add					
Depreciation	59,665	178,318	197,736	211,111	215,810
Non-deductible financial expenses	-	316,489	-	-	-
Bad debts	-	-	-	50,000	-
Tax penalty	-	-	-	31,293	-
Less					
Dividend from listed shares	(319,000)	-	-	-	-
Prescribed assets written-off	(27,960)	(10,775)	-	-	-
Depreciation allowance	(17,403)	(128,162)	(92,383)	(64,799)	(5,488)
Commercial Building Allowance	(68,824)	(68,824)	(96,824)	(96,824)	(100,283)
Gain on disposal of listed shares	-	(2,279,550)	0	(7,455,339)	(2,315,682)
Assessable Profit/(Adjusted Loss) reported by the Appellant	(1,095,175)	3,871,457	(2,724,866)	349,785	164,773
Dividend paid	-	2,500,000	2,000,000	5,000,000	3,300,000

5. In essence, the Appellant argued before the assessor and the Deputy Commissioner of the Inland Revenue ('the DCIR') that the gains were gains arising from the disposal of 'long term investments' and hence were not chargeable to profits tax under section 14(1) of the Inland Revenue Ordinance, Chapter 112 ('the IRO'). It alleged that due

to a clerical error the gain of $123,693 was not deducted from the assessable profits in the 2000/01 audited accounts.

6. The Appellant's argument was rejected by the assessor and by Determination dated 29 August 2011 ('the Determination') the DCIR confirmed the assessor's assessments subject to some minor amendments to correct the arithmetics.

Findings of facts

7. The Appellant called its director, Mr A, as witness. Mr A is a certified public accountant. He was the managing director of the Appellant and he signed all the documents on behalf of the Appellant. He made a witness statement for the purpose of the present appeal. It stood as his evidence in chief.

8. Most of the facts have been agreed and/or are contained in documents. We find the facts proved as per paragraphs 9 to 49 below.

The Company B Agreement

9. By an agreement in Chinese dated 16 June 1998 ('the Company B Agreement') made between the Appellant and a company within the Company B group of companies ('the Company B Group'), the Appellant was engaged to provide advisory services to the Company B Group to prepare the group for an initial public offering ('IPO') on either the Hong Kong Stock Exchange ('HKEx') or the American Stock Exchange. In summary, the Company B Agreement provided as follows:

(1) Clauses 1 to 5 set out the scope of services to be provided by the Appellant.

(2) Clause 6 provided for reimbursement of the Appellant's expenses.

(3) Clause 7 provided that upon the signing of the agreement, the Company B Group would pay the Appellant an advisory fee of $50,000 per month for a period not exceeding 18 months until the successful IPO of the Company B Group.

(4) Clause 8 provided that within 6 months of the signing of the Company B Agreement, the Appellant had a right to purchase from the major shareholder of the Company B Group, Mr C, up to 3% of the shares in the capital of the Company B Group at a consideration of 3 times the group's 1997 audited consolidated profits after tax ('the Company B Share Option').

(5) Clause 9 provided for a success fee of $3 million payable by the Company B Group to the Appellant upon the successful IPO of the group

on the HKEx or the American Stock Exchange.

(6) Clause 10 provided for a commission to the Appellant for the successful introduction of an investor in the event of a prelisting placement of shares.

10. On 29 January 1999, pursuant to Clause 8 of the Company B Agreement, the Appellant entered into an agreement in Chinese ('the Company B Share Purchase Agreement') with Mr C and Mr D to purchase 3% of the equity interest of the holding company of the Company B Group which was to be listed at the price of $2,660,000 calculated using the formula:

Company B Group's 1998 consolidated profits x 3 x 3%
= $29,632,128 x 3 x 3% = $2,660,000

(The 1998 instead of 1997 consolidated profits were used because of a change of accounting year end date for the Company B Group.)

11. It was agreed that the Appellant would pay a deposit of $10,000 and the balance of $2,650,000 would be an interest free loan repayable within one year from the date of the Company B Share Purchase Agreement.

12. On 15 March 1999, the Appellant was allotted 74,743 shares in Company E (a company within the Company B Group) representing 3% of Company E's total issued shares.

13. On the same day at a directors' meeting of the Appellant, as per the minutes thereof, it was resolved, inter alia, that it was for the benefit and interest of the Appellant to acquire the 74,743 shares in Company E which was intended to be held by the Appellant as a long term investment.

14. By a sale and purchase agreement dated 5 October 1999, Company B purchased from Mr C, Mr D and the Appellant as vendors, the entire issued share capital of Company E in consideration of which Company B issued and allotted to the vendors 1,000,000 'Consideration Issue Shares', out of which the Appellant was allotted 60,000 shares.

15. On 19 October 1999, Company B issued 208,000,000 and 70,000,000 shares as a result of a Capitalisation Issue and Share Offer respectively. The Appellant's 60,000 Consideration Issue Shares became 6,300,000 Company B shares (208,000,000 x 3% + 60,000) under the Capitalisation Issue. The Appellant was not allotted any share under the Share Offer.

16. On 4 November 1999, Company B was listed on the HKEx. The issue price was $1.00.

17. On 15 November 1999, Mr C issued a receipt acknowledging repayment of $2,650,000 by the Appellant.

18. On 16 November 1999, the Appellant received $350,000 by cheque representing the balance of the $3,000,000 success fee payable under the Company B Agreement after deducting the aforesaid $2,650,000.

