Case No. D52/94

Profits tax – purchase and sale of shares in property owning company – whether capital gain or taxable profit.

Panel: Kenneth Kwok Hing Wai QC (chairman), Karl Kwok Chi Leung and Vincent To Wai Keung.

Date of hearing: 6, 7 and 8 July 1994.
Date of decision: 23 November 1994

The taxpayer purchased and late sold shares in a company which owned certain property. The taxpayer argued that the shares had been acquired as a capital asset and that the gain or profit which arose on their sale was not liable to be assessed to profits tax.

Held:

The onus of proof is upon the taxpayer. The taxpayer failed to call evidence to substantiate its case.

Appeal dismissed.

[Editor's note: The taxpayer has filed an appeal against this decision but subsequently has withdrawn.]

Cases referred to:

Marson v Morton [1986] STC 463
Simmons v IRC [1980] 1 WLR 1196
Simmons v IRC [1980] 53 TC 461
Sharkey v Wernher [1956] AC 58
Norman v Golder 26 TC 293
Shadford v H Fairweather & Co Ltd 43 TC 291
Eames v Stepnell Properties Ltd 43 TC 678
CIR v Scottish Automobile and General Insurance Co Ltd 16 TC 381
Rellim Ltd v Vise 32 TC 254
Beautiland Co Ltd v CIR [1991] 2 HKLR 511

S P Barns for the Commissioner of Inland Revenue.
Brenda Cheung of Messrs Grant Thornton Byrne for the taxpayer.

Decision:

1. This is an appeal against the determination dated 3 February 1994 by the Commissioner of Inland Revenue, confirming the profits tax assessment for the year of assessment 1990/91.

The Facts

2.1 The Taxpayer is a private company and was incorporated in Hong Kong in May 1987.

2.2 At all material times, the issued and paid-up capital of the Taxpayer has been $2.

2.3 In its application dated 19 June 1987 for business registration, the Taxpayer stated that the nature of its business was 'Trading/Investment' and put 'Not yet commenced' as the date of commencement of its business.

2.4 Sometime in 1987, the Taxpayer entered into an agreement ('the Shareholders' Agreement') with Company A to purchase all the issued shares (they were only 2) of Company B which was the registered owner of a property ('the Property'), and to define the rights and obligations of the Taxpayer and Company A as shareholders of Company B. There is no evidence on the date of the Shareholders' Agreement, and we have only been supplied with a copy of the Shareholders' Agreement which is undated and was signed on behalf of the Taxpayer but not Company A. The Shareholders' Agreement provided that:

(a) All costs and expenses of the acquisition shall be contributed by Company A and the Taxpayer in the proportion of 55:45 [Clause 2];

(b) After completion of the purchase of the 2 shares, Company A shall procure Company B to allot the 9,998 unissued shares to Company A and the Taxpayer so as to maintain a shareholding proportion of 55:45 by issuing 5,498 shares with voting rights to Company A and 4,500 shares without voting rights to the Taxpayer [Clause 3(i)];

(c) Company A and the Taxpayer shall advance to Company B the sum of $4,625,000 in the shareholding proportion to enable Company B to pay off its creditors [Clause 4];

(d) 'Any party wishing to sell any of its shares in Company B must first offer it to the other party which offer shall be made in writing stating the selling price and valid for 30 days from the date of receipt of the offer notice by the other party' [Clause 7(a)];

(e) 'If the offer is not accepted by the other party within the period stipulated in Clause 7(a) hereof, the party which is desirous of disposing of its shares may sell it to outsiders at the same price as that offered to the other party provided that Company B will only approve and register the transfer of the shares if that outsider has previously agreed in writing to be bound by all the terms and conditions of this Agreement' [Clause 7(b)];

(f) 'Unless and until otherwise agreed in writing by the parties hereto; Company A shall have the sole and absolute right to nominate and appoint directors to the board of Company B' [Clause 8];

(g) Company B 'shall not enter into any other form of trade or business save and except the management letting and selling of the Property and such other acts which are necessary for the upkeeting (sic) of the Property' [Clause 9];

(h) Company A or its appointee shall be appointed as the manager of Company B [Clause 10];

(i) Any party to the Shareholders; Agreement which has introduced a purchaser for the unit(s) of the Property shall be entitled to charge Company B a finder's fee of 1% of the purchase price [Clause 12]; and

(j) 'Company A hereby agrees that within 7 days after the completion of the sale of each individual unit or units of the Property, it shall procure Company B to distribute 45% of the profit (if any)' to the Taxpayer after certain specified deductions [Clause 13].

