Case No. D61/87

Profits tax – sale of letters of entitlement to land – whether profits were trading gains or realization of capital – s 14 of the Inland Revenue Ordinance.

Panel: Denis Chang QC (chairman), Eric Lo and David Wu.

Dates of hearings: 7, 8, 12, 19 and 27 of May 1987.
Date of decision: 9 February 1988.

Mr K, who owned the taxpayer company, had lent money to a debtor in 1960 who defaulted in 1974. The debt was secured by a mortgage over land. In an action to recover the debt, the court permitted the debtor to exchange the land with the Government in return for Letters B which would stand as security for the debt. Mr K then sought to exercise his power of sale over the Letters B in order to have his debt repaid. As he wished to gain control over the Letters B himself, he formed the taxpayer company with the intent that the taxpayer buy the Letters B with money which he provided to the taxpayer for this purpose. The true ownership of the company was disguised because Mr K as a mortgagee was legally obliged to sell the shares to an unrelated party. The taxpayer paid $2,400,000 for the Letters B.

In 1978, Mr K sold the shares in the taxpayer company to a purchaser who resold the shares. Subsequent litigation ensued concerning these sales. This litigation was settled in 1980 under an agreement whereby the taxpayer agreed to sell the Letters B to a third party for $113,165,965.

The Commissioner assessed the taxpayer to profits tax.

The Board found that (a) the taxpayer had performed no other activities in its history; (b) although Mr K had a prior history of property dealings, his activities concerning these Letters B was distinct from such other dealings; (c) the taxpayer did not borrow funds to finance the purchase of the Letters B and therefore had no need to sell them quickly; (d) although Letters B did not produce income, they were suitable for investment purposes due to their particular characteristics; (e) because of the massive increase in the value of the Letters B, it was reasonable for the taxpayer to realize them whether or not they were capital assets.

Held:

The Profits were not assessable.

(a) The taxpayer's holding of the Letters B was effectively the result of Mr K's investment in the long-term debt and his de facto foreclosure of the security which he held for such debt. No steps had been taken to use the Letters B in a trading fashion. The Letters B had therefore been acquired as capital assets and remained so throughout.

(b) Even if the taxpayer had intended to exchange the Letters B for land for the purpose of trading with that land, that did not mean that the Letters B themselves had been acquired for trading purposes.

Appeal allowed.

Cases referred to:

Marson v Morton [1986] 1 WLR 1343
Simmons v IRC [1980] 2 All ER 798
Shadford v H Fairweather & Co Ltd (1966) 43 TC 291

Mr Luk Nai Man for the Commissioner of Inland Revenue.
Mr A G Rogers for the taxpayer.

Decision:

In this appeal from the Commissioner's determination the issue is whether the surplus derived by the appellant ('the Company') from the sale of Letters of Entitlement A and B (collectively referred to herein as 'Letters B') is a non-assessable capital gain or an assessable trading profit. The onus of proof of showing that the assessment is excessive or incorrect is on the appellant: section 68(4) of the Inland Revenue Ordinance.

The Agreed Facts

The following facts are agreed:

1. One Mr L was in 1960 the owner of a piece of land in the New Territories in Castle Peak Road. The area of the land was some 189,385 sq. ft. of which 11,467 sq. ft. could be built upon and the rest was for agricultural use.

2. In March 1960 the said Mr L mortgaged his land (hereinafter referred to as the 'Land') to a Mr K to secure a loan. The said Mr L subsequently died and his son, Mr LS, became the administrator.

3. In May 1974, Mr LS brought proceedings against Mr K to restrain Mr K from selling any part of the land under the mortgage and Mr K counterclaimed for the mortgage debt. These proceedings were settled in July 1974 and by consent judgement was entered in favour of Mr K in the sum of $2,532,000 plus interest with a provision that Mr K would reassign the Land to Mr LS to enable him to proceed with a land exchange with the Hong Kong Government and that the rights and benefits under such land exchange would stand as security for the sum payable to Mr K.

4. Accordingly in August 1974 the Land was reassigned by Mr K to Mr LS who surrendered it to the Government in August 1974 in exchange for the Letters B, namely two Letters of Entitlement both dated August 1974.

