Case No. D44/04

Profits tax – convertible participating certificates – annual income – profits from disposition – section 26 of the Inland Revenue Ordinance ('IRO').

Panel: Benjamin Yu SC (chairman), Leung Hing Fung and Alan Ng Man Sang.

Dates of hearing: 9, 10 March, 6, 7 May and 9 June 2004.
Date of decision: 15 September 2004.

The taxpayer (Company A) is a subsidiary of Company D (previously known as Company C). Company C was and is an investment holding company. Company C through other companies held 80% of Company F.

In November 1994, Company C sold its interest in Company F to the latter's major shareholder in return of cash and partly convertible participating certificates issued by Company B.

Under the terms of these certificates, the holder of them shall be entitled to a payment by Company B at the rate of 5.5% per annum of the outstanding amount of the certificates. Besides, the holder shall have the right to convert the certificates into ordinary shares upon a conversion price.

The taxpayer derived profits in the year of assessment 1994/95 from the 5.5% annual income (the annual income) and in the year of assessment 1995/96 mainly from the gain on disposition of the certificates or the shares converted from them (profits from disposition).

Held:

1. In respect of the annual income, the Board held that it was in the nature of interest and prima facie falls within 15(1)(f) of the IRO.

2. The Board is also satisfied that the taxpayer did carry on a business namely the investment in the certificates (American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue applied).

3. The Board, nevertheless, found section 26 of IRO not applicable. The purpose of section 26 is to avoid double taxation. In order for the section to apply, it must be

shown that the profits in question are profits of Company B. Here the profits of the taxpayer was not profits of Company B but rather its expense. Thus, the annual income was taxable.

4. In respect of the profits from disposition, the Board considered all the evidence and accepted that the taxpayer did not embark upon an adventure in the nature of trade. Company C caused the taxpayer to take the certificates primarily because of the certainty of the recoupment of its investment with a modest return, that is, a low risk investment but with the potential of a significant upside if the Company B shares should perform extraordinarily well. (Simmons v IRC; All Best Wishes Limited v Commissioner of Inland Revenue; Hong Kong Oxygen & Acetylene Co Ltd v Commissioner of Inland Revenue and Crawford Realty Limited v Commissioner of Inland Revenue followed). Thus, the appeal relating to the profits from disposition would be allowed and the case would be remitted to the Commissioner for further consideration.

Appeal allowed in part.

Cases referred to:

Simmons v IRC [1980] 1 WLR 1196
All Best Wishes Limited v Commissioner of Inland Revenue 3 HKTC 750
Hong Kong Oxygen & Acetylene Co Ltd v Commissioner of Inland Revenue [2001] 1 HKC 531
Crawford Realty Limited v Commissioner of Inland Revenue (1991) 3 HKTC 674
Iswera v Commissioner of Inland Revenue [1965] 1 WLR 663
Wisdom v Chamberlain (1968) 45 TC 92
Ransom v Higgs [1974] 1 WLR 1594
American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue [1979] AC 676
Commissioner of Inland Revenue v Bartica Investment Ltd (1996) 4 HKTC 129
Rangatira Ltd v Commissioner of Inland Revenue [1997] STC 47
Brand Dragon Ltd v Commissioner of Inland Revenue HCIA 2 of 2001

Johnny Mok Counsel instructed by Department of Justice for the Commissioner of Inland Revenue.
Stewart Wong Counsel instructed by PricewaterhouseCoopers Limited for the taxpayer.

Decision:

Introduction

1. This is an appeal by Company A ('the Taxpayer') against the determination of the Commissioner of Inland Revenue ('the Commissioner') dated 8 September 2003. In that determination, the Commissioner overruled the Taxpayer's objection and increased the profits tax assessment for the year of assessment 1994/95 to assessable profits of $1,285,308 with tax payable thereon of $212,075 and confirmed the profits tax assessment for the year of assessment 1995/96 showing assessable profits of $62,339,295 with tax payable thereon of $10,285,983.

