Case No. D50/91

Profits tax – whether investments in unit trusts were capital or trading – whether losses capable of deduction from assessable profits.

Panel: William Turnbull (chairman), Foo Tak Ching and Lester Kwok Chi Hang.

Date of hearing: 6 February 1991.
Date of decision: 9 September 1991.

The taxpayer was a limited company carrying on business in Hong Kong. The taxpayer acquired units in unit trusts which were sold at a loss. The taxpayer sought to deduct the losses from its taxable profits.

Held:

On the evidence before it, the Board found as a fact that the taxpayer had surplus funds available for investment and the same were invested for short term purposes in the unit trusts. Accordingly, the taxpayer was trading and the losses were capable of being deducted from the taxpayer's assessable profits.

Appeal allowed.

Cases referred to:

CIR v Dr CHANG Liang Jen 2 HKTC 975
Graham v Green 9 TC 309
D61/88, IRBRD, vol 4, 62
Cooper v C & J Clark Ltd 54 TC 670
Lewis Emanuel & Son Ltd v White 42 TC 369
Salt v Chamberlain 53 TC 143
BR 11/79, IRBRD, vol 1, 239

H Bale for the Commissioner of Inland Revenue.
Jenny Leung Kwai Chun of K L Young & Co for the taxpayer.

Decision:

This is an appeal by a limited company against a determination of the Deputy Commissioner in which he refused to allow the company to deduct against its taxable profits losses which it had incurred on the disposal of certain units in unit trusts. The facts are as follows:

1. The Taxpayer is a limited company incorporated in August 1972. At all relevant times, it was carrying on the business of manufacturing.

2. On 29 December 1988, the Taxpayer submitted its profits tax return for the year of assessment 1987/88 together with a tax computation showing assessable profits of $4,107,281 after deducting a loss on disposal of units in unit trust funds amounting to $788,735.

3. On 26 January 1989, the assessor raised on the Taxpayer a tax assessment for the year of assessment 1987/88 in which the assessor assessed the Taxpayer to tax on a profit of $4,107,281 as per the tax return submitted by the Taxpayer.

4. The assessor made enquiries of the tax representative of the Taxpayer with regard to the claimed loss on disposal of unit trust funds and as a result of these enquiries formed the opinion that the loss on disposal of units in the unit trust funds should not be allowable and on 27 September 1989 the assessor raised an additional profits tax assessment on the Taxpayer in the sum of $788,735 with tax payable thereon of $141,972.

5. On 11 October 1989 the tax representative for the Taxpayer lodged objection to the additional assessment.

6. By his determination dated 9 October 1990, the Deputy Commissioner confirmed the additional assessment and rejected the objection by the Taxpayer.

7. The Taxpayer duly appealed to the Board of Review.

At the hearing of the appeal, the Taxpayer was represented by its tax representative and two witnesses were called to give evidence who were directors of the Taxpayer. The representative for the Taxpayer submitted that on the facts of this case, the Taxpayer had acquired the units in the unit trust funds with a view to trading therein and not as a long term capital investment. Accordingly it was submitted that the losses which were incurred were of a trading nature and capable of being deducted from the taxable profits of the Taxpayer.

The representative for the Commissioner likewise submitted that this case is to be decided on its facts and that on the facts it was clear that the losses were not trading losses but were of a capital nature.

The representative for the Taxpayer referred us to the following cases:

CIR v Dr CHANG Liang Jen 2 HKTC 975
Graham v Green 9 TC 309
D61/88, IRBRD, vol 4, 62

The representative for the Commissioner referred us to the following additional cases:

Cooper v C & J Clark Ltd 54 TC 670
Lewis Emanuel & Son Ltd v White 42 TC 369
Salt v Chamberlain 53 TC 143
BR 11/79, IRBRD, vol 1, 239

To decide this case, it is clearly necessary to look at the facts and determine whether or not the Taxpayer acquired the units in the unit trust funds as a trading transaction or as a capital investment. We had the benefit of hearing evidence from two witnesses and also of perusing various documents and papers which were before us. We accept the evidence given by the two witnesses who were directors of the Taxpayer. We find in addition to the facts set out above the following facts:

1. The Taxpayer was a family-owned private company controlled by Mr X who was its managing director and who died intestate in 1982.

