Case No. D57/90

Profits tax – land exchange entitlements – pooling of entitlements with others to tender for land for development – whether share of profit on sale of finished units was capital.

Panel: Denis Chang QC (chairman), Victor R P Hughes and Tse Tak Yin.

Dates of hearing: 30 April, 1, 2, 3, and 4 May 1990.
Date of decision: 24 January 1991.

The taxpayer was a company which acquired certain land exchange entitlements. It agreed to pool the land exchange entitlements with others to tender to the Government for land to be developed. At the completion of the development the taxpayer sold all of its entitlements in the joint development at a profit but had classified the units in the completed building as fixed assets. The assessor assessed the profits to tax. The taxpayer appealed and argued that it was a disposal of capital assets.

Held:

On the facts it had been the intention of the taxpayer at all times to trade in the units and accordingly the profits arising were taxable. Badges of trade applied.

Appeal dismissed.

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

Cases referred to:

Sharkey v Wernher [1956] AC 58
Lionel Simmons Properties Ltd v Commissioners of Inland Revenue [1980] 53 TC 461
Iswera v CIR [1965] 1 WLR 603
Kirkham v Williams [1989] STC 333
JP Harrison (Watford) Ltd v Griffiths [1962] 40 TC 281
Cunliffe v Goodman [1950] 1 All ER 720
Rees Roturbo v Ducker [1928] 13 TC 366
BR 12/74, IRBRD, vol 1, 233
D12/80, IRBRD, vol 1, 380
D60/87, IRBRD, vol 2, 24

So Chau Chuen for the Commissioner of Inland Revenue.
Brian P Clancy of Philip K H Wong & Co for the taxpayer.

Decision:

The following facts are agreed:

1. The Taxpayer company ('the Taxpayer') has objected to the profits tax assessments for the years of assessment 1983/84, 1984/85 and 1985/86 raised on it. The Taxpayer claims that the surplus derived from sales of units in a residential/shopping complex it jointly developed with others represents capital gains not chargeable to profits tax.

2. The Taxpayer was incorporated as a private company in Hong Kong. At all relevant times the Taxpayer's authorized and paid-up capital has been $1,000,000 and Mr A has always been the chairman of the board of directors of the Taxpayer.

3. Soon after incorporation, a board meeting of the Taxpayer was held. The resolutions made in the meeting are as follows:

   (1) That the transfer of land exchange entitlements from Mr A, Mr B, Mr C, Mr D and Madam E to the Taxpayer as provisional/nominal considerations be accepted.

   (2) That the participation with F Limited, G Limited and H Limited to tender and develop Town Lot No XX be approved.

   (3) That the considerations of the land exchange entitlements by reference to market valuation to be determined on commencement of development of the project if the tender be successful.

   (4) That on fulfilment and compliance of the covenants terms and conditions and after part of the properties sold for repayment of building mortgage, the portion of properties so allotted to the Taxpayer be maintained by the Taxpayer for long term investment.

4. In early 1977, the following companies ('the co-owners') entered into a heads of agreement to pool up their respective land exchange entitlements to tender to the Government for exchange and development of Town Lot No XX ('the land'):

   (a) The Taxpayer (25.425306%);

(b) F Limited ('F Ltd') (55.912548%);

(c) G Limited ('G Ltd') (9.4%); and

(d) H Limited ('H Ltd') (9.262146%).

5. The co-owners' tender was accepted by the Government. In April 1977 the land was granted to the co-owners at a premium of $3,011,600.43.

6. Construction work commenced in 1979. The new development ('the new development') consists of a podium of four levels for car parking spaces and shops. Above the podium are eight residential blocks of twenty-two storeys namely blocks A1, A2, B1, B2, C1, C2, D1 and D2.

7. In mid-1980 the co-owners applied to the Government for consent to sell the units in the new development except those car parking spaces and shops on levels two and three which, under the conditions of grant, must be retained by the co-owners.

8. On 23 April 1981 the co-owners executed a building mortgage in favour of a bank ('the bank') to secure loan facilities to the extent of $75,000,000. In the building mortgage, the 'repayment date' was defined as follows:

> ' "repayment date" means 30 December 1982 or the date which falls one month after the date of the issue of the certificate of compliance or (where consent for extension is not obtained by 30 November 1981) 5 December 1981, whichever is the earliest'.

