

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D41/87

Board of Review:

Andrew K. N. Li, *Chairman*, J. S. Brooker and Richard Mills-Owens, *Members*.

14 December 1987.

Profits Tax—whether the gain realised on the acquisition and disposal of an asset an adventure in the nature of trade or a capital gain.

The Appellant company is the wholly owned subsidiary of an Investment Company whose Directors and shareholders were members of a family. The Appellant company acquired 30% of the issued capital of the company M whose only asset was the right to acquire portion of a property which was under construction in 1979. The balance of 70% was acquired by an individual. In late 1979 the property developer nominated company M to take up the option to purchase the property and company M began paying the instalments. The Appellant company's acquisition of its 30% interest was dependent on financing from its parent company which at that time had few projects in hand involving substantial investments.

In late 1980 the Appellant company and the individual shareholder sold their entire shareholding to another company and in that process made a profit of HK\$5.9 million. The original intention was nevertheless a long term investment but the disposal took place because the property market was softening in 1980.

Held:

The 30% shareholding held was a capital investment and not an adventure in the nature of trade.

Appeal allowed.

Cases referred to:

CIR v. Reinhold [1953] 34 TC 389
Marson v. Morton [1986] 1 WLR 1343
Simmons v. IRC [1980] 2 All ER 798
West v. Phillips [1958] 38 TC 203

Wong Chi-wah for the Commissioner of Inland Revenue.
Anthony G. Rogers, Q.C. for the Appellant.

Reasons:

Introduction

This is an appeal by LHE against its profits tax assessment for 1980/81.

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In December 1979 LHE acquired 30% of the issued capital of M Limited. The balance of 70% was acquired by one Mr. L. In October 1980, LHE and Mr. L sold the entire issued capital of M Limited. The only asset of M Limited was the right to acquire the office space on one floor of U Centre which was then in the course of construction. The gain made by LHE on the acquisition and disposal of its 30% amounted to \$5,953,708. The issue on this appeal is whether this amount was the profit of an adventure in the nature of trade or was a capital gain on the realisation of a capital asset.

LHE did not offer this sum for assessment. But the assessor treated this sum as profits chargeable to profits tax. Taking into account the loss of \$1,980 as per LHE's accounts, he assessed the profits at \$5,951,728 (\$5,953,708-\$1,980) with tax payable thereon of \$982,035. The Commissioner confirmed the assessment.

At the hearing before us, Mr. A. Rogers, Q.C. appeared for LHE. Messrs. PR and OR, directors of LHE gave evidence. Mr. Wong Chi-wah appeared for the Revenue.

The Facts

For reasons explained below, we do not express any view as to whether the evidence of PR and OR in relation to PC Garden should be accepted. Subject to this, we found PR and OR to be truthful witnesses. On the basis of the documentary and any oral evidence before us we find the following facts.

The corporate background

LHE was a wholly owned subsidiary of AF Limited. The late Mr. R founded this company many years ago. Its directors and shareholders were members of his family. During his lifetime he ran the company. He was a conservative businessman of the old school. His policy was that borrowing should be avoided and profits should be reinvested. So, during his lifetime AF Limited did not pay any dividends. He died in 1978. After his death, his son PR became managing director and ran the company. On matters of policy, he consulted OR, the grandson of Mr. R and the nephew of PR who has been a director since 1968. They made the policy decisions. Messrs. PR and OR were influenced by the conservative policy laid down by Mr. R. They avoided borrowing and did not pay any regular dividends though it paid dividends on two occasions after the death of Mr. R because family members needed money. AF Limited had a number of subsidiaries. Both before and after the death of its founder, it was basically an investment company holding properties and some shares.

The purchase

In late 1979, U Centre was in the initial stage of construction. Because of restrictions in the Conditions of Grant, no agreements for sale and purchase could be concluded. But the developer entered into agreements granting options to purchase. The authorities did not

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challenge this and these agreements were treated in the market place as the purchase of the premises.