2. Mr X when he died left a widow and four sons. The widow was appointed as the executrix of the estate. Following the death of Mr X, the Taxpayer was continued to be run by the widow and sons.

3. During his lifetime Mr X had advanced money to the Taxpayer from time to time interest free. There was no formal loan agreement but it was understood that the Taxpayer would repay the moneys at some unspecified future date when it was able to do so. After the death of Mr X, his widow continued to advance moneys to the Taxpayer in the same manner and on the same terms as Mr X had done previously.

4. The affairs of the late Mr X took some years to be administered. In 1988 the family members agreed that the assets of the estate would be distributed amongst the various beneficiaries and that ownership of the Taxpayer would be acquired by some members of the family only which excluded the widow. It was then necessary that the moneys due from the Taxpayer to the estate and the widow should be repaid.

5. During the period between the death of Mr X and the ultimate family agreement and distribution of the assets of the estate of Mr X, the Taxpayer carried on its business. Initially the Taxpayer had substantial requirements for funds which as mentioned above were provided on an interest free loan basis. Subsequently the Taxpayer generated a positive cash flow and by early 1987

the Taxpayer had surplus moneys available for investment. One of its directors who was a son of the late Mr X and who gave evidence before us, made enquiries with regard to the investment of the surplus moneys. He received professional advice recommending or suggesting that the surplus moneys could be invested in units in various unit trust funds. The alternative was to retain the moneys on fixed deposit with the bank. The matter was discussed by some of the directors and it was decided that a better return could be obtained by investing the surplus moneys in units in unit trust funds. On 10 February 1987 a directors' resolution was passed that the Taxpayer would diversify its business by trading in equity and trust funds or listed shares in the market whenever cash might be available for such purpose.

6. The Taxpayer proceeded to acquire units in unit trust funds in March 1987. Unfortunately for the Taxpayer there was a substantial decline in world equity markets in October 1987. A decision was taken to liquidate the unit trust fund investments and this the Taxpayer proceeded to do in February and March 1988. The proceeds of sale were required by the Taxpayer to make repayment of the moneys due to the estate of the late Mr X and his widow which had been lent interest free and had to be repaid as part of the family agreement.

We find as a matter of fact that the Taxpayer had surplus funds available for investment in 1987 and that it was decided to acquire the units in unit trust funds as short term investments with a view to making greater profits than would have been available if the money had been left on deposit with the bank. In any case of this nature, the question to be decided is always the intention of the Taxpayer when it made the investment. As we have found that the investments were short term investments, it follows that the Taxpayer was trading and that the assessor and the Deputy Commissioner were wrong in holding that the loss made by the Taxpayer was a capital loss.

We feel that a few words of explanation as to why we have reached this decision is appropriate. First of all there is evidence before us that the directors of the Taxpayer passed a resolution at the time to the effect that it intended to trade in equity and trust funds or listed shares in the market. It was not suggested that the minutes were anything other than genuine. Two of the company's directors appeared before the Board and gave evidence and offered themselves for cross-examination. They explained the background relating to the decision for the Taxpayer to acquire units in unit trust funds for short term purposes. Though units in unit trust funds are normally considered to be investments of a long term nature, they afford a method of investing in diversified equities on a worldwide basis which would not be available to an individual who tried to invest for his own account. From the evidence given by the two directors, it would appear that this was their thinking and that they considered investing in units in unit trust funds would be a better form of investment than if they tried to handle the investments themselves or left the money on deposit.

It was also explained in evidence before us that at all times the directors had in mind that as soon as the family affairs were settled, it would be necessary for the Taxpayer

to repay the interest free loans which had been made by the late Mr X and his widow. There was evidence before us of a family dispute with the widow and certain other members of the family on one side and the two directors who gave evidence before us on the other side. In such circumstances it would have been very unwise for the directors who had control of the affairs of the Taxpayer to have invested in long term investments knowing that at any moment in time they might have to realise the investments and pay off the substantial borrowings of the Taxpayer. A unit trust fund is of course a form of investment where it is possible to liquidate the investment at any time at short notice.

Having found as a fact that the Taxpayer acquired the units in the unit trust funds as trading investments and not as long term capital investments, it follows that the appeal is successful. We direct that the assessment appealed against be referred back to the Commissioner so that he may reduce the same accordingly.