Case No. D65/87

Profits tax – change of intention – development of investment properties after a decision had been made to sell them – whether an adventure in the nature of trade – s 14 of the Inland Revenue Ordinance.

Profits tax – sale of godowns – unforeseen factors causing investment returns to be lower than projected – whether profits were trading gains or realization of capital – s 14 of the Inland Revenue Ordinance.

Profits tax – sale of shares in subsidiary – whether holding company can trade in the assets of its subsidiaries – whether profits were trading gains or realization of capital – s 14 of the Inland Revenue Ordinance.

Panel: Andrew Li QC (chairman), R J McAulay and B S McElney.

Dates of hearing: 3 to 8, 10 and 12 August; 19 and 20 October 1987.
Date of decision: 8 March 1988.

This decision involved appeals by three taxpayer companies (A, B and C) who were subsidiaries of another company (T).

Land: A, B and C had acquired land in 1973 in order to develop cold storage warehouses. A and B had no other assets, whereas C had traded with another property.

Due to (a) an economic recession, (b) the inability of the warehouses to handle growing containerization and (c) in the case of C, nearby underground construction works, the warehouses were unlikely to produce the income which had been anticipated and which was needed to fund a major project by another subsidiary of T (which project was in fact completed and still held by the group). Therefore, in January 1976, A, B and C decided to sell their properties.

In order to obtain the best price, they nevertheless continued with the developments which were 50%, 33% and 16% respectively completed as at that date. The developments were sold off over the next one year, five years and two years respectively.

A prospectus issued by T, and the accounts and directors' reports issued by A, B and C, treated the properties as investment assets throughout.

With respect to A and B, the Commissioner conceded that they had acquired their land as investments but claimed that they had subsequently engaged in an adventure in the

nature of trade by continuing with development after the decision to sell had been taken. With respect to C, the Commissioner further claimed that it had originally acquired its land as trading stock.

Shares: In addition, C in January 1977 acquired all of the shares in a company (K) which owned land. The original intention was that the group would develop the land with the proceeds from the sales (described above) of the lands owned by A, B and C. The original cash flow forecasts were reasonable and realistic. However, there were unforeseen construction problems and huge increases in building costs. The group needed to conserve cash in order to finance the major project referred to above, and did not wish to borrow further funds. Therefore, in June 1979, C decided to sell the shares and use the proceeds for the other major project. C's accounts and directors' reports treated the shares as fixed assets.

The Commissioner claimed that C had engaged in an adventure in the nature of trade with respect to the land owned by its subsidiary (as opposed to the shares themselves).

Held:

The profits were not assessable.

With respect to the land:

(a) A, B and C had acquired the land in question as long-term investments.

(b) Although an investor might subsequently change its intention from investment to trading, so as to convert investment property into trading stock, such a change could not be inferred if an investor merely sells investment assets, takes steps to enhance the value of the investment or takes steps to achieve the most advantageous realization of its investment. One must have regard to the reasons behind an alleged change of intention in order to determine the true effect.

(c) Here, the acts of A, B and C in continuing development of their land after deciding to sell were done merely to enhance the value of their investments and to realize their investments in the most advantageous way.

(d) Statements in prospectuses should be given weight due to the penalties which apply for misstatements in prospectuses.

The Board made the following observation. Although it is necessary to have an intention to trade at the time of acquisition of property in order that the property be trading stock, that intention is gauged by looking at all circumstances ('badges of trade'). The intention to resell is only a factor for this purpose.

With respect to the shares in K owned by C and the land owned by K:

(f) It cannot be said that C was trading in the assets of its subsidiaries. To do so would be to disregard the separate existence of the subsidiary. Also, there would be a risk of double taxation if C were to be taxed with respect to the shares and its subsidiary were to be taxed with respect to its own assets.

(g) The Board could therefore only consider whether C was trading in the shares of its subsidiary. Here, the shares were acquired as investments and remained so throughout.

(h) Even if it were appropriate to determine whether C was trading in its subsidiary's assets, the answer would be no. Those assets were investments throughout.