5. Mr LS subsequently defaulted on the judgment debt (which was to be repaid by October 1974) and in February 1975 Mr K exercised his power of sale.

6. By a Deed dated February 1975 the Letters B were assigned by Mr LS to the Company for $2,400,000 with Mr K as the first confirmor and one Mr A as the second confirmor.

7. The acquisition of the Letters B by the Company was mainly financed by a loan from Mr K amounting to $1,920,600.

8. In April 1975 Mr K and his wife took over the Company and became the directors of the Company.

9. In May 1978 Mr and Mrs K transferred for a consideration of $15,000,000 all the issued shares of the Company to Mr C and his nominee, Mr M. Thereupon Mr C and Mr M held respectively 5,001 shares and 1 share in the Company. Simultaneously, they were appointed as directors of the Company.

10. In order to finance the purchase of the shares of the Company, Mr C sought financial assistance from a Company named R Ltd. By an agreement dated May 1978 ('the Agreement'), R Ltd agreed to purchase all the issued shares in the Company from Mr C. The purchase consideration was calculated at $441 per sq. ft. by reference to the area of the Land which was approximately 189,800 sq. ft. Completion of the transaction was conditional upon the regrant of the Land by the Government in exchange for the Letters of Entitlement. In the meantime R Ltd paid to Mr C a deposit of $15,400,000 and, as security for repayment of this deposit in the event of cancellation of the Agreement, Mr C agreed to procure the Company to execute a mortgage of the Letters of Entitlement in favour of R Ltd. Accordingly the Company executed two mortgage deeds in May and June 1978 in favour of R Ltd.

11. In August 1978 Mr C sold all his shares in the Company to Mr M, subject to the prior rights of R Ltd. However, Mr C subsequently disputed the validity of the documents which effected the sale and, in April 1979, commenced proceedings in the High Court for a declaration that he was the beneficial owner of all the shares in the Company. The proceedings were finally settled by compromise and the judgment dated July 1980 declared that Mr M replaced Mr C as the beneficial owner of all the shares in the Company as from August 1978.

12. In April 1980 the Company commenced legal proceedings against R Ltd seeking, inter alia, (a) a declaration that the mortgages referred to in Fact 10 were illegal and void as being in contravention of Section 48 of the Companies Ordinance (Cap. 32); and (b) delivery up of the Letters of Entitlement to the Company.

13. The Government did not regrant the Land to the Company as contemplated in the Agreement. R Ltd, therefore, in June 1980 commenced legal proceedings against Mr C, the Company and Mr M seeking, inter alia, enforcement of the mortgages referred to in Fact 10 and the relief provisions in the Agreement.

14. The two cases referred to in Facts 12 and 13 were settled out of court when in September 1980 Mr M, the Company and R Ltd entered into an agreement which included, inter alia, the following terms:

    (a) The Company would sell the Letters of Entitlement to B Ltd;

    (b) R Ltd would reassign the Letters of Entitlement covered by the mortgages and cancel the Agreement, in consideration of a sum of $50,000,000 payable to R Ltd and a further sum of $2,500,000 to be held by solicitors as stake money. The latter sum was to be payable out of the sale proceeds per (a) and was ear-marked ‘towards payment of one half share of all share of all tax (if any) payable by R Ltd so far as such tax is attributable to any taxable profit deemed to have been earned by R Ltd from the acquisition and disposal of the benefit of the Agreement and the Mortgages’; and

    (c) Each of the parties would release and discharge each other from all claims and demands whatsoever.

15. Pursuant to the above agreement the Company sold the Letters of Entitlement to B Ltd in October 1980 for $113,165,965.

16. During the period from the date of incorporation to the date of sale of the Letters of Entitlement the Company did not undertake any business activity other than the acquisition and disposal of the Letters of Entitlement. In its Profit and Loss Account for the year ended 31 March 1981 the Company

included its profits from the sale of the Letters of Entitlement as an 'Extraordinary Item'. The profits were computed as follows:

Sale proceeds	$113,165,965
Less: Amount reserved for discharging R Ltd's tax liability	2,000,000
Cost of the Letters of Entitlement	2,454,320
Profits	$108,211,645

In its Profits Tax Return for 1980/81 the Company did not offer the above profits for assessment.