PR was offered one floor. The vendor had entered into such an agreement with the developer at the price of \$27,660,000 of which the first instalment of \$1,383,000 had been paid. The balance had to be paid by four further instalments of \$1,383,000 each on the completion of RCC works up to various stages with the final tranche of \$20,745,000 payable on completion of the building. The vendor required payment of \$6,812,735 (the first instalment of \$1,383,000 plus a "premium" of \$5,429,735). So the purchaser had to pay that sum and be responsible for the further payments to the developer. The total consideration for the 14th Floor would come to \$33,089,735. (\$6,812,735 to the vendor + \$5,532,000 being 4 further instalments of \$1,383,000 + \$20,745,000 on completion). With an area of 20,489 sq. ft. the cost came to about \$1,615 per sq. ft.

PR's idea was for the AF Ltd. Group to take a 50% interest and he would get Mr. L to take the other 50%. Mr. L is a well known businessman. PR knew him well for many years.

PR consulted OR on the proposed purchase. After assessing the cash flow of the Group and the requirements of the development of a composite building at H Road which AF Ltd. Was undertaking, OR was of the view that a 50% participation was too much. He thought that they could manage a 30% participation was too much. He thought that they could manage a 30% participation comfortably. Even if there were insufficient cash, they would only have to borrow about \$2 million for about 1 year or sell some shares. PR reluctantly agreed.

PR approached Mr. L who would take 70%. He told Mr. L that the property would be a long term investment and Mr. L agreed. Mr. L was keen to purchase as he regarded the offer price of \$1,615 per sq. ft. as below the market price.

On 23 November 1979 the vendor nominated M Ltd. to take up the option to purchase the property. On 18 December 1979, M Ltd. Allotted shares as to 30% to LHE and as to 70% to Mr. L.

By a board minute of 16 December 1979 LHE resolved to invest for long term investment in 30% in M Ltd. The minute noted that the directors of M Ltd. Intended to acquire the property for long term investment. It was further resolved to obtain from the holding company as and when required the amounts necessary to pay the instalments. The minute was drawn up to record the conclusion reached by PR and OR. The reference to the intention of the directors of M Ltd. was based on PR's conversation with Mr. L. Mr. L and his daughter were directors of M Ltd. PR and OR were not represented on that board.

PR and OR decided to take a 30% stake because they thought it would be a good investment. They estimated the rental on completion to be about \$20 per sq. ft. In using this figure OR who is an executive director of W Ltd. had asked people in his office although no professional opinion was sought from a surveyor. This would make the gross yield on the

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purchase price to be 14.86% which was very good. The property is in Central and the AF Ltd. Group had no property in Central. Although it was not in the traditional heart of Central, it had good accessibility by MTR.

Further, PR had at the back of his mind the possibility of moving his offices as a solicitor into the property or part of it paying rent to M Ltd. although he did not mention this to anyone at the time.

OR produced a draft shareholders agreement for PR to discuss with Mr. L. PR said this was unnecessary in view of the long standing and good relationship between them.

Financial ability

LHE decided to acquire its 30% interest in November/December 1979. It was dependent on financing from its parent company AF Ltd. Looking at the position in late 1979, could the Group afford the 30% acquisition?

For its 30% commitment, LHE had to pay the following sums: \$2,043,825.50 on acquisition, \$1,659,600 by 4 instalments of \$414,900 each (these were in fact paid between April and September 1980) and \$6,223,550 on completion of the building.

OR gave evidence that looking at the position in late 1979 AF Ltd. Could finance this 30% commitment. At most it would have to borrow about \$2 million for about 1 year or realize some shares. We accept this evidence which was supported by the financial materials before us. Indeed the Revenue did not dispute this. It accepted that there were sufficient financial resources for the 30% acquisition with marginal short term borrowing or the selling of shares.

We had the following financial materials before us to support the evidence of OR. The group balance sheet of AF Ltd. shows that as at 31 March 1980, the group had quoted investments with a market value of \$5,107,870 and bank and cash balances of \$5,898,955. So it had some \$11 million worth of liquid assets. It only had liabilities of \$660,222 of which \$504,983 represented rental deposits. The audited balance sheet of course shows the position as at 31 March 1980. But we can infer that the position in late 1979 was similar.

Further the following figures were produced in evidence to show the rental income, the expenditure and the recurrent surplus of AF Ltd. for various years. These were extracted from the audited accounts.