2. The central issue in this appeal is whether the income derived by the Taxpayer from certain convertible participating certificates ('the Certificates') is taxable. The Taxpayer acquired the Certificates in November 1994 in circumstances described below. The Certificates are instruments issued by Company B. Company B's shares are listed on the Hong Kong Stock Exchange. Under the terms of the Certificates:

(1) each certificate holder shall be entitled to a payment by Company B at the rate of 5.5% per annum of the outstanding amount of the certificates held by such holder; such payment shall be made whether Company B has profits or not or has paid dividends on ordinary shares or not;

(2) a holder of certificates shall have the right, at any time after the first anniversary of the date of the certificate up to and including the third anniversary of the date of the certificate, to convert all or part of the amount of the certificates held by such holder outstanding from time to time into ordinary shares at the 'Conversion Price', that is, $6.9 per share subject to adjustment in accordance with the terms of the certificate;

(3) there will be automatic conversion when the daily average of closing price for a consecutive period of 20 days exceeds the daily average conversion price by not less than 20%.

The profits derived by the Taxpayer in the year of assessment 1994/95 from the Certificates came from the 5.5% annual income whilst the profits in the year of assessment 1995/96 came in part from the 5.5% annual income but in the main from the gain on disposition of the Certificates or Company B shares acquired by the Taxpayer after conversion. For convenience, we shall call the annual income of 5.5% 'annual income' and the income from disposition as 'profit from disposition'. The Taxpayer's argument in respect of the annual income is that the same is not taxable as this was paid from the after-tax profits of Company B and exempt from tax under section 26(b) of the Inland Revenue Ordinance ('IRO'). The Taxpayer argues in the alternative that the Taxpayer merely held the Certificates and did not have any trade or business, so that the annual income cannot be taxable as income derived from the carrying on of a trade or business. In respect of the profits from disposition, the Taxpayer's argument is that this was a capital gain from disposition of a capital asset, and hence not taxable under section 16 of the IRO.

3. The background facts set out below are either agreed or are proved to our satisfaction.

(1) The Taxpayer was incorporated on 29 September 1994 under the laws of the British Virgin Island. Its ultimate holding company was Company C, now known as Company D, a company incorporated in Hong Kong.

(2) Mr E is and was at all material times the managing director of Company C.

(3) Company C was and is an investment holding company. It seeks to invest especially in companies with a record of profit growth, strong management, high levels of technical expertise and research and development capabilities as well as management commitment to long term growth.

(4) In November 1991, Company C's group acquired an effective 8% in a telecommunication company called Company F. Company F is one of the three licensed mobile network operators in Hong Kong.

(5) The investment of Company C in Company F was held through a company called Company G. Company C held 80% of Company G, and Company G held 10% of the holding company of Company F, called Company H.

(6) The other shareholders of Company G were companies held by Company I.

(7) The intention of Company C and of Company G was to hold the investment in Company F through Company H on a long term basis.

(8) In 1994, the major shareholder of Company F wished to buy back the shares of Company H held by Company G. What was offered to the shareholders of Company G were partly cash and partly convertible participating certificates.

(9) In the event, in November 1994, Company C decided to sell its interest in Company F in return for cash and certificates. For its 80% interest in Company G, Company C through the Taxpayer took 60% of the cash offered and the remainder in certificates. For its 20% interest in Company G, Company I took 40% of the cash offered and the remainder in certificates. In other words, through the Taxpayer, Company C took proportionately more certificates (and less cash) than Company I.

(10) The Certificates held by the Taxpayer have a face value of $262,500,000.

4. At the time when the Taxpayer acquired the Certificates, the market value of Company B shares on the stock market was about $5.30 to $5.45 per share. Company B shares rose in value between November 1994 and November 1995. Appendices K and M of the determination show the spectacular rise in the value of Company B shares. From a price of less than $5 in January 1995, it kept rising beyond $7 in May 1995 to around $8 in August, hitting $9 in October 1995 but easing back to somewhere above $8 in November 1995.

5. Company C's executive committee resolved on 19 September 1995 to authorise Mr E to sell the Certificates. Pursuant to such authority, the Certificates were disposed of either in the form of certificates or, after their conversion, in the form of Company B shares, producing substantial profits for the Taxpayer.