Appeal allowed.

Cases referred to:

D30/87 (unreported)
Marson v Morton [1986] STC 463
Simmons v IRC [1980] STC 350
Taylor v Good [1974] 49 TC 277
Wing On Cheong Investment Co Ltd v CIR (1987) HCt, Inl Rev App No 1 of 1987
West v Phillips (1985) 38 TC 203

Luk Nai Man for the Commissioner of Inland Revenue.
John J Swaine QC with J J E Swaine instructed by Woo, Kwan, Lee and Lo for the taxpayers.

Decision:

Introduction

We are concerned with three appeals by A Company, B Company and C Company respectively. They were all subsidiaries of T Company, a public listed company.

A Company appeals against its profits tax assessments for the years of assessment 1977/78 and 1978/79. The issue is whether the surplus derived from the sale of units in a building in Hong Kong ('the A property') represents capital gains arising from realization of a capital asset or represents profits arising from trade. The Revenue accepts that the property was originally a capital asset but contends that by or in January 1976 A

Company embarked on an adventure in the nature of a trade and the property became its trading stock.

B Company appeals against its profits tax assessments for the years of assessment 1979/80 to 1983/84. The issue is whether the surplus derived from the sale of units in a building in the New Territories ('the B property') represents capital gains arising from realization of a capital asset or represents profits arising from trade. The Revenue again accepts that the property was originally a capital asset but contends that by or in January 1976 B Company embarked on an adventure in the nature of a trade and the property became its trading stock.

C Company appeals against its profits tax assessments for the years 1978/79, to 1983/84. There are two assets involved. First, a property in the New Territories ('the C property'). The issue is whether this property was throughout a capital asset (as contended by C Company) or trading stock (as contended by the Revenue). If the former, the surplus on sale of units in the building represents capital gains arising from realization of a capital asset and C Company is entitled to a rebuilding allowance. If the latter, the surplus represents profits arising from trade. The second issue concerns the shares representing the entire issued capital of K Company which owned a property in the New Territories ('the K property'). The issue here is whether the surplus from the sale of these shares represents capital gains arising from the realization of a capital asset or represents profits arising from trade.

At the hearing before us, Mr John Swaine QC and Mr J J E Swaine instructed by Messrs Woo, Kwan, Lee & Lo represented the Taxpayers. Mr Luk Nai Man, Mr D O'Dwyer and Mr Yeung Chi Chui appeared for the Revenue. The hearing took a number of sessions and we are grateful for the assistance they gave the Board.

Apart from documentary evidence, the following witnesses gave oral evidence for the Taxpayers: Mr V, Mr W, Mr X and Mr Y. Mr V was the right hand man of the late Mr Z who died in January 1984. Until his death, Mr Z was the chairman and managing director of T Company. Mr W is the son of the late Mr Z and a director of T Company since 1973. He has been chairman since his father's death. Mr X handles tax matters for T Company. Mr Y is an accountant employed by T Company since November 1979. He was chief accountant until July 1981 when he became group accountant.

The facts

We found the witnesses to be truthful witnesses. On the basis of the documentary and oral evidence before us we find the following facts. The facts in relation to each appeal are inter-related and the facts below in relation to each Taxpayer or otherwise should be taken as facts found for each and every appeal.

T Company

T Company was floated in 1973 when it issued a prospectus inviting subscription for its shares. Its controlling shareholders were the late Mr Z and his brother (who died in November 1976) and their families. Until his death in January 1984, Mr Z was its chairman and managing director. He decided the policy and management of T Company and its subsidiaries ('the Group'). He was a conservative businessman of the old school who liked to keep external borrowing to a minimum.

The prospectus stated that T Company's purpose was to develop real estate by constructing modern warehouses (for which a shortage was anticipated).