19. On 5 May 2000, upon the expiration of the Appellant's undertaking not to dispose of the Company B shares for a lock up period of 6 months, Company B issued 15 share certificates to the Appellant in respect of the 6,300,000 Company B shares.

20. 5 days after that, at a directors' meeting of the Appellant on 10 May 2000, as per the minutes thereof, it was resolved, inter alia, that (1) the Appellant required additional finance to make application for a Chapter 21 Listing (that is under Chapter 21 of the HKEx Listing Rules) early the following year; and (2) 6,300,000 Company B shares originally held under long term investment be sold for this purpose.

21. On 12 May 2000, the Appellant sold 500,000 of the 6,300,000 Company B shares for a total of $335,000 (representing $0.67 per share). According to the Appellant's calculation, its 'gain on disposal' was $123,693 ('Company B Profits 1'). This sum was reported in the Appellant's 2000/01 audited accounts (see Table 1 above). It was not deducted in the calculation of the assessable profits/adjusted loss (see Table 2 above).

22. On 29 September 2000, the remaining 5,800,000 Company B shares were transferred to Company F, a Country G company incorporated for the purpose of the Appellant's intended Chapter 21 Listing. Mr A was Company F's only shareholder. This transfer was treated as a sale by the Appellant in its 2001/02 audited accounts. The sale proceeds were paid by way of a credit in the Appellant's accounts with the sale of the Company B shares and a corresponding debit of Mr A's current account with the Appellant. According to the Appellant's calculation, the sale proceeds were $4,640,000 (representing $0.8 per share) and, after deducting the cost of $2,436,000, its 'gain on disposal' came to $2,204,000 ('Company B Profits 2').

23. Further, between 30 October and 2 November 2000, the Appellant purchased and sold other lots of shares in Company B (a total of 570,000 shares) unrelated to the Appellant's rights under the Company B Agreement. According to the Appellant's calculation, the sale proceeds totalled $189,090 and, after deducting the cost of $113,540, the 'gain on disposal' came to $75,550 ('Company B Profits 3'). The Appellant admitted in the course of the assessor's enquiries that the purchase and sale of these shares were done on a short term basis and that Company B Profits 3 was taxable. The 2001/02 audited accounts, in excluding Company B Profits 3 from the calculation of the assessable profits, were incorrect.

24. The Appellant reported Company B Profits 2 and Profits 3 in its 2001/02 audited accounts as $2,204,000 + $75,550 = $2,279,550 (see Table 1 above).

25. In summary, the disposals of the Company B shares were as follows:

	Date of sale	No. of share	$ per share	Sale proceeds $	Purchase cost $	Handling fee $	Reported gain $	
2000/01	5-12-2000	500,000	0.67	335,000	-210,000	-1,307	123,693	Company B Profits 1
2001/02	29-9-2000	5,800,000	0.8	4,640,000	-2,436,000	-	2,204,000	Company B Profits 2
		6,300,000			-2,646,000			
2001/02	30-10-2000 – 2-11-2000	570,000		189,090	-113,540	-	75,550	Company B Profits 3
							2,279,550	

26. In the above calculation, the Appellant had understated the purchase cost of Company B Profits 2 by $14,000:

$210,000 + $2,436,000 = $2,646,000

Whereas the total cost should be $2,660,000.

27. The DCIR treated this as an arithmetical error and adjusted it in his assessment (see paragraph 97 below).

The Company H Agreement

28. By an agreement in Chinese signed on 22 November 1999 ('the Company H Agreement') made between the Appellant and a company within the Company H group of companies ('the Company H Group'), the Appellant was engaged to provide advisory services to the Company H Group to prepare the group for an IPO on the main board of the HKEx. The Company H Agreement was in similar terms to the Company B Agreement. In summary, the Company H Agreement provided as follows:

(1) Clauses 1 to 5 set out the scope of services to be provided by the Appellant.

(2) Clause 6 provided for reimbursement of the Appellant's expenses.

(3) Clause 7 provided that upon the signing of the agreement, the Company H Group would pay the Appellant an advisory fee of $50,000 per month (for a period not exceeding 12 months) until the successful IPO of the Company H Group.

(4) Clause 8 provided that 3 months after the signing of the Company H Agreement, the Appellant had a right to acquire from the major shareholder of the Company H Group, Mr J, or his nominated shareholders, between 2% to 3% of the equity interest of the Company H Group (on a sliding scale depending on the amount of funds ultimately raised upon the group's IPO) at a consideration of $3 million ('the Company H Share Option').

(5) Clause 9 provided for a success fee of $2 million payable by the Company H Group to the Appellant upon the successful IPO of the group on the HKEx.

(6) Clause 10 provided for a commission to the Appellant for the successful introduction of an investor in the event of a prelisting placement of shares.

29. On 15 May 2000, at a directors' meeting of the Appellant, as per the minutes thereof, it was resolved, inter alia, that it was for the benefit and interest of the Appellant to acquire 2% to 3% of the shares in Company K (a company of the Company H Group) from Madam L, which were intended to be held by the Appellant as a long term investment.