Profits from disposition

6. We turn first to the question of whether the profits from disposition are taxable. The parties are *ad idem* that the law which applies here is that enunciated in the well-known decisions of Simmons v IRC [1980] 1 WLR 1196 and All Best Wishes Limited v Commissioner of Inland Revenue 3 HKTC 750, namely, what was the intention of the Taxpayer at the time when the Certificates were acquired. If the intention of the Taxpayer was to embark upon trading or an adventure in the nature of trade, the profits from disposition are taxable. If the Certificates were acquired as capital asset, profits arising from sale of such assets are exempt from profits tax. It is also not in dispute that the burden rests on the Taxpayer to satisfy us that the determination is wrong.

7. In the course of the evidence and in Mr Wong's submission, the Taxpayer constantly stressed the fact that the acquisition of the Certificates must not be looked at in isolation, but rather as a continuation of an investment made some three years ago since 1991. As there is no dispute that the original investment by Company C in Company F via Company G was a long term investment, Mr Wong initially argued that the Board should consider the investment as one for a period of four years, that is, from November 1991 to December 1995 (see opening submissions paragraphs 15 and 16). Mr Mok submitted that where a taxpayer chose to dispose of a capital asset to be substituted by new assets which are trading in nature, that taxpayer can be held to be embarking upon a trade or an adventure in the nature of trade, and any profits derived from the disposition of the substituted assets are taxable. He cited the case of Hong Kong Oxygen & Acetylene Co Ltd v Commissioner of Inland Revenue [2001] 1 HKC 531 as an illustration of that scenario. There, the taxpayer originally held certain land as its capital asset. It entered into an agreement with its subsidiary and a property developer whereby the land was surrendered in exchange for some other land transferred to its subsidiary for redevelopment. Under the agreement, the taxpayer would receive a non-refundable initial payment. The question was whether this payment was trading receipt and chargeable to tax. The Board held it was and its

decision was upheld by the Court of First Instance. In the course of his judgment, Tong J adopted the analysis expounded by Barnett J in Crawford Realty Limited v Commissioner of Inland Revenue (1991) 3 HKTC 674 as follows:

> '*... Enhancement of an asset, making it as attractive and saleable as reasonable expenditure of time and money can achieve, is one thing. The end product remains substantially the same. Substitution, however, is another matter. It is the taking of one's old car, removing the body work, engine and suspension from the chassis and replacing them with the latest styling and mechanical components. And that is effectively what happened here. The Appellant obtained a price for the old car far in excess of its apparent value (about which no complaint is made by the Commissioner) but then went on to participate in the expenditure of time and money on rebuilding the car with new components in the hope of another profit therefrom. The Appellant was actively involved in this process...*'

Tong J continued:

> '*In any case, it was said that the question of whether an item of receipt is of a capital or revenue nature, the approach adopted should be that of a practical and business point of view, rather than upon the juristic classification of the legal rights. (See CIR v Wattie [1999] 1 WLR 873 (AC), applying the dictum by Dixon J in Hallstroms Pty Ltd v Federal Commissioner of Taxation (1964) 72 CLR 634 at 648). Based on these principles, I could not really find fault with the findings of the Board that by consenting to the joint venture agreement, the taxpayer had, by the terms and conditions of the agreement as a whole, evinced an intention to trade by which the subject property, originally a capital asset, had changed its characteristic by substitution.*'

8. We accept the statements of principle in these cases, and are indeed bound by them. To be fair to Mr Wong, in his submissions in reply, he did not seek to challenge the principle either. He accepts that a taxpayer who holds a capital asset may be found to have substituted it for another asset which involves trading or an adventure in the nature of trade.

9. There is thus no dispute on the law. What remains to be considered is whether the Taxpayer can satisfy the Board in the present case that there was, at the time of the Taxpayer's acquisition of the Certificates, no intention to trade or to embark upon an adventure in the nature of trade. The fact that the Taxpayer originally held a capital asset is not conclusive of the matter. It is, however, part of the background which may be relevant in ascertaining the intention of the Taxpayer.

