INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D53/89

Profits tax – whether share trading – onus of proof – section 68(4) of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Robert Gaff and Eleanor Wong.

Date of hearing: 18 May 1989.
Date of decision: 25 September 1989.

The taxpayer was a private limited company which sold certain quoted public company shares at a profit. In a previous Board of Review decision, the taxpayer had appealed against an assessment and it had been decided that the taxpayer had traded in shares. No direct evidence was given at the hearing as to the intention of the taxpayer when it acquired the shares in the public company.

Held:

The previous Board of Review decision was only relevant in so far as it established the fact that the taxpayer had previously traded in shares. However, the onus of proof is upon the taxpayer and the taxpayer had not been able to produce any direct evidence of the intention of the taxpayer when it acquired the public company shares. On an analysis of the facts before the Board, it was decided that the taxpayer had not been able to discharge the burden of proof imposed by section 68(4) of the Inland Revenue Ordinance.

Appeal dismissed.

S P Barns for the Commissioner of Inland Revenue.
Patrick B Paul of Price Waterhouse for the taxpayer.

Decision:

This is an appeal by a private limited company ('the Taxpayer') against an assessment to tax of a profit or gain realised when certain quoted public company shares were sold by the Taxpayer.

The facts appear in the Commissioner's determination, a statement of agreed facts prepared by the Taxpayer, and from the evidence of a director of the Taxpayer who was called to give evidence. We will first set out the facts as we find them from the Commissioner's determination and the statement of agreed facts prepared on behalf of the Taxpayer. They are as follows:

1. The Taxpayer was incorporated as a private company in Hong Kong in 1973. In June 1976 it obtained registration as a deposit taking company ('DTC') under the Deposit Taking Companies Ordinance (then Chapter 328). The Taxpayer commenced business in April 1977 and its principal activities as described in its annual accounts were 'investment holding, deposit taking and related financial services.'

2. Mr X was the founder of the Taxpayer. He was a businessman who was also one of the founders of a public quoted company in Hong Kong, 'the public company'. Mr X controlled the Taxpayer and was a director of the public company.

3. Though it was registered as a DTC the Taxpayer did not carry on an active DTC business. The Taxpayer received few deposits and made few loans. The deposits which it received were from friends and associates of the founder of the Taxpayer. For practical purposes and for the purposes of this appeal it is assumed that the deposit taking business of the Taxpayer was not material at any time during the history of the Taxpayer including the years in question. The real business of the Taxpayer was to employ its share capital and moneys which it borrowed from its bankers in the acquisition of shares in private and public quoted companies, in the making of deposits with banks and in foreign currency transactions.

4. It was the intention of the founder of the Taxpayer that he would find a well-known bank or important financial institution to be his partner and to give the Taxpayer financial backing. Unsuccessful attempts were made to find such a partner.

5. In the year ended 31 March 1978 the Taxpayer acquired 4,000 shares in the public company. In the next following year the Taxpayer acquired a further 3,000 shares in the public company and in the same year sold all 7,000 shares and realised a profit of $11,042 which it included in its profits tax return for the year of assessment 1978/79 and was duly assessed to profits tax thereon. Subsequent to this sale of 7,000 shares in the public company the Taxpayer started to acquire in the same year a much larger block of shares in the public company. The Taxpayer ultimately acquired a total of 193,248 shares in the public company which comprised 0.927% of the total share capital of the public company. These shares were acquired as follows:

Year of Acquisition	Number of Shares	Method of Acquisition
1978/79	106,000	Eleven separate purchase
1979/80	16,000	Purchased
	12,200	Bonus issue
1981/82	26,840	Bonus issue
1982/83	32,208	Bonus issue
	193,248	

6. In January 1983 all of the 193,248 shares in the public company were sold by the Taxpayer and a profit or gain of $1,011,250 was realised.

7. In addition to the shares in the public company, the Taxpayer bought and sold shares in a number of other quoted companies in Hong Kong. With the exception of certain profits on the sale of what the Taxpayer classed as 'trade investments' in 1978/79, the Taxpayer maintained that all of the profits on sale of other quoted shares were of a capital nature not subject to profits tax. The Commissioner decided that the Taxpayer was taxable on these profits. The Taxpayer appealed the Commissioner's determination to the Board of Review in a previous appeal which the Board of Review determined against the Taxpayer and held that the profits which arose on the sale of other quoted shares were all subject to profits tax.

8. When the Taxpayer made a profit on the sale of the public company shares in January 1983 as set out in facts 5 and 6 above, profits tax was assessed on the profit. The Taxpayer objected to this assessment but the Deputy Commissioner upheld this assessment for the year of assessment 1982/83 in his determination dated 10 December 1987 from which the Taxpayer is now appealing. The Deputy Commissioner based his determination on the previous Board of Review decision which found that the Taxpayer's holdings in quoted shares were trading stock. The Deputy Commissioner decided that there was no evidence before him to prove that the profit of the shares bought and sold in the public company from which is the subject matter of this appeal were in anyway different from the other shares bought and sold by the Taxpayer and which the previous Board had found were trading transactions.

9. The Taxpayer was wholly owned subsidiary of another company of which Mr X was the chairman and his son and daughter-in-law were directors.

10. With effect from 1 July 1981 the law relating to DTCs was amended to prohibit a DTC from holding the share capital of other companies to an aggregate value

in excess of 25% of the paid up capital and reserves of the DTC. A grace period of two years from 1 July 1981 was provided during which the Taxpayer had to comply with the new regulation. On 3 January 1983 an examination of the books and records of the Taxpayer took place and the Taxpayer was informed by the office of the Commissioner of Deposit Taking Companies that it was required to comply with the new law within the prescribed period. The directors of the Taxpayer resolved at a board meeting held on 10 January 1983 to try to sell all or part of the Taxpayer's holding in the public company and recorded that the shares in the public company which were stated to be held as a long term investment would not have been considered to be sold but for the requirement to meet the new law relating to DTCs.