30. By an agreement in Chinese dated 28 May 2000 ('the Company H Share Purchase Agreement') made between the Appellant and Mr J, it was agreed that for the right to acquire 2% to 3% of the equity interest of the Company H Group as per Clause 8 of the Company H Agreement, the Appellant would pay a deposit of $10,000 and the balance of $2,990,000 would be an interest free loan repayable within 1 year.

31. By a sale and purchase agreement dated 31 May 2000 between the Appellant and Madam L, the Appellant agreed to purchase 2.25% of the shares of Company K from Madam L for $3 million.

32. On 22 August 2000, the Appellant was allotted 8,085 Company K shares representing 2.25% of Company K's then total issued shares.

33. A receipt in Chinese dated 27 November 2000 was signed by Mr J acknowledging (1) receipt of the deposit of $10,000 by cheque; and (2) that the balance of $2,990,000 with interest (at prime +1% starting from 1 June 2000) was payable before 27 May 2001.

34. Subsequently on 21 September 2001, by a handwritten note in Chinese on the

aforesaid receipt, Mr J agreed (1) not to charge interest after 30 June 2001; and (2) to defer the repayment date to the IPO of the Company H Group.

35. By a supplemental agreement in Chinese dated 31 May 2002, it was provided, inter alia, that pursuant to the Company H Agreement, the Appellant had provided services to the Company H Group for 30 months, 18 months more than the originally estimated period of 12 months, due to delay by the China Securities Regulatory Commission in approving the IPO. It was agreed that starting from 1 June 2002, the Company H Group would continue to pay the Appellant an advisory fee of $50,000 per month until the successful IPO of the Company H Group.

36. By a debt set off agreement in Chinese dated 10 June 2002 ('the Debt Set Off Agreement'), it was agreed that whereas a success fee of $1,055,000 was payable by the Company H Group to the Appellant pursuant to the Company H Agreement and the balance of $2,990,000 was payable by the Appellant to the Company H Group, the two sums would be set off against each other leaving a balance of $2,990,000 - $1,055,000 = $1,935,000 payable by the Appellant to the Company H Group without interest after the IPO of the Company H Group.

37. On 28 November 2002, the Appellant was allotted 14,200,000 Company H shares (representing 2.5% of the total issue shares of Company H) in exchange for the 8,085 Company K shares.

38. 3 days thereafter, on 1 December 2002 at a directors' meeting of the Appellant, as per the minutes thereof, it was resolved, inter alia, that (1) the Appellant required additional finance to either do a back door listing or make application for an IPO on the Australia Stock Exchange ('ASX'); and (2) 14,200,000 Company H shares originally held under long term investment were to be sold for this purpose.

39. On 5 December 2002, Company H issued 26 share certificates to the Appellant in respect of the 14,200,000 Company H shares.

40. On 10 December 2002, Company H was listed on the HKEx. The issue price was $0.77.

41. There was no lock up period in respect of the Company H shares. Between 19 December 2002 and 25 June 2003, the Appellant sold a total of 12,196,000 Company H Shares. According to the Appellant's calculation, its 'gain on disposal' was $7,455,339 ('Company H Profits 1'). Company H Profits 1 were reported in the 2003/04 audited accounts (see Table 1 above).

42. Between 3 July 2003 and 29 September 2003, the Appellant sold the remaining 2,004,000 Company H shares. According to the Appellant's calculation, its 'gain on disposal' was $2,032,562 ('Company H Profits 2').

43. Further, on 15 May 2003 the Appellant was granted an option by Company H to purchase 3 million of its shares at $1.19. This option was unrelated to and independent of the Appellant's rights under the Company H Agreement. The Appellant exercised the option and purchased 1 million Company H shares on 3 February 2004, which shares it sold shortly thereafter – between 13 February and 1 June 2004. According to the Appellant's calculation, its 'gain on disposal' of these Company H shares was $257,136 ('Company H Profits 3').

44. The Appellant admitted in the course of the assessor's enquiries that Company H Profits 3 were trading profits and were taxable. Like Company B Profits 3, on the Appellant's own admission, the 2004/05 audited accounts in excluding Company H Profits 3 from the calculation of the assessable profits were erroneous.

45. Company H Profits 2 and Profits 3 were reported in the 2004/05 audited accounts as $2,315,682 (see Table 1 above).

46. We note that the sale of the 14,200,000 Company H shares was looked at as two tranches in the Determination and the profits are divided into Company H Profits 1 and Profits 2 herein purely as a matter of convenience because they fell within two fiscal years, not because the Appellant divided the Company H shares into two tranches by any deliberate act.

47. In summary, the disposals of the Company H shares were as follows:

	Date of sale		Sale proceeds	– Purchase cost	– Transaction cost	= Profits	
2003/04	19-12-2002 – 25-6-2003		$10,229,880	–$2,737,487 (see below)	–$37,050.68	= $7,455,339	Company H Profits 1
2004/05	3-7-2003 – 29-9-2003		$2,491,400	–$449,813 (see below)	–$9,028.08	= $2,032,562	Company H Profits 2
2004/05	13-2-2004 – 1-6-2004		$1,452,580	–$1,190,000	–$5,444.00	= $257,136	Company H Profits 3

48. The purchase costs for Company H Profits 1 and Profits 2 were based on the Appellant's calculations. According to the Appellant, interest amounting to $187,300 was paid making the total cost of the 14,200,000 Company H shares $3,000,000 + $187,300 = $3,187,300. So the costs for Company H Profits 1 and Profits 2 were:

$$\text{For Company H Profits 1} : \left(\$3,187,300 \times \frac{\text{Purchase cost } 12,196,000}{14,200,000}\right) = \$2,737,487$$

$$\text{For Company H Profits 2} : \left(\$3,187,300 \times \frac{2,004,000}{14,200,000}\right) = \$449,813$$

49. Further enquiries revealed that the total interest should be $316,489 instead of $187,300. The DCIR accepted the error and adjusted the assessments accordingly (see paragraph 98 below).