The evidence

10. The Taxpayer called Mr E to give evidence before the Board. In his written statement which he adopted as part of his evidence, Mr E explained the reasons why Company C was prepared to sell its indirect interest in Company F and the reason why Company C was prepared to take the Certificates. He stated in paragraph 22:

> ' First, the valuation given to the [Company H] shares was good. Second, [Company H] was a private company with restrictions on the transfer of shares. That would limit the ability and freedom of [Company C] to realise this investment if it wanted to. While this in itself would not stop [Company C] from investing, as it did with [Company H] and other unlisted investments, the offer of "replacing" these unlisted, restricted, shares with the Certificates which would be convertible into shares of the ultimate parent of the original "investee" and which was a listed company (i.e. [Company B]) was attractive, because, while there was no plan of our own at the time to realise the investment (as we were still gungho on [Company F]), the increased liquidity of the investment (which remained with the [Company B] group) would certainly enhance its value. Further, with a private company and the restrictions on transfer, the immediate market for those [Company H] shares, if and when [Company C] decided to realise the investment, would naturally be [Company B] and [Company J], and so if they came with an offer to buy it would be imprudent to refuse, as otherwise there might well be no further market for the shares if and when we decided to realise the investment. While we were only getting the Certificates but not [Company B] shares immediately, that also had its own advantages, namely the earning of dividend income at 5.5% in the meantime, and the protection against downward market risk of the value of the [Company B] shares. As there was no plan at all at the time to realise the investment, the fact that [Company C] was not getting [Company B] shares immediately was not a problem. More importantly, as we believed at the time that [Company F] still had room to grow, holding the Certificates meant [Company C] continued to have an interest in a growing business, albeit indirectly via [Company B], and vastly diluted.'

11. In cross-examination, he summed up the reason for agreeing to sell Company C's interest in Company F in return for cash and the Certificates as follows:

> ' I do not want to get on the wrong side of these two parties (that is, [Company B] and [Company J] who were the majority shareholders), (b) I think I get a reasonable deal (c) I still get some mileage.'

12. In a later part of his evidence, Mr E said if given the choice, Company C would have taken cash instead of the Certificates. He said the Certificates were the only way Company C could liquidate its investment. Nevertheless, he said it was out of choice that Company C took a higher portion of certificates than it was obliged to.

13. As to the terms of the Certificates, Mr E's evidence in his written statement was that he did not 'quibble' with the conversion price as he thought that the price was unlikely to be attained having regard to the price of Company B shares at the time. We note, however, that in his oral evidence he said Company C made a 'valiant attempt' in asking for a lower conversion price. He also stated that he did not bargain over the automatic conversion mechanism in clause 7 of the instrument because it was unlikely to be triggered during the term of the Certificates and Company C was content to hold the Certificates to the end of the period. Under the instrument, the Taxpayer had the right of conversion into Company B shares at $6.9 after the first year. Mr E stated that this could only arise if Company B shares were traded above $6.9 and he did not foresee that happening. Attention was also drawn to the fact that the Certificates had a large denomination and the time lag before the Certificates could be converted into shares as pointers against any intention to trade. Mr E said he would have asked for small denomination certificates and minimal conversion hassles to facilitate quick and repetitive share sales if Company C did intend to trade on the Certificates. He accepted, however, in cross-examination that, like the conversion price, he did try his best to get the best terms and that he believed he got the best he could in the circumstances.

14. At the time, time deposits rate for one month deposit would have yielded about 5% per annum. Mr E accepted that a yield of 5.5% or even 6.5% per annum, if looked at on its own, would have been a 'disastrous' investment, but that would have been his 'safety net'. He agreed that in 1995, a return of 5% would not even beat inflation. He explained his expectations on the Certificates in these words:

> ' I am trying to let you gauge the expectation of this investment. If anything happens, I get a 5.5% dividend every year and at the end of three years, I get a $6.9 possibly plus a 5% advantage which is one of the terms of the certificates. Now, if I did get $7.3 over $5.4, then I would have made roughly 40% over three years plus the 15, 16.5% for the three years of dividend, very simply. So I am looking at roughly, when I estimate it, my expectation is roughly in the range of 16% a year ... That's in my view a fairly conservative investment with a very reasonable return ... It would be considered as a good place to invest if you get ... around 16% ... on a relatively risk free basis.'