17. In October 1983 the Assessor raised on the Company the following 1980/81 Profits Tax Assessment:

Profits per return	$ 181,812
Add: Profits from the sale of the Letters of Entitlement ($113,165,965 - $2,454,320)	110,711,645
Assessable Profits	$110,893,457
Tax Payable thereon	$ 18,297,420

18. By a letter dated 4 November 1983 the Company's tax representatives, Messrs S L Poon & Co lodged an objection against the assessment in the following terms:

'(a) The assessable profits are excessive.

(b) The surplus on disposal of the Letters of Entitlement did not arise from the carrying on of any trade or business; it arose purely as a result of the sale of capital assets, the Letters of Entitlement in question being in effect the sole assets of the Company.

(c) The Company acquired the Letters of Entitlement in February 1975 not in the course of an adventure in the nature of trade but as the vehicle for the exercise of a power of sale under a mortgage. The mortgagee Mr K, together with his wife Madam W, were the sole shareholders of the Company until May 1978.

(d) The disposal by the Company of the Letters of Entitlement in October 1980 came about as part of a much larger arrangement for the settlement of complex litigation in which the Company was involved. The disposal was not pursuant to any trade carried on by the Company.

(e) From beginning to end, as summarized in paragraphs (c) and (d) above, the Letters of Entitlement were held by the Company as a capital asset. Accordingly there is no liability for profits tax on its realization under section 14 of the Inland Revenue Ordinance.'

19. In a letter dated 2 May 1984 the Company's legal representatives, Messrs C P Lai & Co ('the representatives'), stated that:

> 'As far as the Company is concerned, it has never made any attempt to exchange its Letters of Entitlement for land, nor to develop such land. The purchaser of the shares, R Ltd might have entertained hopes of obtaining the Land upon favourable terms, but the Company had never been offered a re-grant, and any suggestions of the Company developing the land were quite illusory.
>
> However, it can be seen from the agreement between Mr C and R Ltd that a term of that conditional sale was that the Company would seek a regrant of the original land owned by Mr LS, and upon terms which favoured high-rise development. Mr C presumably made efforts to achieve this regrant, but of course was unsuccessful. (The land having been resumed by the Crown for a public purpose, it would seem a little improbable that the Government would have regranted it to the Company as the holder of the Letters of Entitlement).'

20. In another letter dated 25 July 1984 the Representatives further stated that:

> 'The Company's case for saying that the Letters of Entitlement were, from beginning to end, capital assets is this:
>
> (i) They were acquired by the exercise of the mortgagee's (Mr K's) rights under his mortgage, and held by the Company thereafter for about 6 years.
>
> (ii) Mr C acquired all the shares in the Company from Mr K, and mortgaged the Letters of Entitlement as a means of raising money.
>
> (iii) By his conditional sale to Mr M, control of the Company was in dispute, and the Company's management became paralysed.

(iv) Ultimately the Letters of Entitlement were sold as a part of a complicated package to compromise the three actions in which the Company became involved.

(v) It can be seen from the above that the character of the asset in the hands of the Company never changed; it was a capital asset, and remained so until the sale in October 1980. The question of income never arose.'

Additional Facts (as Found)

The Revenue has not argued and there is no evidence to suggest that when Mr K became mortgagee of the Land in March 1960 he was doing so pursuant to some money-lending or other business. The mortgage debt was left outstanding for a long time. By 1974 Mr K was simply seeking to realise his security; he was prevented from doing so because of the proceedings which in July 1974 resulted in the consent order stated in fact 3. The Letters B were merely security obtained in substitution of the original land pursuant to the said consent order.

Upon the subsequent default of Mr LS (Fact 5) Mr K could simply have sold the Letters B to a third party. On the face of it that was what he did, to one Mr A (Fact 6). The evidence, however, establishes to our satisfaction that Mr A was not an independent third party but was no more than a nominee of Mr K and we so find as a fact.