By a supplement to building mortgage and guarantee dated 17 March 1983, the 'repayment date' was extended to '30 June 1983 or the date which falls on month after the date of issue of certificate of compliance, whichever is earlier.'

9. In August 1981, the Government granted the consent to sell units in the new development to the co-owners.

10. By an agreement supplemental to heads of agreement in early 1977 ('supplemental agreement') which was in mid-1982, flats in blocks B1 and B2 were allotted among the co-owners and it was agreed that the flats be sold to repay the building mortgage and to defray building cost. The Taxpayer relinquished its interest in blocks A1 and A2 in return for the allocation of the whole of block C1. Flats in blocks C2, D1 and D2 were allotted by ballot and as a result, the following flats were allotted to the Taxpayer:

Block	Flats
C2	All flats on 2/F, 3/F, 10/F and 11/F
D1	All flats on 8/F, 9/F, 21/F Flats A, B, G and H on 22/F
D2	All flats on 10/F, 13/F, 15/F and 19/F

11. Unit in blocks B1 and B2 were offered for sale to the public by the co-owners in mid-1982. Except flat C on 11/F in block B1, all units were sold during the year ended 31 March 1983.

12. On 25 April 1983 the co-owners resolved a method of partitioning the shops on level one. Clause (6) of the agreement provided that shop 19A be auctioned among the co-owners. By Deed of Partition dated 30 December 1983, the shops on level one were allotted among the co-owners. The second schedule to the Deed showed that shop 19A was acquired by the Taxpayer.

13. In April 1983 the occupation permit of all units in the new development was issued.

14. In mid-1983 the Taxpayer put up all its share of residential units in blocks C1, C2, D1 and D2 of the new development to the market for sale.

15. In the Taxpayer's accounts for the years ended 31 March 1984, 1985 and 1986, all the unsold units in the new development were classified as fixed assets of the Taxpayer and the profits on disposal of the units in the new development during the relevant years were classified as an 'extraordinary item' being 'surplus from disposal of investment properties' and were not offered for assessment in the proposed tax computations for the relevant years.

16. On various dates, the assessor raised on the Taxpayer the following 1983/84, 1984/85 and 1985/86 profits tax assessments:

Year of Assessment 1983/84	$
Estimated assessable profits under section 59(3) of the Ordinance	25,000,000
Less: Loss set off	969,284
Net assessable profits	$24,030,716 =========

Tax payable thereon		$3,965,068
		========

Year of Assessment 1984/85

	$	$	$
Profits per return			866,425
Add: Rebuilding allowance claimed		249,310	
Profits on disposal of properties per extraordinary item	2,213,798		
Less: Interest income already adjusted in the Taxpayer's computation	2,400	2,211,398	2,460,708
Assessable profits			$3,327,133
			========
Tax payable thereon			$615,519
			=======

Year of Assessment 1985/86

Estimated assessable profits under section 59(3) of the Ordinance	$6,000,000
	========
Tax payable thereon	$1,100,000
	========

17. The Taxpayer's tax representatives ('the representatives') objected against the assessments on the grounds that the assessments were excessive and not in accordance with the returned profits.

18. The assessor revised the assessments as follows:

Year of Assessment 1983/84

	$	$	$
Assessable profits per proposed tax computation			603,056
Add: Rebuilding allowances claimed	297,228		
Less: Rebuilding allowances allowed $6,563,316 x 0.75%	49,225	248,003	
Profits on sales of properties	30,392,297		
Less: Interest income	780,970	29,611,327	29,859,330
Assessable profits			$30,462,386
Less: Loss set off			969,284
Net assessable profits			$29,493,102
Tax payable thereon			$4,866,361

Year of Assessment 1984/85

Assessable profits as assessed	$3,327,133
Less: Rebuilding allowances allowed	49,225
Assessable profits	$3,277,908
Tax payable thereon	$606,412

Year of Assessment 1985/86

	$	$	$
Assessable profits per proposed tax computation			629,369
Add: Rebuilding allowances claimed	163,152		
Less: Rebuilding allowances allowed	49,225	113,927	
Profits on sales of Properties		4,520,451	4,634,378
Assessable profits			$5,263,747
			========
Tax payable thereon			$973,793
			=======