15. Mr Mok challenged that evidence and suggested that Company C was looking for not less than 30% per annum. He suggested to Mr E that on the basis of the investment climate at the time, 16% would not be a handsome reward. He relied on the statement by the chairman of Company C in the 1994 annual report, a document which Mr E said he had a key hand in drafting. It was stated there that:

> ' [Company B] is a dynamic company and has performed well over the lst few years. I expect this investment (meaning the Certificates) to handsomely reward us over its term.'

Mr E's reply was that 16% would have been quite acceptable as a handsome reward. Later in his evidence, he said that his mindset was that he was cashing in on a rather large profit. His first priority was to make sure that Company C would get the money back. He said:

> 'Of course, I hoped for making even more money. Nothing wrong with that. But, expectation is another thing, I think the board of directors at that moment were quite happy that the profit was locked in, which was why they agreed the terms of the certificate without much quibble.'

16. Mr Mok also challenged Mr E's evidence that he did not foresee or expect at the time that Company B share price rising to the level of $6.9. Mr Mok pointed to the spectacular rise in the market value of the shares from March 1994 up to November 1994. Mr E responded that the share price in November 1994 of $5.4 was already quite high. He emphasized that whilst the stock was a volatile one, Company C had a safety net.

17. Mr E explained the disposal of the Certificates in his statement in paragraph 31. After referring to the fact that the market price of Company B shares kept rising from January 1995 to August and September 1995, he stated:

> 'It was my view at the time that this very high level of the market price for [Company B] shares was unusual, quite unreasonable and could not be sustained. With this trend, the automatic conversion mechanism under cl. 7(A) of the Instrument (i.e. if the closing market price of [Company B] shares exceeded HK$8.28 (HK$6.90 x 120%) by 20 consecutive days), considered by [Company C] and me as remote at the time of the issue of the Certificates, might soon be triggered. The Taxpayer would then be holding the [Company B] shares at a price which I found to be unrealistically and unsustainably high. While the Taxpayer was holding the Certificates, it was protected from downside market risk because at maturity, one of the following would happen (assuming there was no conversion or part conversion in the meantime):
>
> (1) if the average closing price of [Company B] for the last 20 days exceeded HK$7.245 (i.e. HK$6.90 x 105%), there would be automatic conversion under cl. 7(B) of the Instrument at the conversion price of HK$6.90. Thus, the Taxpayer would actually have a gain, in that it was given 38,043,478 shares (262,500,000 ÷ 6.9) but with an average market value of more than HK$7.245, i.e. more than HK$275,625,000;
>
> (2) if cl. 7(B) is not triggered, then [Company B] would have the option of paying the Taxpayer in cash or in shares. If in cash, that would be HK$262,500,000. If in shares, then it would be the lower of HK$6.90 or 95% of the average

closing price on the last 20 trading days. Because cl.7(B) was not triggered, the average price must be at or less than HK$7.245, so that 95% is at or less than HK$6.90, meaning that will get the following number of shares, i.e. 262,500,000 ÷ (0.95 x P) = 276,315,789/P, where P is the average closing price for the last 20 trading days. Thus, the total value of the shares converted would be HK$276,315,789.

(3) However, once the Taxpayer was holding the [Company B] shares, it would be subject to the risks of market fluctuation. Further, on conversion, the 5.5% annual payment would stop. Thus, at automatic conversion, which appeared imminent on the market trend, there was a fundamental change in the risk position for the Taxpayer.

(4) Thus, it would only be commercially prudent for the Taxpayer to sell the Certificates at the high market price rather than holding onto [Company B] shares which value would, in my estimation at the time, more likely fall than rise (probably below HK$6.90), with no income stream for us in the meantime ...'

18. In cross-examination, Mr E stated that Company C started thinking about liquidating the Certificates when it dawned on the company that there was the risk of compulsory conversion, that is when the risk would completely change on the company. Near the end of his evidence, he stressed again the importance of the safety net. He said:

> ' The safety net enables you to continue your expectation. The removal of the safety net completely changes the decision-making basis. It becomes a pure betting in the shares. As I said before, our primary objective in accepting the Certificates was to cash out in the old investment. You have to take this as the basis of my thought process. Once you take that, everything makes sense. Once you refute that, nothing makes sense. In my mindset at that moment, if you took that mindset, you would see that all I am doing is only logical.'