We also find as a fact that the Company was Mr K's creature right from the beginning (until the disposition of the shares in the Company in 1978 – Fact 9). The Company was, we find, used by Mr K as part of a scheme whereby the Letters B held as security by him could pursuant to his exercising the power of sale under the consent order be put into the name of and held by his company, thus to all intents and purposes achieving what he could not openly and validly do, namely a sale to himself. There was no mechanism under the consent order for him to foreclose on his security in extinguishment of the debt. By the device of using a company, however, he could simply (subject to going through the necessary accounting and company law procedures and paying up the issued share capital) lend money to his company to enable the company to pay himself (by way of the purchase price) and apply the net proceeds of the sale towards satisfaction of the debt and thus end up in absolute control of the Letters B. The purchase price at which the Company acquired the Letters B was $2,400,000 compared with the debt under the consent order which amounted to $2,530,000 odd plus interest. There was therefore no surplus to pay over to the debtor.

There was no difficulty in Mr K finding the necessary money to lend to the Company to enable the Company to pay himself and the Revenue fully accepts that this was so. In other words we are not here looking at a case where in order to finance a purchase of property the taxpayer had to borrow heavily and at high interest rates thus compelling him to turn the property quickly into account. In ascertaining the purpose of the acquisition in the present case we cannot proceed as if this were an independant purchase in the open market by a company with no relevant prior history. The governing intention in and motivation of

the series of operations resulting in the Letters B being held by the Company was to ensure that Mr K would end up in practically as good a position as an absolute owner of the Letters B which had been held by him as security. We are fortified in our conclusions by a consideration of the following matters placed before us in evidence.

The Company was incorporated in August 1974 with two subscriber shares. Its nominal capital was originally $10,000 divided into 100 shares of $100 each. By an ordinary resolution dated December 1974 the Company increased its nominal capital to $1,000,000 but the issued capital was $500,200 divided into 5,002 shares of $100 each registered as fully paid. The Letters B were the only assets of the Company. Apart from holding the Letters B (until their sale some six years later, infra) the Company carried on no business.

The enclosures to the letter dated 2 May 1984 from the Company's representatives Messrs C P Lai & Co to the Revenue shows a fairly detailed picture of the history of events. At the time when the Letters B were put into the Company's name the registered shareholders and directors of the Company were one Mr S and his wife Mrs H who, according to a return of allotment filed in January 1975, each held 2,501 shares. It is clear, however, from the evidence given by Mr S that he and his wife were mere nominees of Mr K. Mr S briefly recounted how he was approached by Mr K (who was in his early 70's at the time) to use the Company as a vehicle to take over the Letters B from Mr K's first nominee the said Mr A (who acted as one of the confimors) whom Mr S described as 'an old gentleman in poor health' who had acquired the land 'for and on behalf of Mr K'. Mr S also said in cross-examination that he made a bridging loan of $500,000 to Mr K to enable the shares in the Company to be paid up but that he was repaid by Mr K shortly afterwards. Whilst we have some reservations as to whether the money did come from Mr S's pocket as he claimed we have no doubt that the whole exercise was directed at creating the facade that as at the date of acquisition the Company was owned by independent third parties when it was all the time only a creature of Mr K. Mr S was in any event promptly re-imbursed. According to the Company's audited accounts a loan of $1,920,000 was made by Mr K to the Company (see Fact 7). If this is added to the paid-up capital of $500,200 we arrive at a figure of $2,450,000 odd as against the price of $2,400,000 at which the property was sold to the Company. In short Mr K caused to be made available to the Company just sufficient money to pay himself (and some expenses to set up the Company). The shares in the Company were in April 1975 taken over by Mr K and his wife from Mr S and his wife who also relinguished their directorships (Fact 8).

The Letters B

There were two Letters of Entitlement, both of 1974 vintage. The total number of square footage regarding building land registered was 11,467 sq. ft.; the total square footage regarding agricultural land was 167,918 sq. ft. On the basis of 2 sq. ft. of building land for every 5 sq. ft. of agricultural land the Letters B gave entitlement to 78,634.2 sq. ft. of building land.