<i>Year ending</i>	<i>Rental Income</i>	<i>Expenditure</i>	<i>Surplus</i>
31/3/80	\$2,595,035.00	\$ 595,038.48	\$1,999,996.52
31/3/81	\$2,937,503.00	\$ 724,243.32	\$2,213,259.68
31/3/82	\$4,375,263.00	\$1,134,599.28	\$3,240,663.72
31/3/83	\$5,108,214.00	\$1,592,909.52	\$3,515,304.48

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These figures were of course not available to PR and OR looking at the position at the end of 1979. But as at that time, they could estimate the rough order of the recurrent surplus in the coming years. They could foresee that the rental income and the surplus for the year ending 31 March 1982 would increase significantly as the H Road development would then be completed.

As against such liquid assets and estimated surpluses, the only substantial capital commitment for the AF Ltd. group was the H Road development. (The above figures for recurrent expenditure of course do not include capital expenditure) But by 31 March 1980, the sum of \$4,322,195.92 had been incurred. A further sum of \$1,257,792.12 was incurred during the year ending 31 March 1981. It was completed during the year ended 31 March 1982 with the expenditure of a further sum of the order of \$1,000,000. By the end of 1979, it would appear that a substantial part of such expenditure had been incurred.

The AF Ltd. group also had a site at Bonham Strand and WL Street. The old building was demolished in 1977–1978. The construction cost was originally estimated to be about \$2 million. By 31 March 1980 a sum of \$985,911.35 was incurred for site investigation. No expenditure was incurred during the year ended 31 March 1981. The site was plagued by soil problems and development did not proceed. It would appear that by the end of 1979 the problems had been revealed (it was during the year 1 April 1979 to 31 March 1980 that the above sum was spent on site investigation) and development was grinding to a halt.

Trading Activities of the M Ltd. Group

Before the end of 1979, when the 30% was acquired the AF Ltd. group had not previously traded in property or shares.

In July 1980, LHE and E Ltd. (also a subsidiary of AF Ltd.) successfully tendered for Sha Tin Town Lot by the use of Letters B they held. They developed a residential block with 16 units using first class materials known as RC Garden. It was completed in 1983. The cost was some \$7 million apart from a premium of \$1.7 million to Government. It was difficult to let and the units were then sold. 2 units are still left. LHE and E Ltd. regarded it as a long term investment. The Revenue appears to dispute this. It is unnecessary for us to make any finding and there may be a dispute about this which we should not prejudice. We wish to make clear that we do not make any finding as to whether PC Garden was a capital investment or an adventure in the nature of trade or any finding as to whether the evidence of PR and OR on this matter should be accepted.

After 1979, the AF Ltd. group embarked on a number of transactions which were admittedly trading transactions. From the year ended 31 March 1981 it held a portfolio of quoted shares for trading. During that year, its subsidiary D Limited acquired 4% in a property trading company, a joint venture with the H Group. That company owned land at Sai Kung which was resumed by Government. During the year ended 31 March 1982 its subsidiary, LD Ltd. took a one-ninth stake in HF Limited which was a property trading company developing a site at Kowloon Bay. During the year ended 31 March 1984, its

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subsidiary LI Ltd. engaged in share dealing and commission agents (from underwriting for W Ltd.).

The sale

On 18 October 1980, LHE and Mr. L sold their shareholding being 100% of its issued capital to S Limited. The sale was completed on 15 November 1980. The total consideration was \$20,120,744.80. Further on completion, S Limited would lend \$12,045,655.20 to M Ltd. to enable it to repay the outstanding debt of that amount it owed to LHE and Mr. L.

The sale was concluded in the following circumstances. Mr. L telephoned PR several times. He said that he wanted to dispose of the property as the market was softening. PR said as far as he was concerned he was not selling. When PR tried to put him off, Mr. L called OR to persuade him to agree to a sale. Mr. L invited them to lunch at the American Club. At this lunch, Mr. L insisted on selling despite the wish of PR and OR to hold as a long term investment.

In view of the insistent attitude of Mr. L, Messrs. PR and OR had no alternative but go along with it. They were in a minority of 30%. They did not want to be locked in with Mr. L selling his 70% to a stranger. They could not buy Mr. L out; they had earlier concluded that they should not take more than 30%. Nor did they consider a partition. That was not regarded as possible presumably because of the Conditions of Grant.