Mr Z was keen to develop a network of warehousing facilities mainly for rental income but also for self use. The investment in such facilities has remained the Group's principal business. It was never its policy to develop warehousing for sale. Indeed the market for this is limited; very few people purchase such properties. They have to be constructed to special design specifications, for example, higher ceiling, higher floor loading capacity, and requirements for cold storage facilities. They are significantly more expensive to construct compared to ordinary industrial premises. Building to the higher floor loading capacity was generally 20-30% more expensive. With other special requirements, construction costs could be up to 50% higher. But of course, premises constructed for use as a godown could be used as a factory.

<u>The Y project</u>

This project assumes a central significance in these appeals. It is convenient to describe it first.

In 1973, soon after its public floatation, the Group acquired a large site. The subsidiary which made the acquisition was D Company.

It was intended that a large warehouse be built on the site. It is an advantageous locality for transportation on both land and sea with an exclusive wharf for loading and unloading of goods. This would be the largest facility in the Group. Indeed it would be one of the largest facilities in Hong Kong and the Far East. The Chairman's statement in T Company's annual report estimated annual rental income of $30,000,000, being a 100% increase in revenue for the company. The project called for very considerable capital expenditure. Apart from the premium that had to be paid to Government, the estimated construction cost was around $70,000,000, although the actual costs turned out to be more than double this amount. It was intended to be largely financed from within the Group including, in particular, from rental income from the Group's warehousing facilities.

The project would feature container facilities. The use of containers in preference to the traditional methods for handling cargo was growing. By 1974 and 1975, it was becoming increasingly popular. This led to a fall in demand for facilities which were unsuited to container use.

Plans for the Y project were submitted in 1975. Foundation work commenced in 1976. The final phase was completed in 1985. As envisaged, it provides substantial income to the Group.

A Company

By the time of T Company's public floatation, A Company had become its subsidiary. The prospectus described the nature of its business as a godown and referred to its proposed general cargo warehouse at the A property as a project to be retained for investment in contrast to the development projects listed.

The architect's plans described the lower floors as 'godown' and the higher floors as 'factory' although all floors were in fact to godown specifications with the extra floor loading capacity.

This was A Company's only project. It was largely financed by way of interest-free loan from T Company. The estimated annual income, which had been confirmed in the prospectus by professional estate agents and valuers, would have given a substantial return on capital and would have provided a continuing source of funds to T Company. This was to be a key source of income for the Y project.

Contrary to expectations, the Hong Kong economy suffered a serious downturn from about mid 1973. In about April 1973 the stock market had crashed and the property market became depressed. There was an economic recession which lasted until about 1976 though there were signs of improvement from mid/late 1975. It became difficult to rent out premises. In December 1974, it was decided to divide the construction into two phases. Phase I was completed and the occupation permit was issued in late 1975 for a godown. This fulfilled the building covenant in the Conditions of Grant. From late 1975/early 1976, A Company commenced to receive storage income from Phase I until its sale. But it was always the intention to complete the building, suitable for use as a godown, in accordance with plans which had been approved. The architect had been engaged for the whole building and the foundation work therefor had been contracted for and done. In late 1975, the architect applied for consent to the commencement of Phase II building work. Before this, T Company had decided to proceed to complete the building in accordance with the original and unchanged design with construction to godown specifications on all floors in accordance with its intention to hold for investment. When T Company decided to proceed, there was no intention to sell. Phase II was completed in early 1978.

The warehouse business which started in Phase I after its completion met with little success and results from advertisements for godown rental space were disappointing. Hong Kong was still in recession although there were signs of improvement by this time. Containers were now becoming popular and the A property and its locality in an inner street were unsuitable for container handling. It became clear that A Company would not meet the income estimates. It was originally envisaged that such income would be used to repay its outstanding indebtedness to T Company (which was incurred for the redevelopment of the

site) and to provide a continuing source of funds to it. These were funds required for the Y project. With the increasing demand for container facilities which the Y project could provide, this project was expected to provide a better return than the project of A Company on the A property, the project of B Company on the B property and the project of C Company on the C property. These factors led Mr Z to recommend and the board of A Company to decide on 26 January 1976 to dispose of the A property.