Mr P who gave evidence on behalf of the appellant was a careful and reliable witness. Now a member of staff with Jones Lang Wootten he has knowledge and experience of the Letters B system and market. He explained, and we readily accept, that Letters B had at all material times a 'vintage value' – the older they got the more valuable they generally became. This is because under the system prevailing at the material times the Government in deciding which Letters of Entitlement to accept in exchange for development land would take into account the age of the Letters B by way of a formula which involved multiplying the number of square footage of entitlement with the number of days from the date of the original surrender or notice thereof. Letters B with the highest aggregated ages ('vintage') and areas in terms of entitlement would be given priority. Furthermore the older the Letters B the less premium would be payable in exchange since the premium would be calculated as if the Government land was sold at the date of the Letters B. In short, there was an inflation factor built into the exchange value of Letters B.

The aggregate entitlement under the two Letters B in question was quite large but the system allowed them to be spilt up and some portions used for financing land exchanges. Letters B were freely assignable. Land values in the New Territories however were quite stable in 1975/76 and the Letters B market was such that Letters B at the time were not regarded as speculative items nor as items which were acquired more likely than not as trading assets. Letters B had a connection with general property values although they did not necessarily respond immediately to fluctuations in the rest of the property market.

Letters B also had a 'fall-back' value, that is the value appearing on the face of the Letters B which could be 'cashed in' like a sort of IOU from Government.

We find on the evidence that the Letters B in question constituted eminently suitable assets for investment in 1975/76 despite the fact that they did not produce 'recurrent income'. The Commissioner has given as one of his reasons for treating the Letters B as trading stock the fact that the Letters B 'by themselves did not produce any recurrent income to the Company' and that 'this element precludes any possibility that the Company could have taken up the Letters of Entitlement as its long-term investment assets'. We disagree with this. In so saying we are of course aware that the question before us is not whether the Commissioner had erred in his reasoning but whether the profits were rightly brought to charge and that the burden of proof is on the Company to show that they were not. Incidentally before this Board the Revenue has made the limited concession that having regard to Mr P's evidence the Letters B could be an 'objective of hedging against inflation' but submits that the burden of proof of showing that they were capital assets has not been discharged.

We have considered the events leading up to and including the acquisition of the Letters B by the Company. It is necessary for us to consider also the events thereafter insofar as they might throw light on the character of the assets in question. Mr K did cause the Company to hold on to the Letters B but in May 1978 he and his wife transferred all the issued shares in the Company to Mr C for $15,000,000 (Fact 9). There were subsequently a

series of disputes and court proceedings not involving Mr K and his wife (Facts 10 – 15) and it was not until October 1980 that the Letters B were sold by the Company for $113,165,965.

A most striking feature of this case was the truly astonishing rise in the value of the Letters B since the date of acquisition by the Company. The Revenue has not suggested that the Company acquired the Letters B at an undervalue which accounted for any appreciable part of the difference between the original price at which the Company acquired the Letters B in 1975 and the $15,000,000 consideration paid to Mr K and his wife for the shares in the Company in 1978. The rise in price was so dramatic that even if the Company had disposed of the Letters B in 1978 instead of Mr K and his wife selling their shares in the Company it would not have given rise to the inference that the Company had probably acquired the Letters B as a trading and not as a capital asset. In the face of such a dramatic rise in value it would have been perfectly reasonable for the Company to have realised the assets quite irrespective of whether they were of a capital or a trading nature. The fact that Mr K and his wife did dispose of their shares is certainly one of the factors to be taken into account but no more than a factor among many others.

Among other factors we have considered are the business and other activities of Mr K (and insofar as it is relevant of Mr S) at the material times. Mr K was described by Mr S as a wealthy man. He was the owner of W Factory. He was also a director of C Ltd between 1973-1977 and of a Company called Y Ltd between 1972-1981. Mr S was a director of Y Ltd which carried on a business of developing properties for sale. C Ltd was a real estate, construction, and import/export company in which Mr K and a Mr W were directors and shareholders. There is evidence of C Ltd dealing with certain agricultural land in the New Territories. There is also evidence of a temporary partnership arrangement between Mr K and a Mr F in relation to a sale of certain other agricultural lands. There is likewise evidence of Mr K developing some properties in the urban areas for rental income. Mr K died in October 1981.