19. He disagreed with the suggestion that the attractiveness of the price was sufficient to prompt the Taxpayer to dispose of the Certificates. He said:

> ' The decision-making process is all based on the safety net. By the "safety net" I mean the certainty of payment.'

To him, the removal of the safety net was crucial. It changed the risk entirely.

20. We should note that during cross-examination, Mr Mok put a series of questions to Mr E designed to show that Company C had a need to sell the Certificates because of the need for funds. Mr E refuted the suggestion. We have no hesitation in accepting his evidence on this.

The Commissioner's arguments

21. Mr Mok took us to the badges of trade. He argued that if the transaction has all the hallmarks of trading, it matters not that the Taxpayer did not have the motive of trading, relying on Iswera v Commissioner of Inland Revenue [1965] 1 WLR 663 and Wisdom v Chamberlain (1968) 45 TC 92. He contends that the investment in the Certificates was an investment in its underlying stock coupled with a guaranteed income and the Taxpayer's intention cannot be divorced from that of making an investment in the underlying stock. He argued that in examining the badges of trade, the Board should look first at the characteristics of an investment in the underlying stock, and then the question whether and how such characteristics would be different if the investment was coupled with a guaranteed income for a limited period of three years. He proceeded to argue that the acquisition of a very volatile stock would inevitably be an exercise in speculation and that the fact that the Certificates gave a guaranteed income in no way detracts from the inherent nature of this acquisition as a speculation, because, in Mr E's own words, a return of only 5.5% per annum would have been a disastrous investment.

22. Mr Mok relies in particular on the chairman's statement in the 1994 annual report to the shareholders of Company C where the chairman stated that he expected the investment on the Certificates to 'handsomely reward' the company over its term. He emphasised that Company C decided of its own volition to take a higher portion of certificates.

23. Mr Mok next submitted that the period of ownership was short. The decision to liquidate was made in September, which was less than a year after the Certificates were acquired.

Our finding on the Taxpayer's intention

24. Although there are certain aspects of his evidence upon which we entertain some doubt, we find Mr E on the whole to be a reliable witness. In particular, we accept his evidence as to the crucial importance he attached to the safety net in embarking upon the investment. We do not agree with Mr Mok's submission that we should first have regard to the volatility of the shares, nor with his submission that we should place little weight on the safety net since Mr E accepted an investment which brought forth a meagre 5.5% annual return would have been disastrous. In our view, when determining what was the intention of the Taxpayer at the time of acquiring the Certificates, we should have regard to the circumstances of the acquisition as a whole. The volatility of the Company B shares is one factor. The positive view which Mr E and his fellow directors took of the prospect of Company B is also an important factor. The availability of the safety net is an important and, we accept, a crucial factor. Mr Mok's submission amounts to this: that we should find on the evidence that the Taxpayer's intention in opting for the Certificates was to reap a handsome gain on a speculative stock, and that the safety net was of marginal relevance. It is perhaps for this reason that he had to challenge Mr E's evidence that he did not expect the conversion price of $6.9 to be reached.

25. We find on the evidence that at the time when Company C decided to sell its investment in Company B, it did have, to some extent, a choice over the amount of the certificates to take; and that it did opt to take a higher proportion of certificates than it was strictly obliged to. We do not, however, consider that in so doing, the Taxpayer embarked upon an adventure in the nature of trade. Rather, as a means of realising its investment, Company C caused the Taxpayer to take the Certificates primarily because of the certainty of the recoupment of its investment with a modest return, that is, a low risk investment but with the potential of a significant upside if the Company B shares should perform extraordinarily well.

26. We are satisfied on the evidence that in doing so, the Taxpayer was not engaged in trading or an adventure in the nature of trade.

The annual income

27. We turn next to the annual income. Section 15(1)(f) of the IRO deems sums received by a corporation carrying on a trade, profession or business in Hong Kong by way of interest derived from Hong Kong to be receipts arising in or derived from Hong Kong from a trade, profession or business.