Following this decision, units were advertised for sale and agreements for sale were entered into between February 1976 and January 1977 for the disposal of all floors. The lower floors were sold to E Company, a private company owned by Mr Z and his family which was not part of the Group. Subsequently in 1980/81 when economic factors were favourable, T Company acquired a 95% holding in E Company by an exchange of shares and thereafter used the premises owned by E Company for warehousing.

By January 1976, A Company had incurred about 50% of the eventual total construction costs. Following the decision to dispose in January 1976, there was no modification of plans except to enable the subdivision of floors into units. The occupation permit for Phase II was issued in early 1978. The purpose for the lower floors was described as 'godown' and that for the higher floors was described as 'factory'. The latter reflected the use to which the purchasers would put the premises.

In May 1976 the Chairman in his statement in the annual report of T Company reported that, to meet recent demands for industrial space and because of the need for cash by the company for the development of other investment properties, the board had decided to speed up the construction works of the 2nd stages of the A property, the B property and the C property for sale purposes.

Throughout the years, A Company's annual directors' reports described its principal activities to be land investment. Its audited accounts classified the premises as fixed assets and the profits on sale as an extraordinary item on disposal of fixed assets.

B Company

By the time of T Company's public floatation, B Company had become its subsidiary. The prospectus described the nature of its business as a godown and referred to its proposed warehouse and factory building on the B property as a project to be retained for investment in contrast to the development projects listed.

The architect's plans described the lower floors as 'godown' and the higher floors as 'factory' although all floors were in fact to godown specifications with extra floor loading capacity.

This project was financed by T Company. The estimated annual income as confirmed by professional estate agents and valuers would have given a substantial return on

capital and would have provided a continuing source of funds to T Company. Again, this was to be a key source of income for the Y project.

Having regard to the economic downturn from 1973, it was decided to construct the building in two phases. In mid 1975, the Chairman in T Company's annual report reported that the sub-structure was now completed and the lower floors were to be built first. In mid 1975, the architect so informed the Building Authority. The architect was engaged for the whole building and foundation work was contracted for and done for the whole building.

Phase I comprising the lower floors was completed in early 1976. Due to problems in getting approval for minor structural amendments, delays in obtaining certification and in construction by Government contractors of car-park access to the building, the temporary occupation permit was only issued in mid/late 1976. This described the purpose of all but one of the lower floors as 'godown' and the other floor as 'godown/factory'. The building covenant in the Conditions of Grant in fact had expired earlier by March 1976. B Company proceeded to construct Phase II without any interruption and the occupation permit therefore was issued in mid 1979.

In early 1976 as completion of Phase I drew near, it was apparent that the project would not yield the expected return to enable it to contribute to the substantial funds required for the Y project. The same factors as those affecting the A Company project affected this project. Consequently on 26 January 1976 the board of B Company on Mr Z's recommendation resolved to dispose of this property.

By January 1976, B Company had incurred about 33% of the eventual total construction costs. Following this decision, units were advertised for sale. Agreements were entered into mostly in 1976 and 1977. But Phase I was sold later; some floors were sold in June 1980 and the remaining floors in June 1981. Between the completion of Phase I in 1976 until its sale, the Company received rental and/or storage income therefrom. There was no modification of plans except to enable the subdivision of floors into units. The occupation permit issued in mid 1979 for Phase II described the purpose as 'factory'. Units had been sold and the permit was applied for on the basis of the use as factory to which the purchasers would put the premises.

In May 1976 the Chairman made the statement referred to above in T Company's annual report concerning the board's decision to speed up the construction of Phase II of this project.

Throughout the years, B Company's annual directors' reports described its principal activities as land investment or property owning. Its audited accounts classified the premises as fixed assets and the profits on sale as an extraordinary item on disposal of fixed assets.

C Company: the C property

By the time of T Company's public floatation, C Company had become its subsidiary. The prospectus described the nature of its business as 'godown, and real estate'. It referred to two projects of C Company. First, a project which is to be retained for investment namely a proposed general cargo warehouse at the C property. Secondly, a commercial/residential development project in the New Territories. The prospectus estimated that it would be due for completion in late 1973.