After the lunch OR casually mentioned the property to the managing director of S Limited as he knew they were looking for office premises to purchase. He is an executive of the H Bank seconded to W Ltd. which was responsible for the management in Hong Kong of S Limited a subsidiary of a Philippine company. He expressed interest. OR gave him Mr. L's name and telephone number. He then negotiated direct with Mr. L and came to terms. PR and OR were not involved in the negotiation. They were presented with the concluded deal.

Capital asset or adventure in the nature of trade?

Uncompleted units in buildings in Hong Kong are often purchased for trading. Equally they are often purchased for investment. Each case depends on its own facts and circumstances and the interaction between the various factors present. See *Marson v. Morton* (1986) 1 WLR 1343 at 1348 and *CIR v. Reinhold* (1953) 34 TC at 39. A single one-off transaction can be an adventure in the nature of trade. See *Marson v. Morton* at 1347H. The question is whether it was acquired with the intention of disposing of it at a profit or was it acquired as a permanent investment? Although intentions may change (what was first an investment may be put into trading stock and vice versa), we are not concerned with that in the present case; neither LHE nor the Revenue is contending that there was any change after acquisition. It is not possible for an asset to be both trading stock and permanent investment at the same time. Nor can it possess an indeterminate status neither

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trading stock nor permanent asset. See *Simmons v. IRC* (1980) 2 AE 798 at 800 e-h. Frustration of a plan for investment, which compels realisation, even if foreseen as a possibility cannot give rise to an intention to trade. See *Simmons* at 802j.

We note that the group had not engaged in habitual trading. As at the end of 1979, it had not previously traded in property or shares. That LHE acquired the 30% as a long term investment was stated in its contemporaneous board minute of 16 December 1979. That statement was a self-serving one and by itself is of little weight.

But of great weight is the evidence of Messrs. PR and OR before us which has been tested by cross-examination. We have accepted their evidence that as policy makers of the AF Ltd. group including LHE, their intention at the time of the acquisition of the 30% was to hold it as a long term investment. So LHE's intention at the time of acquisition was to hold for long-term investment.

That this was the intention at the time of acquisition is supported by a number of matters.

First, as at the end of 1979 the acquisition appeared to be a good investment yielding a good return. Even accepting that the estimate of about \$20 per sq. ft. with a gross return of 14.86% was on the optimistic side, the likely return was still a good one.

Secondly, the evidence before us establish that looking at the position in late 1979, the AF Ltd. group could finance the 30% acquisition without much difficulty. The group had substantial liquid resources, both cash and quoted investment. The amount of its liabilities was low. Significant recurrent surpluses were estimated for the coming years. As at the end of 1979 the capital expenditure on the H Road project was nearly completed and apart from this project the group did not have any heavy commitments. At that time the Sha Tin site had not been acquired. It was only acquired in July 1980. At worst, the AF Ltd. would have to borrow some \$2 million for a year or realize some quoted investments to pay its share amounting to \$6,223,550 on completion of U Centre.

Thirdly, at the time of acquisition, there appeared to be no problem in holding it as a long term investment although LHE was a 30% minority in M Ltd. When PR approached Mr. L, he explained that the property would be held as a long term investment and Mr. L agreed. So they were ad idem. PR reasonably relied on that having regard to their good and long standing relationship. Mr. L changed his mind subsequently. But PR and OR could not have foreseen that.

The time between acquisition and disposal was short, only 10 months. That by itself would tend to be a pointer to trading. But it cannot be considered in isolation. The reason for the change from holding to realization "colours and colours heavily the whole matter". See *West v. Phillips* (1958) 38 TC 203 at 213.

Here the reason for the sale was that Mr. L changed his mind and Messrs, PR and OR in a 30% minority position had no practical alternative but to go along. As we have said, they

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could not have foreseen this. So in view of the particular circumstances here, the short time is explicable and does not support a trading intention.

Having regard to the above, we hold that the 30% in M Limited held by LHE was a capital investment and not an adventure in the nature of trade. The gain on sale is therefore not chargeable to profits tax.

Accordingly, we allow the appeal and annul the assessment in question.