In the light of all the evidence, however, we are satisfied that the acquisition of the Letters B by the Company was a singular transaction that fell outside the pattern of other transactions in which Mr K or his other companies were engaged in. The singular factors of the Letters B acquisition include:

(1) The mortgage-history and other events leading to the acquisition of the Letters B by the Company; it was a history which involved a long-term investment in a debt secured by mortgage culminating in enforcement of the substituted security (the Letters B) by way of the colourable sale to the Company. At the end of the process Mr K found himself in a position which for all intents and purposes was not (apart from the corporate veil) appreciably different from that of someone who had foreclosed absolutely on a security in extinguishment of the debt (assuming no one challenged the sale to the Company).

(2) The subject-matter of the acquisition by the Company: these were Letters B of a young vintage suitable for holding as long-term investments. To equate them with the specific agricultural lots acquired by Mr K jointly with Mr F in 1977 or with the properties dealt with by C Ltd or re-developed by Y Ltd is in our view to ignore not only the history of the acquisition but also the special nature of Letters B. No Letters B transactions were involved in the other cases. Y Ltd for example purchased some old houses in Yuen Long for re-development.

(3) The history subsequent to acquisition of the Letters, B by the Company: as we have seen, Mr S and his wife made a brief appearance at the beginning of the Company's history but being mere nominees of Mr K retired from the scene as soon as Mr K wanted them out when their purpose was spent. Mr S himself was no stranger to property dealings but quite clearly in this instance (unlike the position in Y Ltd) Mr K was not interested in giving him a continued role or other participation in the Company. Mr K and his wife never entered into any joint venture with anybody in relation to the Company or the Letters B. No steps were taken by the Company (whether before or after Mr K and his wife had sold their shares) to exchange the Letters B for land or otherwise utilise them. The Company held on to the Letters B as aforesaid.

Mr S said in evidence that as far as he knew Mr K intended to exchange the Letters B for development but that he (Mr S) did not know whether the development would be for sale or rental purposes. The Revenue has submitted that his ignorance of the specific purpose of any such development (for sale or rental) is fatal to the appeal. We have come to the conclusion that it is not. In the first place, we have to ascertain the character of the assets not just by reference to declarations of intent or to what somebody else thought or had been told was the taxpayer's intent but to the whole of the evidence, including particularly what could be objectively ascertained as having led to the acquisition. Secondly, an owner of Letters B would in general not know what specific pieces of land would be available for exchange or whether any of them would be suitable until the same had been made available by Government. There would also be questions of what premium was payable and what financing methods would be chosen. In other words, a land exchange using Letters B which had been acquired (with or without further cash being injected by way of premium) must not be confused with the original acquisition of the Letters B. If the land exchange should in any particular case be characterised as a trading venture it would not follow that the Letters B themselves must also have been originally acquired for the purposes of trade and this would be so irrespective of whether there was an intention at the time of acquisition of the Letters B to utilise them for land exchange. Thirdly, in the context of this case, we are satisfied (on all the evidence, including in particular the history of events and the course of Mr K's conduct both before and after the acquisition) that the intention and purpose of the relevant operations was to achieve what virtually amounted to a de facto absolute foreclosure of the Letters B originally held as security by Mr K (supra) and the retention by the Company of these 'young' Letters B for capital appreciation not only in terms of increases due to the

market but also in terms of the inbuilt inflation factor and the vintage value considered above. We find that there was no intention to trade in the Letters B or an adventure in the nature of trade. In short we find that the Letters B were acquired and held as capital assets.

The relevant intention was that which existed at the time of the acquisition. Events after Mr K and his wife had disposed of their shares in the Company, although we have considered them, did not throw any real light on the intention at the relevant time. In Simmons v IRC [1980] 2 All ER 798 at 800 Lord Wilberforce said: '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 in order to acquire another investment thought to be more satisfactory ... What I think is not possible is for an asset to be both trading stock and permanent investment at the same time nor for it to possess an indeterminate status, neither trading stock nor permanent asset. It must be one or the 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'.

We have also considered other authorities referred to us including the case of Shadford v H Fairweather & Co Ltd (1966) 43 TC 291 regarding the burden of proof and the case of Marson v Morton (1986) 1 WLR 1343 which considered the 'badges of trade' in the context of new approaches to forms of investment which allow for and emphasize capital profits.

All in all we find that the Company has discharged the burden of proof that the Letters B were not trading but were capital assets and we accordingly allow the appeal and order that the relevant Assessment be annulled.