2.5 In the 2 balance sheets of the Taxpayer as at 30 September 1988 and 30 September 1989, the 4,500 shares in Company B acquired by the Taxpayer ('the Shares') were listed as 'Investment' at cost at $4,500.

2.6 The 2 balance sheets also recorded loans to Company B respectively in the sums of $2,081,250 and $3,566,369. The loans to Company B were non-interest bearing and repayable on demand.

2.7 The acquisition of the shares and the loans to Company B were financed by loan(s) by the Taxpayer's shareholders. These loans appeared under 'Current Liabilities' in the 2 balance sheets.

2.8 Apart from disclosing that the loans by the Taxpayer's shareholders were recorded in the Taxpayer's books as funds advanced from Company C, the Taxpayer has declined to disclose the identity of the beneficial owners of the shares in the Taxpayer.

2.9 The operating profit of Company B for the year ended the 31 December 1987 was $109,133 and for the year ended 31 December 1988 was $313,800.

2.10 The Taxpayer has not received any dividend from the shares.

2.11 Sometime between 1987 and 1989, Company A transferred its entire shareholding in Company B to Company D. We are unable to make any finding on the date of transfer as the Taxpayer has made no attempt to adduce any evidence on the point. Nor has the Taxpayer made any attempt to adduce any evidence on (i) whether Company A had given notice to the Taxpayer in accordance with Clause 7(a) of the Shareholders' Agreement; (ii) what decisions, if any, were made by the Taxpayer on receipt of such notice; and (iii) whether Company D had agreed to be bound by the terms of the Shareholders' Agreement.

2.12 The Property was mortgaged to Company E.

2.13 Company F was also a customer of Company E. Company F was interested in acquiring property and was introduced to the Property. We accept the evidence of Mr P, who was at the material time in the employ of Company E, that Company F was indifferent whether to purchase the shares in Company B or to purchase the Property.

2.14 Negotiations led to a letter dated 22 August 1989 from Company F's solicitors to Mr Q who were understood to be acting for the shareholders of Company B. The letter set out Company F's offer to purchase all the shares in Company B upon the terms set out therein, Special Condition Clause 6(k) of which provided that in certain specified events, Company F should purchase the Property by way of assignment directly by Company B. The copy letter produced contained the Taxpayer's signature accepting the offer 'to purchase the shares or the Property…'

2.15 Sometime after the letter of 22 August 1989, the Taxpayer sold the shares to Company F. Again we are unable to make any finding on the date of completion of the sale for the simple reason that the Taxpayer has made no attempt whatsoever to adduce any evidence on the point. The copy letter dated 20 December 1989 from Company E to Company B referred to a 'Share Purchase Agreement' dated 6 October 1989. But no attempt has been made to produce such 'Share Purchase Agreement' or a copy thereof.

2.16 The Taxpayer went into members' voluntary winding-up on or before 12 October 1990.

2.17 The gain by the Taxpayer on disposal of the shares was $6,415,356. The assessor raised profits tax assessment on the Taxpayer for the year of assessment 1990/91 in that sum.

2.18 The Taxpayer objected, but the Commissioner confirmed the assessment. The Taxpayer appealed from the determination.

Relevant provisions

3.1 Section 68(4) of the Inland Revenue Ordinance (the IRO), Chapter 112, provides that the onus of proving that the assessment appealed against is excessive or incorrect is on the Taxpayer.

3.2 Section 2 defines 'trade' as including *'every trade and manufacture, and every adventure and concern in the nature of trade'*. Section 14 excludes profits arising from the sale of capital assets.

The Issue

4. The issue is whether the Taxpayer has discharged its onus of proving that the assessment on the gain arising from the sale of the shares is incorrect in that it is not assessable to profits tax in accordance with section 14 on the ground that the shares were capital assets.

Authorities

5. A number of authorities were cited to us. We do not find it necessary to refer to all of them. Each case depends on its own facts.