This dichotomy in treating the former as an investment project and the latter as a development project was maintained in C Company's audited accounts. As from 1982, the audited accounts before us classified the C property as fixed assets and the proceeds from disposal as an extraordinary item on disposal of fixed assets, whilst the other property was classified as current assets and profits from sale were classified as trading profits chargeable to profits tax. This classification contrasted with that of both properties under 'Land Investment' in the audited balance sheet for 1972. We are only concerned with the C property on this appeal.

Building plans were approved initially in mid 1973 and amended building plans were approved in raid 1974. Both sets of plans were produced before us. They show that the floor loading capacity had been reduced from 320 lbs to 250 lbs per square foot for the lower floors and 200 lbs to 100 lbs for upper floors. Both sets of plans show 'factory or godown' for the various floors, as was conceded by the Revenue properly. Both sets of plans provided for a machine room on the top floor. Although it was called 'machine room for aircondition', it was in fact for chilling the air for cold storage and could serve many floors. We find that even after the plans were amended in mid 1974, the proposed building could be used for godown or factory purposes and had facilities for cold storage. The reduced loading on the upper floors meant that it could only be used for lighter storage.

The project was financed by T Company. The expected rental income from it (which had been confirmed in the prospectus by professional estate agents and valuers) was to be an important source of funding for the Y project.

From December 1973, the Company had advertised in the press for lettings of units. Response was poor. As earlier mentioned, Hong Kong was in economic recession.

Building plans had been submitted to Government in late 1972 and the prospectus had forecast that development would commence in early 1973 and be completed by the end of 1974. But there was considerable delay. This was mostly due to the intervention of MTR works in 1973 and 1974. Another reason for the delay was that, in view of the downturn in the economy, C Company was not anxious to push ahead as fast as it could. The caisson plans were only approved in September 1975 and caisson works then started. In May 1976, the architect applied for consent to commence superstructural building works. The building was completed and the occupation permit was issued in mid 1978. C Company had to apply for an extension to the deadline for fulfilling the building covenant in the Conditions of Grant on a number of occasions.

On 26 January 1976, the board of C Company, on the recommendation of Mr Z, decided to dispose of the C property. The same factors as those in the case of A Company and B Company led to this decision. Hong Kong was still in economic recession although there were signs of improvement by this time. Containers were now becoming popular and this project was particularly unsuitable for handling container traffic by reason of the narrowness, gradient and curves of its access road. It became clear that, in those circumstances, it would not yield the expected income to provide funds required for the Y project. In May 1976 the Chairman made the statement referred to above in T Company's annual report concerning the board's decision to speed up this project.

By January 1976, C Company had incurred about 16% of the eventual total construction costs. Following this decision, units were advertised for sale. By the end of 1978, most of the units had been sold. There was no modification to the plans approved in mid 1974 except to enable the subdivision of floors into units. The occupation permit issued in mid 1978 after units had been sold were applied for on the basis of the use as factory to which the purchasers would put the premises.

C Company: the K Company shares

In January 1977, the board of C Company resolved to purchase the entire issued capital of K Company for about $11,400,000 from Mr Z, his son (Mr W) and two others. The only asset of K Company was the K property with a site area of 51,000 square feet. The board minute recorded the Chairman's recommendation for purchase. He said that 'a godown industrial building may be built to suit this company's long term investment in building industrial building for godown and factory rental income purpose'. Pursuant thereto, C Company purchased the shares of K Company. The board minute referred to godown and factory rental income. It was envisaged that lower floors would be rented out for storage whilst the upper floors would be rented out for lighter storage or for use as a factory.

At the time of purchase, C Company intended to hold the shares of K Company and the K property owned by K Company as a long-term investment for rental.