28. The annual income received by the Taxpayer was in the nature of interest and *prima facie* falls within section 15(1)(f). The Taxpayer raises two arguments why it should not have to pay profits tax on the annual income. Its first argument is that the Taxpayer did not carry on any trade profession or business in holding the Certificates. Its second argument is that section 26(b) of the IRO affords relief to tax.

29. Mr Wong submitted that the carrying on of a business required some activities, however minimal or infrequent, on the part of the taxpayer. He relied on Ransom v Higgs [1974] 1 WLR 1594 at 1600H and 1611B-C and American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue [1979] AC 676 at 684D-E and Commissioner of Inland Revenue v Bartica Investment Ltd (1996) 4 HKTC 129, 158-160 and Rangatira Ltd v Commissioner of Inland Revenue [1997] STC 47 at 50-51.

30. As observed in American Leaf Co v Director-General, 'business' is a wider concept than 'trade'. In delivering the opinion of the Board, Lord Diplock stated:

> '*In the case of a private individual it may well be that the mere receipt of rents from property that he owns raises no presumption that he is carrying on a business. In contrast, in their Lordships'view, in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business. Where the gainful use to which a company's property is put is*

letting it out for rent, their Lordships do not find it easy to envisage circumstances that are likely to arise in practice which would displace the prima facie inference that in doing so it was carrying on a business.'

Mr Wong argues that the Taxpayer was acquired by Company C to hold the Certificates passively, and not to put any property or assets to any gainful use. Mr Mok retorts that we should attribute to the Taxpayer the intention of its parent company (relying on Brand Dragon Ltd v Commissioner of Inland Revenue, HCIA 2 of 2001 paragraphs 16-19). Mr Mok also referred us to the evidence to show, inter alia, that

(1) the Taxpayer was incorporated for the purpose of investing in the Certificates,

(2) the Taxpayer obtained a loan from Company C to enable it to invest in the Certificates,

(3) the Taxpayer was the beneficial owner of the Certificates.

31. We are satisfied that the Taxpayer did carry on a business, namely the investment in the Certificates, and as part of that business, obtained a loan from Company C and took steps to dispose of the Certificates. We reject the Taxpayer's first argument.

32. We turn to the second argument. Section 26 of the IRO provides:

'*For the purposes of this Part:*

(a) a dividend from a corporation which is chargeable to tax under this Part shall not be included in the profits in respect of which any other person is chargeable to tax under this Part; and

(b) save as otherwise provided no part of the profits or losses of a trade, profession or business carried on by a person who is chargeable to tax under this Part shall be included in ascertaining the profits in respect of which any other person is chargeable to tax under this Part.'

33. It is not contended that the receipts are in the nature of dividends. Section 26(a) does not apply. Section 26(b) is not as straightforward. The classic case for applying section 26(b) is where a corporation is a member of a partnership and the partnership is assessed to tax as though it were a separate legal entity. Section 26(b) ensures that the corporation does not bear tax again on its share of the profits which has already borne tax.

34. The Taxpayer contends that the present case is analogous. It is said that the sums representing the annual income were paid to the Taxpayer by Company B from its after-tax profits.

The Taxpayer points to two matters. Firstly, it was a term of the Certificates that Company B will not seek to claim a deduction in the amount of the participation right for the purposes of calculating its liability to Hong Kong profits tax. Secondly, the financial statements of Company B show that the annual income were paid out of the after-tax profits of that company.

35. In our view, the purpose of section 26(b) - similar to that of section 26(a) - is to avoid double taxation. In order for the section to apply, it must be shown that the profits which are sought to be assessed are the *profits* (or part of the profits) of another person which is chargeable to tax. Here, the profits of the Taxpayer which are sought to be assessed cannot be regarded as the *profits* of Company B. Rather, it was an expense item. The fact that in the agreement between two parties, the payer and the payee, the payer contracted to pay the sum out of its post-tax profits and not to claim deduction cannot affect the tax liability of the payee. In our view, section 26(b) does not assist the Taxpayer.

36. For these reasons, we would uphold the determination insofar as it relates to the annual income.

Order

37. We accordingly allow the appeal insofar as the same relates to the profits from disposition and remit the assessment appealed against to the Commissioner for further consideration in the light of the decision of the Board.