It is not in dispute that the heads of agreement refereed to in agreed fact (4) above provided that the parties thereto would become tenants in common in accordance with their respective shares of any land acquired pursuant to a successful tender without, however, creating a partnership between the parties; that each of the parties would contribute all costs and expenses incurred in implementing the agreement in accordance with their respective shares; that F Limited (whose management was associated with J Group of property development companies) would be responsible for the arrangement of the necessary finance for the payment of the premium in the exchange but all building costs would be financed by way of loans secured under a building mortgage of the said land; that the premium would be repaid by the parties with interest in accordance with their respective shares. The heads of agreement also provided that the parties thereto would form a management committee consisting of eight members of which four would come from F Limited, two from the Taxpayer and one each from the other two parties; the members of the management committee could dispatch all business and affairs relating to the development of the said land and anything incidental or relating thereto, and the agreement of six members of the management committee would be valid and effective for all purposes as a decision of the management committee.

Mr A in his testimony recounted how he was first approached by the developers through Mr K (who has made a statutory declaration to the same effect) because Mr A's family was known to have a large stock of old Letters B; originally the approach was with a view to the purchase of these Letters B. Mr A made it clear he would only consider the

project on the basis of participation in the project. The negotiations culminated in the heads of agreement referred to above. Mr A was anxious that the Taxpayer should have at least 25% share because of the manner in which the management committee was structured. He explained, and we have no reason to doubt his testimony in this respect, that because Mr A's family did not have enough Letters B of the right vintage, a good friend of Mr A's family, Madam E, who was in a position to make up the shortfall was asked to join the Taxpayer; she took up 6% of the Taxpayer's issued and paid up capital.

All the other Letters B which were injected into the Taxpayer for the purpose of enabling the Taxpayer to tender for the exchange and development of the land came from the stock of Letters B held by Mr A's family. Mr A's father had upon his death left a considerable amount of landed property which was subsequently resumed by the Government and Letters B were taken by Mr A's family in lieu of cash compensation, a choice which we find was at least partly motivated by a very natural desire on the part of Mr A's family to find suitable substitutes for the resumed inherited land. A number of projects were in fact undertaken by individual members of Mr A's family; in most of those projects, which took place between 1962 and 1978, part of the stock of Letters B was used for land exchange, a proportion of the units was sold to pay off mortgage loans and others retained for rental purposes (although they have all now been sold, such sales have commenced some eight years age). There is no evidence that profits tax was assessed on any of the previous sales and in respect of the last of the previous projects, an industrial building project, the Revenue raised an assessment but this was annulled by the Board of Review on the basis that it was a capital venture.

The development project with which we are presently concerned, however, was a very much larger and complicated project than any which Mr A's family had ever undertaken, involving joint participation with more than one outside party, an extensive site of more than 100,000 square feet, requiring huge financial resources and a much longer time for completion with a correspondingly larger contingency element in relation to such matters as building costs and selling prices. From the 'brief summary of previous developments' and Mr A's evidence we know that the previous projects involved sites as small as 2,400 square feet and on larger than 10,500 square feet and were carried out in the individual names of one or other of Mr A's family members; from the Board of Review decision we know that in respect of the industrial building project Mr A's family did not at any time attempt to market any of the floors or car-parking spaces to which it was entitled and the reason for subsequent sales had nothing to do with financing; indeed we find virtually no resemblance between that case and the present.

It is a fact that, unlike the previous projects, Mr A's family found it necessary or convenient to make use of a corporate vehicle, that is, the Taxpayer, for the project. The required Letter B were conveniently collected in and made available to the Taxpayer at a 'provisional and nominal' consideration of approximately $15,600,000 but we find as a fact that it was at all material times the intention of the shareholders and of the Taxpayer to revalue the Letters B at market consideration following the successful tender and upon the commencement of development. The Letters B were in fact revalued upon commencement

of development in early 1979 at $49,800,000 and this figure, which was based on the market value in early 1979, was treated as the cost of acquisition by the Taxpayer of the Letters B and booked as a loan repayable by the Taxpayer to shareholders. (As it turned out all loans from shareholders were subsequently repaid after the Taxpayer had disposed of all the units it could dispose of under the conditions of grant; such loans could not have been repaid without the sales or at least continuing substitute financing).