The Company B Share Option – Clause 8 of the Company B Agreement

50. A translation of the Company B Agreement provided to this Board by the Appellant, stated that the Appellant was granted a right to acquire 3% of the equity interests of the Company B Group 'at a consideration based on a P/E ratio of 3 of the Consolidated Profit after tax for the financial year ended 1997'. Although this was not an accurate literal translation of Clause 8 of the Company B Agreement, the translation did correctly state the effect of that clause. Purchasing the shares at 3 times the Company B Group's audited consolidated profits after tax was in effect purchasing them at a P/E ratio of 3.

51. During cross-examination, Mr A accepted that:

(1) a P/E ratio of 3 was the basis on which the purchase price was calculated;

(2) it was normal to expect companies like Company B and Company H to have a P/E ratio of 8 to 10 in order to be listed on the HKEx; and

(3) hence by agreeing a price based on a P/E ratio of 3, the Appellant was certain to make a large profit when the Company B Group was successfully listed.

52. It is clear to this Board, and we so find, that the Company B Share Option with this assured profit upon the IPO of the Company B Group was part and parcel of the remuneration of the Appellant for the services it provided under the Company B Agreement. By paying an insignificant deposit of $10,000 and deferring payment of the balance for a year (which was the time expected for the IPO process), the share option was the incentive and the reward to the Appellant for the successful IPO of the group within the intended time frame. On the other hand, the Company B Group did not have to pay out any or much money for this incentive and reward because upon completion of the IPO, the success fee would be and was used to set off against the balance of the share option payment. This payment mechanism benefited both sides.

The Company H Share Option – Clause 8 of the Company H Agreement

53. This same mechanism applied in the Company H Agreement. Mr A in his witness statement stated that at the time Clause 8 was agreed, it was estimated that the consolidated profits of the Company H Group for the year ended 31 December 1999 would be close to $40 million. With a P/E of 3, the market capitalisation of the Company H Group would be $120 million and an acquisition of 2.5% of the shares would amount to $3 million of capital. The purchase price of the Company H Share Option was also based on a P/E ratio of 3, which was at a substantial discount to the anticipated issue price. Upon the IPO, Company H issued a total of 568 million shares at $0.77 per share. The 14,200,000 Company H shares acquired by the Appellant (the equivalent of 2.5% of 568 million shares) had a market value of $0.77 x 14,200,000 = $10,934,000, giving the Appellant a high profit.

54. For this option, the Appellant similarly paid a small deposit of only $10,000 with the balance deferred – in fact twice deferred because the IPO was delayed. Pursuant to the Debt Set Off Agreement, the success fee was set off against the balance of the purchase price and the Appellant was allowed to defer payment of the purchase price without interest until after completion of the IPO of the Company H Group. There was at some stage an interest payment on the balance. This was clearly intended to ensure that the Appellant would procure an early IPO of the Company H Group. We are likewise satisfied and we so find that the Company H Share Option was part and parcel of the remuneration of the Appellant for the services it provided under the Company H Agreement.

Other agreements

55. In his witness statement, Mr A sought to argue that the decisions to exercise the share options were made after careful consideration of the investment potential of the relevant groups. In support of this argument, he produced agreements between the Appellant and other clients, namely, the M Group, the N Group and the P Group. In all three cases, the IPO attempts were aborted. Mr A alleged that the first two cases (where the IPO attempts were aborted at an early stage of the process before the Appellant had exercised the share option) were examples of the Appellant deciding not to invest after investigation and the last case (where the IPO attempt was aborted very close to completion well after the Appellant had exercised the share option) was a case where the Appellant invested but failed.

56. We do not see how these cases assist Mr A's argument. Quite the contrary, they reinforce our finding that the share options were clearly intended as a reward to the Appellant upon and only upon the successful IPO of the relevant group, so that if the IPO was aborted, the Appellant did not have to exercise the option or complete the purchase. As shown in the case of the P Group, when the IPO attempt was abandoned, the Appellant was allowed to transfer the shares back to the P Group at the purchase price. If, as alleged, the Appellant exercised the share option purely as an independent investment decision on the basis that the P Group had long term investment potential, then it would and should have kept the shares irrespective of the success or failure of the IPO. There was no reason why

the Appellant should transfer the shares back to the P Group at the purchase price or why they should be allowed to do so.

Relevant provisions of the IRO

57. Section 14(1) of the IRO:

> ' *Subject to the provisions of this Ordinance, 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) as ascertained in accordance with this Part.*'

58. Section 16(1) of the IRO:

> ' *In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period, including …...*'

Ground (1) of the Amended Perfected Grounds of Appeal

59. Ground (1) of the Amended Perfected Grounds of Appeal is as follows: 'The profits derived by the Appellant from the sales of the Company B shares and the Company H shares for the years of assessments 2001/02 (additional), 2003/04 and 2004/05 were not profits from a trade or business; and further or in the alternative, such profits were profits arising from the sale of capital assets which shall not be liable to Profits Tax under s.14(1) of the IRO.'

