

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D42/91

Profits tax – acquisition of loan portfolio by financial institution – realisation of loan portfolio at a profit – whether profit subject to profits tax.

Panel: William Turnbull (chairman), Andrew J Halkyard and Francis Jerome Law.

Dates of hearing: 11 and 12 June 1991.

Date of decision: 6 August 1991.

The taxpayer was a company with a money-lender's licence. It was a member of a large group of companies. Another company within the group which was a financial institution had cash flow problems which required the support of its ultimate shareholders who guaranteed certain of its bad and doubtful loans. Subsequently it was decided to sell the financial institution which had previously had cash flow problems. The third party purchaser did not wish to take over the portfolio of bad and doubtful debts which were then transferred to the taxpayer together with the benefit of the shareholder guarantees. The taxpayer proceeded to realise the bad and doubtful debts and to call upon the shareholder guarantees. As a result the taxpayer made a profit. It was argued by the taxpayer that the profit was a capital gain and that the taxpayer was part of the large group of companies which had made an overall loss and not a profit.

Held:

The gain made by the taxpayer when it realised the loan portfolio was subject to profits tax. The acquisition and liquidation of the loan portfolio was both a trading and a business transaction.

Appeal dismissed.

[Editor's note: The taxpayer has filed an appeal against this decision.]

Cases referred to:

Lionel Simmons Properties Ltd v CIR [1980] 53 TC 461

Ransom v Higgs [1974] 50 TC 1

Marson v Morton [1986] 1 WLR 1343

CIR v Livingston [1927] 11 TC 538

Jones v Leeming [1930] AC 415

Salt v Chamberlain [1979] 53 TC 143

The Dunn Trust Ltd v Williams [1950] 31 TC 477

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Lily Harriet Ram Iswera v CIR [1965] 1 WLR 663

Torbell Investments Ltd v Williams [1986] STC 397

Odhams Press Ltd v Cook [1940] 23 TC 233

Burman v Hedges & Butler Ltd [1979] 52 TC 501

Luk Nai Man for the Commissioner of Inland Revenue.

John J Swaine QC instructed by Messrs Woo, Kwan, Lee & Lo for the taxpayer.

### Decision:

The Taxpayer is a limited company incorporated in Hong Kong. The Taxpayer acquired a portfolio of loans which it realised as quickly as possible and made a substantial profit. The assessor issued three assessments on the Taxpayer which assessed to tax the profits which the Taxpayer made on realising the portfolio of loans. The Taxpayer maintained that the profits were not subject to profits tax because they were an exceptional item which did not form part of the ordinary business of the Taxpayer and did not constitute either an adventure in the nature of trade or a trading or business transaction.

An agreed statement of facts was tabled before the Board and two witnesses were called to give evidence on behalf of the Taxpayer. With few exceptions there was no dispute between the parties regarding the primary facts. To assist the Board, the Taxpayer's representative with the agreement of the Commissioner tabled before the Board many detailed documents which form part of the history of these transactions. However, although the documents were of significant help to the Board in ascertaining what are the primary facts, it is not necessary for us to deal with them in this decision. We find the facts to be as follows:

1. The Taxpayer was incorporated in Hong Kong as a limited company. It subsequently became a wholly owned subsidiary of another company, A Limited. A Limited became a subsidiary of another company, B Limited.
2. A financial institution ('C Institution') ran into cash flow problems. The major shareholders of B Limited decided to assist C Institution by giving various forms of secured guarantees for the substantial number of bad and doubtful loans which C Institution had then on its books. The security given by the major shareholders to secure their guarantees was in the form of cash deposits made by them with C Institution.
3. Later, B Limited decided that it would sell all of its 100% shareholding in C Institution to a third party for a cash consideration.
4. The third party purchaser of the shares in C Institution did not wish to take over the bad and doubtful loans which formed part of the assets of C Institution and

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required that they be acquired by B Limited or anyone nominated by B Limited. The third party purchaser also required or agreed that the then chairman of C Institution, who had a substantial cash deposit with C Institution should convert his substantial cash deposit into shares in C Institution. This would result in his owning 25% of C Institution and the 100% existing shares of C Institution being acquired by the third party purchaser would be equivalent to only 75% of the restructured C Institution.