Two major considerations led to the decision in January 1977 to purchase these shares and to hold as a long-term investment. First, the site was a good site. It was considered suitable for handling container traffic and was accessible to a major container terminal. Secondly, the Group had a reasonable idea of the substantial proceeds that would be flowing in from the disposal of the units in the A, B and C properties. The decision to dispose of these other investment properties had been made in January 1976. Between 1977 and 1985, the sale proceeds received amounted to about $120,000,000 of which about $92,000,000 had been received by 1979, about $95,800,000 received by 1980 and about $116,400,000 received by 1981. By January 1977, agreements had been entered into for the sale of many units. Although the full purchase price would not be payable until completion after the issue of the occupation permits later, the Group confidently expected in January

1977 the cash flow that would be generated from receipt of the proceeds of such sales on completion. With this expected cash flow, Mr Z thought in January 1977 that the Group had sufficient funds to cope with both the substantial Y project and the project on the K property. In January 1977 it was thought that building costs would increase gradually by say 10% or so per annum.

In 1977, the Chairman in T Company's annual report stated that a godown and storage building would be erected on the K property pending approval from the Government. In the next annual report, he stated that a modern storage building was permitted to be built and foundation work was scheduled to commence immediately; on completion it would bring steady income to the Group. These statements reflected the intention to hold as a long term investment.

In the course of 1977, the architect was proceeding to obtain the necessary approvals. In mid 1977 he wrote to the Building Authority seeking modification of a requirement in the building regulations to permit the installation of a horizontal rail and hoist under the ceiling of the 1st floor for easy handling of containers.

But progress was delayed between 1977 and 1979. The site was on reclaimed land and there were difficulties with the foundation. It was not until 1979 when these difficulties were completely overcome and the foundation built. In mid 1979, the Building Authority approved the superstructure plans.

During the period 1977 to 1979, building costs escalated. This is shown by Levett & Bailey's building cost index based on tendered prices for builders' work obtained by competitive tenders. In January 1977, the index was about 265. (In March 1974 it had stood at about 330. It had dropped to 220 in March 1976 and had risen to about 265 in January 1977.) After January 1977, it leaped up reaching about 520 in June 1979 and about 560 in December 1979. So, between January 1977 and June 1979, building costs had doubled.

This was not foreseen by the Group. It is doubtful if this could have been foreseen. With the escalation in building costs, the originally estimated construction cost of $70,000,000 for the Y project had become totally unrealistic. The estimated construction cost for the K property similarly increased. In mid 1979, as a result of the escalation in building costs, the Group considered that it should not continue with both projects, bearing in mind Mr Z's conservative policy of keeping external borrowing to a minimum.

At a board meeting of C Company held on 13 June 1979, the Chairman reminded the board that K Company's original intention was to develop the K property into a factory building for long term investment 'in carrying on godown business and factory rental income purpose'. But the Group was now using its full strength to develop and was very much in need of funds for the Y project. He therefore suggested abandoning the original plan, that the investment in the K Company shares be realized, and that the funds so realized be used for the Y project. The board so resolved.

By an agreement dated September 1979, the shares were sold. At that time, K Company owed T Company the sum of about $4,360,000. Of this sum, K Company had used the sum of about $3,200,000 to pay instalments of premium and the balance of about $1,100,000 for architect's fees and construction costs.

As stated above, when T Company purchased the shares of K Company in January 1977, before the leap in construction costs, the Group thought that it would have sufficient funds to cope with both projects. Was this a reasonable and realistic assessment?

Before us, the Revenue produced an 'Estimated Fund Flow Statement in January 1977'. It seeks to envisage what was expected as at January 1977, although the figures used were actual figures of receipt and expenditure in and after 1977. From this document, as at January 1977, a substantial amount was expected from the proceeds of sale of the three properties. The sum of $120,600,000 was eventually received of which $95,800,000 had been received by 1980. From the document, as at January 1977, the estimated expenditure in the coming years would be as follows:

(a)	Estimated construction cost of the three properties			$ 25,300,000
(b)	K Company			
	(i)	Purchase price of K Company	$11,400,000	
	(ii)	Estimated construction cost	$25,000,000	
	(iii)	Premium	$ 7,400,000	
			$43,800,000	$ 43,800,000
(c)	Y project			
	(i)	Estimated construction cost	$70,000,000	
	(ii)	Premium	$ 5,000,000	
			$75,000,000	$ 75,000,000
			Total	$144,100,000

So, taking the figures in the document, there would at first sight appear to be a shortfall of some $24,100,000 ($144,100,000 – $120,000,000). But in our view, Mr Y (the T Company's internal accountant) correctly pointed out in his evidence that the document failed to take into account the estimated income from the Y project and the K property. From the actual figures, a total of approximately $38,200,000 was earned from the Y project in the years up to the end of 1985 by way of rental income to D Company and by way of income from the storage operations of another subsidiary of T Company. As at January 1977, the anticipated income up to the end of 1985 was not less than the actual amount and indeed was more. This was because at that time it was expected that Phase I of the Y project would be completed by the end of 1978 (and would then start to earn income) and the Chairman's statement in T Company's annual report so stated. In fact Phase I was only completed towards the end of 1979 and could only start to earn income then.

As to the K property, the plan was to construct a godown and storage building. In January 1977, the estimated rental income upon completion was about $660,000 per month and about $7,920,000 per annum based on the following estimates:

Total floor space (plot ratio of 9.5 x 51,100)	= 485,450 square feet
Rent per month at $2 per square foot	= $970,700 per month
At 80% occupancy rate	= $776,720 per month
Less 15% expenses	= $660,212 per month

As at January 1977, taking into account the anticipated income from the Y project as phases were completed and the anticipated income from the K Company project in addition to the figures in the document, a surplus (as opposed to a shortfall) was envisaged. Even if one should take the dividends that would be paid to the shareholders, one should bear in mind that the Group could borrow although Mr Z's policy was to keep external borrowing to a minimum. On the evidence, we find that in January 1977 the assessment by the Group that it had sufficient resources to cope with both the Y project and the K Company project was a reasonable and realistic one.

As at January 1977 the Group had four other development projects which were being developed. The evidence before us is that three of these projects were intended for resale. The last project was intended for rental. The Chairman's statement in the 1977 annual report referred to the development of one of the resale projects as being scheduled for 'leasing and selling'. Having regard to the evidence before us, the reference to leasing presumably related to only part of the development (probably the commercial premises on the ground floor). In January 1977, it was envisaged that the projects intended for resale would not be a demand on the resources of the Group. They could and would be financed from pre-sales and banking facilities presumably with a building mortgage and did not come

into the picture of capital planning. As to the rental project, it was a small project and its demand on resources was very small, around $1,000,000.

Throughout the years, C Company's audited accounts treated the K Company shares as an 'investment in subsidiary' and the surplus from sale as an extraordinary item arising 'on disposal of subsidiary company'.

Capital asset or adventure in the nature of trade?

A number of authorities were cited to us. We do not find it necessary to refer to all of them. In our view, save in relation to the K Company shares, the legal principles are established. They have to be applied to the facts of each case. Each case depends on its own facts.

In Simmons v IRC [1980] STC 350 at 352, Lord Wilberforce authoritatively stated the principles thus:

> 'Trading requires an intention to trade: normally the question is whether the 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? ... intentions may be changed. What was first an investment may be put into trading stock – and I suppose vice versa ...'

In deciding whether there was an intention to trade, all the circumstances must be examined, bare assertions of an intention to hold as a long term investment being of little weight. One should examine whether the transaction bore any of the badges of trade (see Simon's Taxes B3212 and Marson v Morton [1986] STC 463). In each case, it is necessary to stand back having looked at all matters and look at the whole picture and to ask the question – was this an adventure in the nature of trade? (see Marson v Morton at 471lg).

We see no inconsistency between Lord Wilberforce's statement in Simmons and the badges of trade approach. For there to be an adventure in the nature of trade, an intention to trade is required. In deciding whether there was such an intention, one must look at all the circumstances and examine whether the transaction bore any of the badges of trade. If the transaction bore the badges of trade, it would mean that an intention to trade was present notwithstanding protestations by the Taxpayer to the contrary.