6. As Sir Nicholas Browne-Wilkinson VC said in Marson v Morton [1986] STC 463 at pages 470-471:

> *'… The purpose of authority is to find principle, not to seek analogies on the facts.*
>
> *It is clear that the question whether or not there has been an adventure in the nature of the trade depends on all the facts and circumstances of each particular case and depends on the interaction between the various factors that are present in any given case. The most that I have been able to detect from the reading of the authorities is that there are certain features or badges which may point to one conclusion rather than another. In relation to transactions such as this, that is to say a one-off deal with a view to making a capital profit, there do seem to be certain things which the authorities show have been looked at. For convenience I will refer to them in a moment. But I would emphasise that the factors I am going to refer to are in no sense a comprehensive list of all relevant matters, nor is any one of them so far as I can see decisive in all cases. The most they can do is provide common sense guidance to the conclusion which is appropriate.*
>
> *The matters which are apparently treated as a badge of trading are as follows:*
>
> *(1)* …
>
> *(2)* …

(3) …

(4) …

(5) *What was the source of finance of the transaction? If the money was borrowed that is some pointer towards an intention to buy the item with a view to its resale in the short term; a fair pointer towards trade.*

(6) …

(7) …

(8) *What were the purchasers' intentions as to resale at the time of purchase? If there was an intention to hold the object indefinitely, albeit with an intention to make a capital profit at the end of the day, that is a pointer towards a pure investment as opposed to a trading deal. On the other hand, if before the contract of purchase is made a contract for resale is already in place, that is a very strong pointer towards a trading deal rather than an investment. Similarly, an intention to resell in the short term rather than the long term is some indication against concluding that the transaction was by way of investment rather than by way of a deal. However, as far as I can see, this is in no sense decisive by itself.*

(9) *Did the item purchased either provide enjoyment for the purchaser (for example, a picture) or pride of possession or produce income pending resale? If it did, then that may indicate an intention to buy either for personal satisfaction or to invest for income yield, rather than do a deal purely for the purpose of making a profit on the turn. I will consider in a moment the question whether, if there is no income produced or pride of purchase pending resale, that is a strong pointer in favour of it being a trade rather than an investment.*

I emphasise again that the matters I have mentioned are not a comprehensive list and no single item is in any way decisive. I believe that in order to reach a proper factual assessment in each case it is necessary to stand back, having looked at those matters, and look at the whole picture and ask the question - and for this purpose it is no bad thing to go back to the words of the statute – was this an adventure in the nature of trade? In some cases perhaps more homely language might be appropriate by asking the question, was the taxpayer investing the money or was he doing a deal?'

7.1 In Simmons v IRC [1980] 1 WLR 1196 at page 1199 and [1980] 53 TC 461 at page 491-492, Lord Wilberforce authoritatively stated the principles thus:

> *'One must ask, first, what the Commissioners were required or entitled to find. Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired as a permanent investment? Often it is necessary to ask further questions; a permanent investment may be sold in order to acquire another investment thought to be more satisfactory; that does not involve an operation of trade, whether the first investment is sold at a profit or at a loss. Intentions may be changed. What was first an investment may be put into the trading stock - and, I suppose, vice versa. If findings of this kind are to be made precision is required, since a shift of an asset from one category to another will involve changes in the company's accounts, and, possibly, a liability to tax (cf. Sharkev v Wernher [1956] AC 58). What I think is not possible is for an asset to be both trading stock and permanent investment at the same time, nor to possess an indetermine status - neither trading stock nor permanent asset. It must be one or other, even though, and this seems to me legitimate and intelligible, the company, in whatever character it acquires the asset, may reserve an intention to change its character. To do so would, in fact, amount to little more than making explicit what is necessarily implicit in all commercial operations, namely that situations are open to review.'*

7.2 Lord Wilberforce also approved the statement of the law by Orr L J as a generally correct statement (WLR at page 1202 and TC at page 495). At pages 488 & 489 of the report in TC, Orr L J stated the general principles in these terms:

> *'It is also clearly established that on appeal to the Commissioners the burden is on the taxpayer to displace the assessment, and in these circumstances the burden in the present case was clearly on the taxpayers to establish that the sales in question gave rise to a surplus on capital account and not to a trading profit (Norman v Golder 26 TC 293, at page 297, and Shadford v H Fairweather & Co Ltd 43 TC 291, at page 300). On the other hand it is also clear that if an asset is acquired in the first instance as an investment the fact that it is later sold does not take it out of the category of investment or render its disposal a sale in the course of trade unless there has been a change of intention on the part of the owner between the dates of acquisition and disposal (Eames v Stepnell Properties Ltd 43 TC 678). The question, moreover, whether an item is held as capital or as stock-in-trade is not concluded by the way in which it has been treated in the owner's books of account (CIR v Scottish Automobile and General Insurance Co Ltd 16 TC 381, at page 390) or by the Revenue in past years (Rellim Ltd v Vise 32 TC 254).'*