We find as a fact that no feasibility study was undertaken by the Taxpayer but a 'rough estimate' of building cost (at $125,000,000) was provided by the other parties whose representatives on the management committee were experienced developers and whose professed intention – and this was acknowledged by Mr A in his evidence – was to develop the land for the purpose of sale of the units in the development in a scheme of profit-marking. Whilst it s the Taxpayer's contention that this purpose was not shared by the Taxpayer it is quite clear from the whole of the evidence, and we find as a fact, that at all material times and right from the inception of the project the Taxpayer knew that this project would not finically viable without embarking on a scheme of sales (including pre-sales) of units developed or in the course of development and that the Taxpayer had every intention of participating and did participate in such a scheme.

We find that clause 9 in the heads of agreement (which provided that subject to the fulfilment and compliance of the conditions of exchange or grant relating to the land the parties thereto agreed to 'partition the said land and buildings thereon in accordance with the shares or proportion hereinbefore mentioned') was never regarded by the parties as inhibiting and did not in fact inhibit their scheme to pre-sell flats in the development whether on a pooled basis or otherwise.

Indeed, it is quite clear and we find as a fact that Mr A fully participated at meetings held by the joint developers to consider and fix pre-sale prices right at the outset following the successful tender. There was, for example, a meeting held on 4 November 1977 at which sale prices of the commercial units were discussed; another example was at the twenty-second meeting of the joint developers held on 4 June 1981 (some one and a half months after the execution of the building mortgage) at which Mr A was recorded as saying that he considered that the average (pre-sale) price for the properties should be $850 per square foot. Mr A explained in cross-examination that this referred to the residential units. There was also discussion at the meeting as to the best method of promoting the sale of the properties. This was prior to the date (in August 1981) when the Government granted consent to sell the units that were actually later sold. The application for consent had been made more than a year earlier, in mid-1980.

It is part of the Taxpayer's case that as early as September 1981 an oral agreement was reached between the parties, subsequently reflected in the supplemental agreement of mid-1982, that block C1 would be allocated to the Taxpayer in return for the Taxpayer's relinquishing its interest in blocks A1 and A2; and that the Taxpayer requested the allocation of one complete block with a view to facilitating the management of properties for rental. Mr A gave inconsistent evidence both as to the date and effect of the

alleged oral agreement and we are unable to accept his evidence on this aspect of the case and find that it was not until much later that any agreement was reached on the allocation of block C1 to the Taxpayer; the probabilities are that no final agreement was reached until about July 1982 but the supplemental agreement was backdated to mid-1982. There is evidence, and we find as a fact, that the joint developers had prior to mid-1982 decided to sell the residential units in two phases, with a pooled sale of two blocks during the first phase. In an unsigned minute of a meeting in April 1982 it is recorded that the joint developers resolved to commence sales in May, with blocks B1 and B2 to be sold in the first place.

The meaning and accuracy of some of these unsigned minutes were explored in evidence before the Board. Mr A experienced some difficulty in explaining what precisely was meant by the proposals he is recorded to have been made at the meeting of May 1982 'in view of the taxation affairs of [the Taxpayer] …' and the reference to 'the contract of guarantee' which the Taxpayer is recorded to be willing to make with the other joint developers to the effect that it would not sell its share within a certain number of years. We find on the whole of the evidence, including the content of the minutes of the subsequent meeting of 10 May 1982, that Mr A in fact never gave such a guarantee and that what the other joint developers were really concerned or unhappy about was Mr A's insistence at that stage of the joint development that sales of properties distributed to the Taxpayer should be separately handled by solicitors appointed by the Taxpayer.

It is clear from the agreed facts that there was quite a long gap of time between the grant of land by Government in April 1977 and the execution of the building mortgage in April 1981, construction work having commenced in the meantime in 1979. We find as a fact that the Taxpayer had to obtain overdraft facilities from the bank to enable it to contribute towards payment of the initial construction costs and that at least some of the shareholders had to put up time deposits certificates by way of collateral. The actual construction costs at the end of the day was substantially more than the original rough estimate: such costs were around $245,000,000, the Taxpayer's share thereof being some $61,000,000 (about 25%).