5. To effect the foregoing change of ownership and reorganisation of C Institution, it was necessary to adjust the net asset value of C Institution so that the cash deposit maintained by the chairman would equal 25% of the net asset value of the reorganised institution. In other words, the net asset value of C Institution at the date when it was acquired by the third party purchaser must equal three times the amount of the deposit maintained by the then chairman.
6. To carry out this reorganisation, B Limited nominated its group subsidiary, the Taxpayer, to acquire from C Institution the portfolio of bad and doubtful loans together with the benefit of the secured guarantees which had been given to C Institution by the major shareholders of B Limited. The price paid by the Taxpayer was the book value of the portfolio of loans as appearing in the books of account of C Institution less a substantial discount which was the amount that was required to reduce the value of C Institution so that its net asset value would be equal to three times the amount of the deposit maintained by the then chairman.
7. At the time the sale of the bad and doubtful loans was effected, the real estate assets of C Institution were independently revalued downwards and the resulting diminution in value was also used to reduce the net asset value of C Institution for the purposes of negotiating the share sale.
8. The Taxpayer was a company with a money-lender's licence. It had been acting as a financier for customers of the B Limited group of companies. It had not however been carrying on the same business as C Institution.
9. The Taxpayer was chosen by B Limited as the appropriate company for the purpose of acquiring from C Institution the portfolio of bad and doubtful loans because it had a money-lender's licence and was considered to be the only company in the B Limited group of companies which would be legally entitled to acquire the portfolio of bad and doubtful loans and to recover the same.
10. The Taxpayer, like all other subsidiary companies within the B Limited group of companies, did not have any of its own employees. All its daily administrative and operational activities were carried out by A Limited for which services a management fee was paid. A Limited was the company within the B Limited group of companies which employed all staff and performed all such services.

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11. When the Taxpayer acquired the portfolio of bad and doubtful loans, it did so with the intention that it would realise the same as quickly as possible on the best terms for itself that it could. Having acquired the portfolio of bad and doubtful loans, the Taxpayer proceeded forthwith to realise the same and did so within three years of its acquisition. It was necessary for a special and separate collection unit to be established by A Limited with one of the group employees being the managing director of the Taxpayer and responsible for the collection.
12. The Taxpayer, after it acquired the portfolio of bad and doubtful loans, did not advance any further moneys to any of the debtors with one exception which is not considered to be material. The exception was where the original lender had an obligation to make a further advance to complete a project before the moneys already lent could be recovered. The portfolio of bad and doubtful loans was handled separately within the accounts of the Taxpayer and the various debts and debtors were not intermingled with the debts owing by other customers of the Taxpayer.
13. The Taxpayer received substantial sums of money from the major shareholders of B Limited who had given guarantees to C Institution and as part of the ultimate settlement of the matter released to some of the guarantors comparatively small sums of money which they had given by way of security under the guarantees. Details of the negotiations and arrangements made with the guarantors were not provided at the hearing but it is assumed that the Taxpayer called upon the guarantees in respect of those of the bad and doubtful loans where it was not able to recover the full face value thereof in accordance with the wording of the various guarantees.
14. The interest collected by the Taxpayer on the bad and doubtful loans was included in its accounts for tax purposes as part of its taxable profits.
15. When the Taxpayer acquired the bad and doubtful loans, it did so with the hope and expectation that it would be able to realise the same at a substantial profit after taking into account the guarantees and the substantial discount which was given on the value as appearing in the books of C Institution. In the event, the Taxpayer was able to realise a substantial profit. The substantial profit was realised over three years of assessment and was assessed to profits tax by the assessor. The Taxpayer objected to the assessments which were upheld by the Commissioner's determination. The Taxpayer then gave notice of appeal to this Board of Review.

At the hearing, the Taxpayer was represented by leading Counsel. He submitted that the gains made by the Taxpayer on the liquidation of the loan portfolio could not be described as trading profits. He said that the liquidation of the loan portfolio was not in the nature of trade but was in reality a part of a larger transaction, namely, the sale of C Institution by B Limited. The gains were in reality capital receipts being part of the

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consideration received for the sale of the bank. He submitted that this was a unique transaction. It was not part of the regular business of the Taxpayer to lend moneys in such circumstances and the acquisition of the portfolio had nothing to do with the Taxpayer's regular business. It was something which was entirely separate from the Taxpayer's historical business. The Taxpayer's historical business had been advancing money to assist in the purchase of shares by the customers of the B Limited group of companies. The Commissioner was wrong in considering this transaction either to be a trading transaction or an adventure in the nature of trade. Liquidation of a portfolio of loans is not trade. Furthermore, the acquisition of these loans was not an enlargement of the money-lending business of the Taxpayer. It was business of a totally different nature. The business of the Taxpayer was money-lending and, with the one isolated exception, the Taxpayer did not lend any money to any of the debtors involved with the loan portfolio. This was not a business transaction because there was no risk so far as the Taxpayer was concerned. Because the loan portfolio was acquired at a substantial discount, there was no commercial risk and it was assumed that the Taxpayer would make a profit.