11. Following the board resolution to dispose of the public company shares, they were sold later on in a single block to a purchaser who was already a substantial shareholder of the public company and who was well-known and friendly towards Mr X and his family.

Mrs X, the daughter-in-law of Mr X, was called to give evidence for the Taxpayer. Mrs X became a director of the Taxpayer in February 1981 and its managing director in 1983. From her own knowledge and from having access to the books and records of the Taxpayer she was able to substantiate a number of the facts but was not able to give any acceptable evidence as to the critical question of what was the intention of the Taxpayer when it acquired the public company shares in the years 1978/79 and 1979/80. All she was able to say in that regard was that both her husband and her father-in-law were well acquainted with the affairs of the public company because they were directors of the public company and had the philosophy of holding shares for long term investment purposes. She was not a director of the Taxpayer at the time when the shares in the public company were purchased and was not able to give any direct evidence as to the Taxpayer's intention at that time.

At the hearing of the appeal the representative for the Taxpayer submitted that the Commissioner in his determination had placed too much weight upon the previous Board of Review decision. The representative said that the investment in this particular block of shares in the public company should be treated on its own merits and that we as a new Board considering a different investment should not be bound by a previous decision of another Board relating to different investments.

We are in agreement with this submission in that we must consider the facts relating to this particular investment and decide whether or not this particular investment was a trading investment or not. We do not consider ourselves in anyway bound by the previous Board of Review decision. However the fact that the Taxpayer had in the past conducted a share trading business is a relevant fact which must be taken into account.

Having carefully studied the evidence before us we have come to the conclusion that the Taxpayer has not discharged the onus of proof placed upon it by section

68(4) of the Inland Revenue Ordinance. This is a border line case but unfortunately for the Taxpayer the onus of proof is clearly placed upon the Taxpayer and we find that the Taxpayer has not been able to discharge this onus of proof.

There is no direct evidence before us of what was the Taxpayer's intention when it acquired these shares in the public company. Immediately prior to its acquiring these shares it had acquired a small number of shares in the same public company which it had sold at a profit and had offered the profit to the Commissioner as being a trading profit. In the absence of evidence to the contrary there must be some suggestion that when the Taxpayer proceeded to immediately buy further shares in the same public company it was doing so with the intention of continuing to trade.

The suggestion of trading is further reinforced by the fact that the Taxpayer purchased other shares in other quoted companies which it also sold at a profit and which were held to be trading transactions. In the accounts of the Taxpayer the shares which are the subject matter of this appeal and other shares which either were accepted by the Taxpayer to be trading stock or were held by a previous Board of Review to be trading stock were not differentiated in anyway.

Whilst we are satisfied that there was no financial pressure on the Taxpayer to dispose of the shares and that it had finances available to it in the form of its share capital and lines of credit from its bankers, we also must take notice of the nature of the Taxpayer. At all material times it was a DTC and it was the stated intention of its founder and those who controlled it that it should in the future take its place in the financial community in Hong Kong as a DTC with the support of a strong financial institution as its joint venture partner. In such circumstances there must be a suggestion that investments acquired by the Taxpayer were of a short term nature because the intention of the Taxpayer and Mr X was that it would carry on business in the future as a deposit taking company accepting deposits from the public and lending money to the public. The moneys available to it both in the form of capital and loans were, by the nature of its potential and intended business, of a temporary nature awaiting the moment when it could take its ordinary role of being an active DTC. At the time when the shares in the public company were acquired in 1978/79 and 1979/80 Mr X was hopeful that he could find a suitable financial institution to join him in promoting the Taxpayer as a DTC. In the absence of evidence to the contrary, it would be fanciful for us to imply without reason or foundation that the Taxpayer was acquiring a long term strategic holding in the public company.

The evidence before us to support the Taxpayer's case is that Mr X and his family had a long and close connection with the public company. This we accept. However it does not take the case of the Taxpayer any further forward. Indeed the close association of Mr X and his knowledge of the affairs of the public company might well lead him to make the decision that the public company shares were a suitable trading investment for the Taxpayer.

We were told that Mr X and his family held long term investments in their own names in the public company. This again does not further the case of the Taxpayer. What Mr X and members of his family may have done in their own names and for their own reasons does not affect the reasons which the Taxpayer may have had for making this investment. If this was a long term strategic investment of Mr X and members of his family then we would have expected them to have held the shares in their own names as they did with other shares which they owned in the public company. No reason was put forward as to why Mr X would have chosen to hold part of his own long term family investment in the public company in the name of a DTC which he intended should be a joint venture with a third party. All we were told was that Mr X had a long term investment in the public company and we were asked to infer that as Mr X controlled the Taxpayer, therefore it was the Taxpayer's intention also to have a long term investment. To do so ignores the proven fact that Mr X was trying to find a joint venture partner to join the Taxpayer at the same time as the Taxpayer acquired the shares in the public company.

Evidence was given by the witness, as we have mentioned above, that Mr X and his son had the philosophy of owning shares for long term investment purposes. With due respect to the witness we do not accept this statement which she made because it is not borne out by the other facts. Inter alia it completely ignores the fact that the Taxpayer did purchase and sell other quoted shares which were trading transactions.

As stated the Taxpayer has not established to our satisfaction that the Taxpayer has at the time when it acquired these shares in the public company the intention of holding them as a long term investment and we accordingly find that the profit realised on the sale of these shares was a trading profit and is taxable as such. Accordingly we dismiss this appeal and uphold the decision of the Commissioner.