60. This poses 2 issues:

(1) Whether the profits were profits arising in or derived from the Appellant's trade or business.

(2) Whether the profits were excluded as profits arising from the sale of capital assets.

Whether profits arising in or derived from the Appellant's business or profession

61. Issue 1 can be disposed of quickly.

(1) The Appellant carried on trade and/or business as a licensed investment adviser.

(2) The Appellant was engaged to provide services as a licensed investment adviser under the Company B Agreement and the Company H Agreement respectively.

(3) The Company B Share Option and the Company H Share Option granted to the Appellant under the Company B Agreement and Company H Agreement respectively were part and parcel of the Appellant's remuneration for the services it rendered.

(4) The Appellant duly exercised the respective options and eventually sold the relevant shares at substantial profits.

(5) It is clear to us and we so find that these profits were profits arising in or derived from the Appellant's trade and/or business within the meaning of section 14(1) of the IRO.

Whether the profits were 'profits arising from the sale of capital assets'

62. Issue 2 turns on the intention of the Appellant at the time the Appellant decided to exercise the Company B Share Option and the Company H Share Option respectively.

63. There is no question that Mr A was the directing mind of the Appellant and when one speaks of the intention of the Appellant, one is looking at the intention of Mr A.

64. Section 14(1) of the IRO speaks of 'capital assets', not 'long term investment'. The burden of satisfying this Board that the respective shares were capital assets and hence the assessments were excessive or incorrect falls squarely on the Appellant.

The Appellant's case

65. The Appellant's case is clear: because the Appellant purchased the relevant Company B shares and Company H shares pre-IPO and intended to and did hold them through till IPO, the Appellant was holding the shares long term and the shares were long term investments.

66. Mr Cheung in his submission for the Appellant confirmed to this Board that this was the Appellant's case. And this was the case advanced by Mr A in evidence.

67. Mr A told us in evidence that the Appellant had made various attempts to list itself, including the Chapter 21 Listing which was decided at the board meeting of 10 May 2000 but aborted in 2001 and the attempted listing on GEM (that is the Growth Enterprise Market) which was abandoned in August 2002. In August 2003, the Appellant attempted a listing on the ASX. The estimated costs were $5,538,000. In July 2004 the Appellant decided to abandon the ASX Listing. The actual costs incurred were $2,113,353.73.

68. Mr A alleged in his witness statement that the Company H shares were sold to provide capital and working expenses for the ASX Listing. In cross-examination it was pointed out to him that Company H Profits 1 were more than enough to pay for the costs of that listing. He was asked why the Appellant went on to sell the remaining Company H shares. Mr A's answer was that by the time the Appellant began to sell the Company H shares, the Appellant had held the Company H shares for about 2½ years and by the time all the Company H shares were sold, the Appellant had held them for over 3 years 3 months. The Appellant had already held the Company H shares 'long term'. He was then asked to confirm that when he said the shares were intended to be held as long term investment, he meant a period of 2 to 3 years. He said that to him anything more than 2 years was long term.

69. In saying that the Appellant had held the Company H shares for 2½ years when it began to sell them, Mr A was counting from the date of the Company H Share Purchase Agreement, namely from 28 May 2000 until 19 December 2002, which was approximately 2½ years. But Mr A also agreed that the Company H shares could not have been sold unless and until the Company H Group was listed, which was 10 December 2002.

70. The correspondence put forward the same case. The assessor started investigations into the Appellant's tax return for the years of assessment 2002/03 and 2003/04 by letter of 18 July 2005. The Appellant replied by letter of 24 August 2005 in which the Appellant said in relation to the Company H Share Purchase Agreement:

> ' d) We have signed the agreement for this investment on May 31, 2000. We considered this was a long-term investment and believe that the management of [Company H] could provide future growth for the company. Our investment philosophy are no difference to the other long-term minority investors, should our investment achieves good profit return we would consider the alternative of taking profit. We prefer to invest on companies with a long-term growing plan particularly companies with a plan to be listed in a recognized stock exchange. With such a plan we are certain that our investment could be realizable in due course. We do wish that our invested company could distribute dividend but this objective is secondary.
>
> …...
>
> h) Since [Company H] has become a listed company it provided an avenue for us to realize our investment. We were also satisfied with the profit return after disposal.'

71. The Appellant made the same argument in relation to the Company B Share Purchase Agreement as per their letter of 17 July 2006:

> ‘ Please note that the preliminary agreement was signed on January 29,1999, before making this investment decision we had exercised half a year of investigation on the invested company to make sure that it was a profitable manufacturing company. We considered this investment was a long-term investment and at the time of investment there were reasons for us to believe that the management of [Company B] could contribute future growth to the company. Our investment philosophy were no difference to the other long-term minority investors, while we ascertained that our investments achieved good profit return we would consider to take up profits. We prefer to invest on companies with a long-term growth, particularly companies with a plan to be listed in a recognized stock exchange. With such a plan we are confidence that our investment might be realizable in due course. We also wish that our invested company could distribute dividend but this objective is secondary. Since the majority of [Company B] shares were sold by the end of 2000, added to a half year studied time on June 1998 before the actual purchase in January 1999 we had spent more than 28 months on this investment project so it was quite reasonable in regarding to period of investment concern that we could classified this gain on investment as capital gain and should be non-taxable.’