Counsel for the Taxpayer submitted that the gain made by the Taxpayer came from the guarantees which the shareholders of B Limited had given to C Institution. Without these guarantees, there would have been no gains. The secured guarantees given by the shareholders could not be considered to be trading stock or trading receipts. He said that the B Limited group of companies wished to realise the investment which they had made in C Institution. The transfer of the loan portfolio to the Taxpayer was part of this overall transaction and the acquisition by the Taxpayer of the loan portfolio was in no way a trading transaction. The Taxpayer was a member of the group of companies and had no control over its own affairs but had to follow the group policy. It became the nominated company simply because it had a money-lender's licence.

Counsel for the Taxpayer addressed us on the legal aspects of the case and referred us to the following cases:

Lionel Simmons Properties Ltd v CIR [1980] 53 TC 461  
Ransom v Higgs [1974] 50 TC 1  
Marson v Morton [1986] 1 WLR 1343  
CIR v Livingston [1927] 11 TC 538  
Jones v Leeming [1930] AC 415  
Salt v Chamberlain [1979] 53 TC 143  
The Dunn Trust Ltd v Williams [1950] 31 TC 477  
BR 11/76, IRBRD, vol 1, 239

The representative for the Commissioner submitted that the surplus or gain made by the Taxpayer arose either from an adventure in the nature of trade or a business carried on by the Taxpayer in respect of the loan portfolio. He referred us to the well-known 'badges of trade'. He submitted that it was wrong to consider the acquisition of the loan portfolio by the Taxpayer as part of a capital transaction, namely, the disposal by B Limited of C Institution. The acquisition by the Taxpayer was a separate transaction with separate tax consequences. He said that a distinction must be drawn between purpose and

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intention. The intention of the Taxpayer was to acquire and realise the loan portfolio profitably and as soon as possible. He submitted that this type of transaction is not unique. The fact that the Taxpayer did not carry on any retail banking business after it acquired the loan portfolio was irrelevant. He pointed out that the Taxpayer is a separate legal entity and not part of the group of companies for tax purposes. The Taxpayer had acquired the loan portfolio with the intention and expectation that it would make a profit but, at the same time, there was an element of risk. The profit of the Taxpayer depended upon whether or not it could realise the securities given by the debtors and that, if it had not been possible to realise these securities, then there would have been no profit.

The representative of the Commissioner referred us to the following cases:

Lily Harriet Ram Iswera v CIR [1965] 1 WLR 663

Torbell Investments Ltd v Williams [1986] STC 397

Odhams Press Ltd v Cook [1940] 23 TC 233

Burman v Hedges & Butler Ltd [1979] 52 TC 501

This is a very interesting case. However, when analysed for tax purposes, it is clear that the gain made by the Taxpayer over the three years is subject to profits tax.

Counsel for the Taxpayer rightly pointed out that these transactions formed part of a larger transaction, namely, the sale of C Institution by B Limited to a third party. However, this does not mean that the transaction should be viewed simply as one transaction and that the different roles played by different companies can be ignored for taxation purposes. It is a fundamental rule of taxation that each legal entity must be considered in its own right and separately. It would be different if it is alleged that a transaction is a sham – but that is not the case here.

It is not material for tax purposes that the Taxpayer was de facto obliged to follow group policy and to agree to acquire the loan portfolio from C Institution. It is common practice within groups of companies for one company to carry on a business transaction with another company within the same group. Such a transaction cannot be disregarded and the consequences of the transaction must be viewed impartially and independently for taxation purposes. In the present case, the Taxpayer, as a separate legal entity, agreed with C Institution for the purchase by the Taxpayer of a portfolio of bad and doubtful loans at an agreed price.