8. The judgment of the Privy Council in Beautiland Co Ltd v CIR [1991] 2 HKLR 511 was one reached 'upon a consideration of the whole facts and circumstances' of that case (at page 518), and primarily on the construction of the joint venture agreement in that

case. The joint venture agreement in Beautiland is very different from the Shareholders' Agreement in this case. Having said that, we would remind ourselves of what Lord Keith said at page 516:

> *'If there was no contemplation of trading in the shares of subsidiary or associated companies there can be no question of a separate contemplation of trading in land via shares, a concept which their Lordships in any event find difficult to understand.'*

9. In this case, we are concerned with the shares, not the Property.

Our Decision

10.1 Our task is to consider what we have been told of the facts and circumstances of this case.

10.2 It is true that, with no voting rights, and with strict transfer restrictions, both in the Shareholders' Agreement and presumably in the constitution of Company B as a private company, the shares do not sell themselves. On the other hand, a purchaser who happened to be interested in acquiring the Property by way of purchase of all the shares in Company B had to buy all the shares in Company B, including the shares.

10.3 We also remind ourselves that the question whether the shares were capital assets is not concluded by the way they were treated in the Taxpayer's books of account.

10.4 We accept that Clause 13 of the Shareholders' Agreement only obliged Company A to cause Company B to pay the Taxpayer its share of the profits on a sale of a unit or units of the Property and that the finder's fee applied likewise to a sale of a unit or units of the Property. Neither clause governs the sale of any shares in Company B. But we have not been told of the Taxpayer's intention, whether by way of oral evidence, or by way of minutes of meetings of the directors or shareholders of the Taxpayer, or otherwise, at the time of acquisition of the shares.

10.5 Renovation of the Property is at best a neutral factor. It can enhance the value of a permanent investment and increase its rental value. On the other hand, it can promote the sale of the Property or the sale of the shares in Company B. Again, we have no evidence on whether the Taxpayer had paid its share of the renovation cost, or had financial difficulty to do so. Note 10 of the financial statements of Company B for the year ended 31 December 1989 referred to a Writ issued on 30 July 1990 by the contractor for the renovation works against Company B claiming approximately $6,000,000 in respect of work done and materials supplied.

10.6 We accept that the Taxpayer had not previously traded in shares and are prepared to accept that the Taxpayer had not advertised the sale of the shares. These are pointers towards the shares being capital assets, but they are not conclusive or decisive.

10.7 Whether or not the Commissioner had accepted that the gain by Company D on disposal of its shares in Company B is irrelevant to the question whether the sale of the shares by the Taxpayer was capital profit. Different shareholders of the shares in the same company may have different intentions. In any event, the Taxpayer had abandoned ground no 11 of the grounds of appeal.

10.8 We come back to the fact that there is no evidence whatsoever on what the intention of the Taxpayer was at the time when it acquired the shares sometime in 1987. The Taxpayer was incorporated on 26 May 1987. It was a $2 company. It borrowed money to purchase the shares. Its ability to hold the shares as a permanent investment or as capital assets depended upon the financial strength of its beneficial owner(s). While it is the prerogative of the beneficial owner(s) not to disclose his/her/their own identity (identities), the fact and the consequence is that there is no evidence of the financial ability of the beneficial owner(s) to acquire and keep the shares as capital assets of the Taxpayer. We decline to speculate on whether the loans by the beneficial owner(s) to the Taxpayer came from surplus funds or were financed by short-term loans. The fact that the shares had no voting right did not provide pride of possession. We have no evidence on what income was expected from the shares at the time of acquisition. But we do know that no dividend had been received by the Taxpayer, and that the operating profits of Company B for 1987 and 1988 were miserably low. According to ground no 1 of the grounds of appeal, the shares had been held by the Taxpayer for 2 years before the sale, a comparatively short period. There is no evidence of what caused the Taxpayer to agree to sell if the shares had initially been acquired as capital assets.

Appeal dismissed

11. We have carefully considered the grounds of appeal and the submission made on behalf of the Taxpayer. We do not propose to deal with the grounds of appeal or the points made in submission beyond what we have done already. The grounds of appeal and the submission contained far too many assertions of fact not supported by any evidence. In the event, for the reasons we have set out above, we are left in no doubt that the Taxpayer has not discharged the onus under section 68(4) of proving that the assessment appealed against is excessive or incorrect. We dismiss the appeal and confirm the assessment appealed against.

Postscript

12. Before we part with this appeal, we would like to record our thanks to Mr Barns for his able assistance. He was courteous, helpful, to the point, and did not indulge in giving evidence under the guise of making submission.