The Taxpayer's share of the proceeds from the pooled sales of blocks B1 and B2 (which were offered for sale in May 1982) were quite insufficient to enable it to pay its share of the building costs resulting in the need, among other things, to enter into an arrangement (evidenced by a document dated 17 May 1983) with the other joint developers to repay the principal and interest due and owing to the bank (which amounted to over $75,300,000 as at 17 May 1983) in a manner which left the Taxpayer indebted to the other joint developers for advances made by them to the Taxpayer. Such advances totalled approximately $10,200,000 as at the said 17 May 1983. The Taxpayer had to obtain further financing by way of a bank loan repayable within one year. The principal shareholders of the Taxpayer (Mr A and Mr B) had to guarantee repayment of bank loans. Mr A accepted in cross-examination that the loans made to the Taxpayer could not be repaid without selling further flats. The Taxpayer in fact would not have been able to repay all loans without selling a larger number of units than those already sold in May 1982 even if the acquisition

cost of the Letters B (booked as loans from the shareholders) were excluded from the computation.

It was not until about mid-1983 (that is, about a year after blocks B1 and B2 were offered for sale on a basis) that the Taxpayer actually put up all its share of residential units in blocks C1, C2, D1 and D2 to the market for sale (refer agreed fact (14) above) but there is on record a minute of a meeting of the board of directors of the Taxpayer held on mid-1982 (that is, some ten months before the actual sales and about nine months before the occupation permit was issued) in which:

(1) The chairman is recorded to have reported that 'the majority of the shareholders had emigrated or had decided to emigrate shortly and that they had suggested to sell or to make distribution to the beneficiary of the properties allotted or to be allotted to [the Taxpayer] which were originally intended for long term investment';

(2) That 'it was unanimously resolved that the proposal to sell the residential units and shops (level one) allotted or to be allotted to [the Taxpayer] be approved'.

It is part of the Taxpayer's case, reflected in the directors' report and statement of accounts for the year ended 31 March 1984, that it was because of 'the then worrying political uncertainty over the future of Hong Kong' that the shareholders/directors decided to sell the properties and emigrate from Hong Kong.

On the whole of the evidence, however, we find as a fact that right from the outset the Taxpayer not only had every intention of embarking on a scheme of sales but also intended to and did embark on such a scheme in a manner essentially no different from developers developing land for the purpose of sale by way of trade.

The Taxpayer did entertain a desire that it would not need to sell all the units which would be allotted to it but we find that the Taxpayer's desire amounted to no more than a mere contingent hope that some units could be retained (in addition to those units which were unsaleable because of restrictions in the conditions of grant).

We find as a fact that there was present right from the beginning the intention to turn into account by way of trade and that this intention was at no time displaced by any desire or hope that, if possible, some units could be retained for investment.

Section 14 of the Inland Revenue Ordinance provides that subject to the provisions of the Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (<u>excluding profits arising from the sale of capital assets</u>) as ascertained in accordance with the Ordinance.

Section 2(1) defines 'trade' (unless the context otherwise requires) as including 'every trade and manufacture, and every adventure and concern in the nature of trade'.

Lord Wilberforce in Lionel Simmons Properties Ltd v Commissioners of Inland Revenue [1980] 53 TC 461 states:

> '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 with the intention of disposing of it at a profit, or was it acquired as a permanent investment? Often it is necessary to ask further questions: a permanent investment may be sold … 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 (Sharkey 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 indeterminate 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.'

Other authorities cited to us include:

Iswera v CIR [1965] 1 WLR 603 at pages 667-668;

Kirkham v Williams [1989] STC 333 at pages 344-345;

JP Harrison (Watford) Ltd v Griffiths [1962] 40 TC 281;

Cunliffe v Goodman [1950] 1 All ER 720;

Rees Roturbo v Ducker [1928] 13 TC 366;

BR 12/74, IRBRD, vol 1, 233;

D12/80, IRBRD, vol 1, 380;

D60/87, IRBRD, vol 2, 24.

We find that the badges of trade were present; that the Taxpayer's operations in the present case which gave rise to the profit with which we are concerned had all the characteristics of a trade or an adventure in the nature of trade. Accordingly we confirm the assessments and dismiss the appeal.