72. These answers tell us that:

(1) when the Appellant spoke of long term investment, it was counting from the date the share option was exercised (31 May 2000 was the date the Appellant agreed to purchase the Company K shares from Madam L and 29 January 1999 was the date of the Company B Share Purchase Agreement); and

(2) the Appellant regarded the IPO of the relevant group as the opportunity to realise the investment.

No intention to hold the relevant shares as capital assets

73. The Appellant’s case is a clear admission that:

(1) first of all, the shares were purchased with an intention to sell; and

(2) secondly, the intention was to sell upon the first opportunity to do so, namely upon IPO of the group.

74. In line with this admission the Appellant sold 500,000 Company B shares a week after the lock up period expired and the Appellant started selling the Company H shares 2 weeks after the share certificates in respect of the Company H shares were issued to it.

75. To purchase shares with an intention to sell upon the first opportunity to do so (whether after the lock up period expires or after IPO) is a clear intention to trade. Or more appropriately to our present considerations, such an intention is clearly not an intention to purchase or hold the relevant shares as capital assets.

76. In Simmons v IRC [1980] 1 WLR 1196 at page 1199, Lord Wilberforce said:

> ' *Trading requires an intention to trade; normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment? ….*'

77. It is clear to us that the Appellant acquired the Company B shares and Company H shares with the intention of disposing of them at a profit and had no intention of acquiring them as 'a permanent investment'.

78. In Lee Yee Shing v CIR [2008] 3 HKLRD 51, McHugh NPJ said at paragraph 59:

> ' *The intention to trade to which Lord Wilberforce referred is not subjective but objective: Iswera v. Commissioner of Inland Revenue [1965] 1 WLR 663 at 668. It is inferred from all the circumstances of the case, as Mortimer J pointed out in All Best Wishes Ltd v. Commissioner of Inland Revenue (1992) 3 HKTC 750 at 771. A distinction has to be drawn between the case where the taxpayer concedes that he or she had the intention to resell for profit when the asset or commodity was acquired and the case where the taxpayer asserts that no such intention existed. If the taxpayer concedes the intention in a case where the taxing authority claims that a profit is assessable to tax, the concession is generally but not always decisive of intention: Inland Revenue Commissioners v. Reinhold (1953) 34 TC 389. However, in cases where the taxpayer is claiming that a loss is an allowable deduction because he or she had an intention to resell for profit or where the taxpayer has made a profit but denies an intention to resell at the date of acquisition, the tribunal of fact determines the intention issue objectively by examining all the circumstances of the case. It examines the circumstances to see whether the "badges of trade" are or are not present. In substance, it is "the badges of trade" that are the criteria for determining what Lord Wilberforce called "an operation of trade'*.

79. We think this is a case where the taxpayer concedes, whether he knows it or not, the intention to trade. Given such a concession, it is not necessary to resort to the nine badges of trade.

80. In any event, we find nothing in the facts to indicate a different intention and have the following observations:

(1) The circumstances of the share options and our findings that they constituted an incentive/reward to the Appellant to procure the successful IPO of the Company B Group and the Company H Group are consistent with an intention to sell the shares and reap the rewards upon listing of the groups.

(2) The gross profits of the Appellant, except for the year 2001/02, were fairly low and were barely sufficient to defray the operating expenses. 2001/02 was a good year for the Appellant, but this was immediately followed by a bad year in 2002/03 (see Table 1). The Appellant was not in the sort of financial shape to enable it to hold on to millions of dollars' worth of shares as capital assets.

(3) Large dividends were paid out by the Appellant on the back of the share profits. They were not retained by the Appellant as capital.

(4) There was a frail attempt in the witness statement to contend that the Appellant had to dispose of the Company H shares to finance the ASX Listing. But that was quickly refuted in cross-examination.

(5) Nowhere in Mr A's witness statement did he explain why 500,000 Company B shares were sold on 12 May 2000. Nor could he give any explanation when cross-examined before this Board. The only explanation remaining was that they were sold for quick profit.

(6) We accept that 5,800,000 Company B shares were sold to Company F on 29 September 2000 in preparation for the Chapter 21 Listing. But this in no way indicates an intention to hold those shares as capital assets. They were never transferred back to the Appellant after the Chapter 21 Listing failed.

(7) The Board minutes have to be read in the light of Mr A's definition of 'long term'.

(8) The treatment of Company B Profits 2 and Company H Profits 1 and Profits 2 in the audited accounts as non chargeable profits should likewise be examined in the light of Mr A's definition of 'long term investment'. In any case the audited accounts contained multiple inconsistencies and admitted errors and were unreliable.

(9) The sale of other Company B shares and Company H shares resulting in Company B Profits 3 and Company H Profits 3, although totally unrelated to the share options, nonetheless indicate that the Appellant regarded the Company B shares and Company H shares (once listed) more as quick profit opportunities than as lasting investment potentials.