There are many ways of negotiating a price. Counsel for the Taxpayer argued at length that the price had been calculated in a reverse manner. He pointed out that the price to be paid for the bad and doubtful loans was an amount which reduced the book value of C Institution so that the third party purchaser of C Institution could restructure and recapitalise C Institution after it had acquired all the existing shares. From the point of view of the B Limited group of companies, the purchase price to be paid by the third party for C Institution had been reduced by the amount of the discount which had been given to the Taxpayer when it acquired the portfolio of bad and doubtful loans. The witness who was called to give evidence confirmed that this was the manner in which the sale of C Institution

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had been negotiated and the manner in which the purchase price to be paid by the Taxpayer for the bad and doubtful loans had been calculated. We accept this as being true. However, it does not take the matter any further.

What we are required to consider in this case are the affairs of the Taxpayer alone. There is no suggestion that the price paid by the Taxpayer was anything other than a genuine price. The portfolio of bad and doubtful loans has no exact value until after they have all been realised to their best and all expenses and other matters have been deducted or adjusted. The Taxpayer hoped and expected to make a substantial profit. However, the profit was dependent upon the value of the securities which went with the bad and doubtful loans and many other factors. If the securities could be realised at their then current book values or better, the Taxpayer would no doubt make a profit. If, however, it was not possible to realise the value of the underlying securities, then the Taxpayer might well have been faced with a loss.

It is noted by the Board and was indeed submitted by Counsel for the Taxpayer that much of the profit of the Taxpayer came from the value of the guarantees given by the shareholders. Indeed the Taxpayer called almost all of the value of the guarantees and released very small sums to the shareholders who provided the guarantees. This suggests that the profit made by the Taxpayer would have dramatically declined if the value of the underlying securities had not been capable of being realised at their then full book values. The profit of the Taxpayer also depended largely upon how long it would take to liquidate the portfolio of debts. In the event it was possible to liquidate the same in three years. Collection charges can be very substantial. In the case of the Taxpayer, it would seem that the Taxpayer was able to liquidate the portfolio of debts at a comparatively low cost to itself and the three years period required is comparatively short for such a major undertaking.

We agree with Counsel for the Taxpayer that the portfolio of bad and doubtful loans acquired by the Taxpayer was different from the previous business of the Taxpayer and the liquidation of the portfolio was handled separately by the Taxpayer. We note that a separate unit had to be established by A Limited for the benefit of the Taxpayer to liquidate the bad and doubtful loans. However these facts do not materially assist the Taxpayer. The question which we must decide is whether or not the acquisition and liquidation of the portfolio of loans by the Taxpayer was a trading or business transaction. In our view, it clearly was both. The Inland Revenue Ordinance provides that all profits made from carrying on a trade or business are subject to profits tax. A trade includes the carrying on of an adventure in the nature of trade.

Business has a very wide meaning. Obviously what the Taxpayer did in this case constituted business. It could constitute nothing else. Counsel for the Taxpayer submitted that this was a capital transaction and tried to import from the B Limited group of companies into the Taxpayer a capital meaning to the transaction. We cannot accept this submission. As we have said, the Taxpayer is an independent entity. The Taxpayer was nominated by its parent company to perform this transaction, but it was not acting as a nominee or bare trustee for its parent company. It was acting in its own right and was an independent legal entity separate from its parent company.

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There are many ways in which a complex transaction of this nature, the sale of C Institution, could be structured. No doubt different tax consequences would arise depending upon the manner in which such a transaction is carried out. It is impossible for us to accept that, regardless of how a transaction is effected, the tax consequences will be the same. This would be contrary to all taxation principles. Individuals are entitled to regulate their affairs in any way they like and often do so with a view to obtaining the most favourable tax results for themselves. In this case, there was no apparent tax planning to minimize the tax effects of what was being done. Business expediency and not tax expediency appears to have dictated the manner in which this transaction was effected. However, this does not entitle us to look at the transaction again to see if either the tax effects of what was done are unfair or unjust or to reconstruct what was done to give a more favourable tax treatment. The fact is that B Limited did not sell C Institution and retained for itself the portfolio of loans. What it did was to sell the shares in C Institution and include as a term of the sale that C Institution would sell the portfolio of loans to another legal and tax entity. What would have been the effect if B Limited had itself acquired the loans we do not know and it is not for us to speculate because they are not the facts upon which we are required to decide in this case.