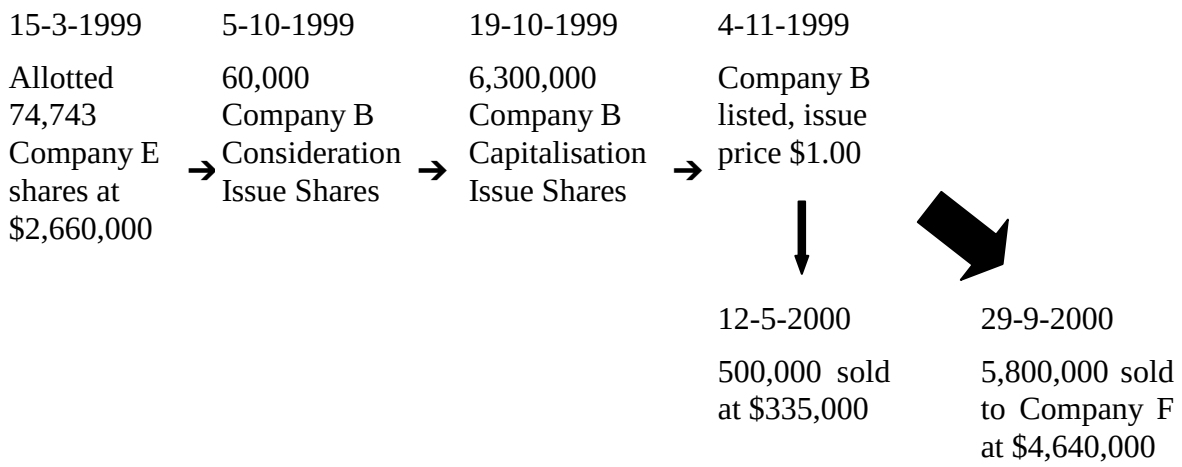
81. In conclusion, the Appellant's case shows clearly an intention to trade and there is nothing in the facts to indicate a contrary intention. We find that the relevant Company B shares and Company H shares were not purchased or held as capital assets and the profits arising from their sale, namely Company B Profits 1 and Profits 2 and Company H Profits 1 and Profits 2, were not profits arising from the sale of capital assets.

82. Further, or alternatively, the Appellant has fallen far short of their burden of proving that the profits were profits arising from the sale of capital assets.

83. Ground (1) of the Amended Perfected Grounds of Appeal is hereby rejected.

Ground (2) of the Amended Perfected Grounds of Appeal

84. Mr Cheung for the Appellant called Ground (2) of the Amended Perfected Grounds of Appeal his fall back position. In it he tried to argue that instead of a profit, the Appellant made a loss out of the Company B Shares in the year of assessment 2001/02. In order to properly understand his argument, it is necessary to recite the chain of events as per the chart below:



85. His argument ran as follows:

(1) When the Company E shares were exchanged for the 6,300,000 Company B Shares, that was one disposal ('Alleged Disposal 1'). Assuming the 6,300,000 Company B Shares on 19 October 1999 had the same value as the issue price of $1.00, the Appellant made a profit:

($1 x 6,300,000) - $2,660,000 = 'Alleged Profits 1'.

(2) This profit, if assessable to tax, should have been assessed in the year of assessment 2000/01. But the assessment for that year of assessment is not under appeal, so this Board has no power to review that assessment.

(3) When the Appellant subsequently sold 500,000 out of the 6,300,000 Company B Shares on 12 May 2000 at $335,000, because the share price had dropped after the 6 months lock up period, the Appellant actually made a loss:

$335,000 - ($1 x 500,000) = 'Alleged Loss 1'.

(4) And when the Appellant sold the remaining 5,800,000 Company B Shares to Company F on 29 September 2000 at $4,640,000, the Appellant again made a loss:

$4,640,000 - ($1 x 5,800,000) = 'Alleged Loss 2'.

(5) Alleged Loss 2 fell into the year of assessment 2001/02. So instead of a profit, the Appellant suffered a loss and should be assessed accordingly.

86. This argument was in complete contradiction to the Appellant's own audited accounts. As stated above, the figures constituting Company B Profits 1 and Profits 2 were given by the Appellant in its audited accounts. The 2000/01 audited accounts never reported the Alleged Profits 1 or the Alleged Loss 1. Instead it reported 'gains on disposal of listed shares' at $123,693. Nor did the 2001/02 audited accounts ever report the Alleged Loss 2. Instead it reported 'gains on disposal of listed shares' at $2,279,550.

87. Mr Cheung argued that because the Appellant treated the Company B Shares as capital investments, there was no need for the account to state the Alleged Disposal 1. We fail to understand that logic. And we do not know on what basis Mr Cheung made such a bold statement. If he was alleging that it was the correct accounting principle not to state the alleged disposal of a capital investment, we would certainly need evidence of that and we have none. And we see no basis for the Appellant to depart from calculations reported in its own audited accounts except for clerical errors which these are not.

88. Mr Cheung's argument was also contrary to the intent and purposes of the Company B Share Option. It is clear from Clause 8 of the Company B Agreement and the Company B Share Purchase Agreement that the price of $2,660,000 was for the purchase of 3% of the equity interest of 'the holding company of the Company B Group which was to be listed', that is Company B, not any intermediary company.

89. Apart from the audited accounts and the Company B Agreement, Mr Cheung's argument was anyway misconceived. Ground (2)(b) of the Amended Perfected Grounds of Appeal premised on the allegation that 'the Appellant acquired the 6,300,000 Company B Shares at HK$1.00 each on 5 October 1999 ...'. But this allegation was simply not true. The Appellant acquired the 6,300,000 Company B shares at zero dollar. It paid nothing for them.

90. Section 16(1) of the IRO tells us clearly how to ascertain the chargeable profits. When the Appellant sold the 500,000 and 5,800,000 shares and received the sale proceeds,

such sale proceeds whether you call them earnings, income, turnover, proceeds, profits or otherwise, were money received by the Appellant arising in or derived from its trade, business or profession. The sale proceeds were chargeable to tax subject to any deduction of outgoings and expenses as provided for by section 16(1) of the IRO. It is up to the Appellant to prove such outgoings and expenses. The Appellant never paid for the 6,300,000 Company B shares. If it ever incurred any outgoings or expenses, they were the payment of $2,660,000 for the Company E shares which were exchanged for the Company B shares. In the absence of authorities, we do not see any basis for allowing notional outgoings and expenses which was what Mr Cheung was trying to argue – notional costs at $1 per share.

91. Mr Cheung referred us to the judgment of Mr Justice To and the subsequent Court of Appeal judgment in Nice Cheer Investment Ltd v CIR (HCIA 8/2007 & CACV 135/2011). We find nothing in those judgments to support his argument. In that case, the taxpayer was an investment trader and in its audited accounts, there was a revaluation of its investment/securities holdings, some of which had increased in value and were reported as unrealized gains while others had decreased in value and were reported as unrealised losses. In computing the adjusted losses and assessable profits, the taxpayer excluded the unrealized gains from the calculations but claimed deduction of the unrealized losses. The taxpayer sought to argue that the unrealized gains were not chargeable because they were unrealized. The two judgments focused on the question whether unrealized profits could constitute assessable profits within the meaning of the IRO. It is immediately apparent that that question has no relevance at all to our present case. Here the profits were realized – the 500,000 Company B Shares were sold at $335,000 and the remaining 5,800,000 Company B Shares were sold at $4,640,000. The only question is what costs should be deducted from these realized profits. The Appellant paid nothing for the Company B Shares and we see no basis whatsoever of allowing notional costs.

92. For the reasons above we reject Mr Cheung's argument in relation to the Company B Shares.

93. As regards the Company H Shares, Mr Cheung advanced the same argument alleging that the Appellant acquired the 14,200,000 Company H shares at $0.77, which was again factually untrue. The Appellant paid nothing for those shares. For the same reasons given above we reject Mr Cheung's argument in relation to the Company H Shares.

94. In any event Mr Cheung accepted that his argument would make no impact on the end results because any alleged profits and losses arising from notional disposals would have balanced each other out. It would be a futile exercise to recalculate the notional profits and losses.

95. In conclusion, Ground (2) of the Amended Perfected Grounds of Appeal is hereby rejected.

The assessments

96. For Company B Profits 1, it was not deducted in the calculation of the assessable profits for the year of assessment 2000/01 (see Table 2 above). The Appellant alleged that there was a clerical error in the audited accounts. It should have been deducted whereby the loss brought forward to the following fiscal year of 2001/02 was understated. The Appellant lodged a claim under section 70A of the IRO to correct the 2001/02 Profit Tax Assessment. This was rejected by the assessor by Notice of Refusal dated 13 September 2006. This notice was upheld by the DCIR. There is no appeal against this part of the Determination.

97. For Company B Profits 2 and Company B Profits 3, the DCIR accepted that the Appellant had understated the costs by $14,000 and had omitted the handling fee for Company B Profits 2. He adjusted them accordingly and made the following Additional Profit Tax Assessment for the year of assessment 2001/02:

	$
Additional profits assessed [Fact (9)(b)]	2,279,550
Less: Purchase cost undervalued	(14,000)
Handling fee	(12,440)
Additional assessable profits	2,253,110
Tax payable thereon	360,497

98. For Company H Profits 1 and Profits 2, the DCIR accepted that the interest paid should be $316,489 instead of $187,300, and the DCIR recalculated the profits as follows:

Sale proceeds	–	Transaction cost	–	Cost		Profits
$10,229,880	–	$37,050.68	–	($3,316,489 x $\frac{12,196,000}{14,200,000}$)	=	$7,344,385

$2,491,400	–	$9,028.08	–	($3,316,489 x $\frac{2,004,000}{14,200,000}$)	+	$257,136	= 2,271,463

99. He adjusted the Profits Tax assessments for the years of assessment 2003/04 and 2004/05 accordingly:

	2003/04	2004/05
For the year ended	30-6-2003	30-6-2004
	$	$
Returned profit	349,785	164,773

	2003/04	2004/05
For the year ended	30-6-2003	30-6-2004
	$	$
Add: Gain on disposal of shares	7,344,385	2,271,463
Assessable profits	7,694,170	2,436,236
Less: Loss set-off	(2,724,866)	
Net assessable profits	4,969,304	
Tax payable thereon	869,628	426,341

Conclusion

100. Grounds (1) and (2) of the Amended Perfected Grounds of Appeal are rejected. The aforesaid Additional Profit Tax Assessment for the year of assessment 2001/02 and the Profits Tax assessments for the years of assessment 2003/04 and 2004/05 as adjusted are set out in the Determination in paragraphs 2(3), 2(4) and 2(5). They are hereby confirmed.