As we have said, what the Taxpayer did was clearly of a business nature and, for the purposes of the Inland Revenue Ordinance, this is sufficient to make the transaction taxable unless it is a capital gain. However for the sake of completeness, we also state that this transaction would also constitute trading and an adventure in the nature of trade. In this case the Taxpayer acquired the portfolio of loans and then took some three years to realise the same. When the Taxpayer acquired the portfolio, it did so with the intention of liquidating the portfolio as quickly as possible. In our opinion, setting up a special collection unit and working for three years to realise the loans constituted the carrying on of a trade. However, once again, it is not a material point because if what the Taxpayer did was not enough to constitute carrying on a trade, then it most definitely was sufficient to constitute a venture in the nature of trade.

In the course of making submissions to the Board, the representative for the Commissioner referred us to the United Kingdom case of Torbell Investments Limited v Williams. Although the law of the United Kingdom is substantially different from that of Hong Kong, and though it is dangerous to refer to the facts of one case when deciding another, we think it is relevant to examine in some detail this particular case, because the decision in that case is consistent with what we have decided.

The facts of the Torbell case were that a bank forming part of a group of companies in the United Kingdom was facing financial problems. It was decided to transfer from the bank to another company within the group certain debts. The debts were transferred at the full book value appearing in the books of the bank. The taxpayer suffered a loss when it tried to realise the debts and sought to deduct the losses from its taxable profits. The Commissioner refused to allow this and argued that the loans had been transferred by the bank at a price which was higher than their market value and therefore the loss was not a genuine loss but an artificial loss. The Court had no hesitation in finding that

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the taxpayer, which had previously been a dormant company and which undertook no business other than the collection of the debts, was carrying on a trade and that the transfer of the loans to the taxpayer had taken place at what could be considered to be their market value.

Harman J stated:

‘It is also clear (and Counsel for Torbell never suggested the contrary) that Torbell did not itself carry on the business of banking at all. The activity was one which is difficult to describe, certainly has no (as Counsel put it) snappy title which can be attached to it, but is described in the accounts of Torbell, in the directors’ reports, as “a trade in the recovery of loans secured on property and in the exploitation of the underlying securities”. It is an odd trade, but it is undoubtedly an activity, and it is an activity which I think it would be difficult to hold was purely carried on for pleasure. I cannot believe that anyone for pleasure would sit down and do these things. Since it is an activity carried on by a trading entity, through qualified individuals, which activity would, in some circumstances, quite undoubtedly be part of one trade (that is, the trade of banking), and which had no other rational appellation to be attached to it, one does fall easily into the conclusion that the activity, though odd and though not snappily described, yet is a form of trade. I accept the proposition of Counsel for Torbell that just as the categories of negligence are never closed, so the categories of trade are never closed, and his further proposition that one is not to be haunted by the fact that there is no easy analogy or experience one can refer to which shows that this is indeed a trade transaction.’

Counsel for the Taxpayer submitted before us that the price at which the Taxpayer acquired the portfolio of loans from C Institution was artificial because of the way in which it had been calculated. However, no evidence was brought to prove the true market value of the portfolio and there was some evidence to indicate that the price paid was a fair market value. Accordingly we cannot accept the submission that the price paid for the portfolio was anything other than a fair market value even though it may have been calculated in an unusual way. It is therefore not necessary for us to consider what would have been the case if the price paid for the portfolio had been artificially low.

However, it seems to us that unless the transaction is alleged to be a sham (and that is not the case here), whether the price is a fair market value or not may not be material. We also note that if the Commissioner and this Board were to be required to look into the value of transactions effected between separate legal entities the consequences could be very far reaching and complex. For example in the present case, we assume that C Institution will have shown in its accounts for tax purposes the price which it realised on the portfolio of loans. If we were now to decide that this value was incorrect in the books of the Taxpayer, then it follows that the value would likewise be incorrect in the books of C Institution. The consequences of such a decision would be very far reaching indeed. However, as we have said, it is not necessary for us to consider this in the case before us.

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For the reasons stated, we find that the acquisition and liquidation of the loan portfolio by the Taxpayer was in the nature of business and constituted the carrying on of a trade or was an adventure in the nature of trade. It was not a capital transaction. Accordingly, the gains made by the Taxpayer are subject to profits tax and have been correctly assessed to tax by the assessor. For the reasons given, we dismiss this appeal and uphold the assessments against which the Taxpayer has appealed.