In Marson v Morton one of the matters examined was the purchaser's intentions as to resale at the time of purchase. This was said to be in no sense decisive in itself (see 471e). In our view, this is consistent with Lord Wilberforce's statement which refers to an intention to trade. In deciding whether the purchaser had an intention to trade, his intention concerning resale is relevant but not decisive.

As Lord Wilberforce pointed out, intentions may change. If an asset was acquired for investment purposes, the owner may by the time of sale have put it into trading

stock and vice versa. The question is whether on the facts, such change had occurred. See Godfrey J's judgement in Wing On Cheong Investment Co Ltd v CIR (1987) HCt Inl Rev App No 1 of 1987, especially at pages 2 and 21-2.

If a property was acquired originally as an investment, it remains an investment unless the owner changes his intention to that of trading. There must be evidence which establishes that change of intention. An investment does not turn into trading stock because it is sold – per Lord Salmon in Simmons at 356h. Further, where the property was acquired originally as an investment, acts and activities designed to enhance the value of the investment in the market, or to achieve the most advantageous realisation of the investment, would not establish a change of intention to that of trading. As Russell LJ pointed out in Taylor v Good (1974) 49 TC 277 at 297:

> 'There is no ground at all for holding that activities such as those in the present case, designed only to enhance the value of the land in the market, are to be taken as pointing to, still less establishing, an adventure in the nature of trade.'

In considering the evidence concerning a change of intention, it is important to take into account the reason for the change. 'The reason for the change colours and colours heavily the whole matter': see West v Phillips (1958) 38 TC 203 at 213.

A Company and B Company

In both the A Company and B Company appeals, the Revenue accepted that the A property and the B property they respectively owned were originally capital assets. But the Revenue submitted that by or in January 1976 the companies had decided to embark on adventures in the nature of trade in respect of these properties. In support, the Revenue relies on the following matters. When the decision was taken in January 1976 to sell, the buildings were not yet completed. It took some time to complete the buildings and substantial construction costs had to be incurred after January 1976. In the case of A Company, in January 1976 Phase I had been completed and A Company had decided to proceed with Phase II which was completed in early 1978. In January 1976, it had incurred about 50% of the total construction costs. In the case of B Company, in January 1976, completion of Phase I was drawing near and about 33% of the eventual construction costs had been incurred. Phase II was completed in mid 1979. In both cases, the plans were modified to enable sub-division of units; there were advertisements for sale; units were pre-sold before completion; and the occupation permits referred to use as 'factory'.

In January 1976, A Company and B Company did decide to change from retention to sale. It is important to consider the reasons for that change. Such reasons 'colour and colour heavily the whole matter'. On the facts found, the reasons were these. It was considered that these properties would not on completion yield the income expected, having regard to the increasing popularity of containers for which these properties were unsuitable and to the recession although there were signs of improvement. Such expected income were funds required for the Y project which was regarded as somewhat of a

'showpiece' of the Group. In the circumstances, the companies decided in January 1976 that it was commercially sensible not to continue to hold them as long term investments and to realize them in the most advantageous manner and use the funds from such realization for the Group's purposes in particular the Y project.

In our judgement, the companies concerned did not form any intention to trade and did not embark on adventures in the nature of trade. The matters relied on by the Revenue were done by them to enhance the value of the assets in question and to achieve the most advantageous realisation of such assets. They did not establish adventures in the nature of trade.

Accordingly, we conclude that the respective properties of A Company and B Company remained capital assets throughout and the surpluses arising from sales are not chargeable to profits tax.

C Company

We shall consider the two assets involved separately.

The C property

In contrast to its position in relation to A Company and B Company, the Revenue contended that this was an adventure in the nature of the trade throughout.

In our judgement, there is no doubt that it was a capital asset at the time of the prospectus. The prospectus stated it as a project to be retained for investment. This statement of intention should be given great weight. The prospectus is an important document for the accuracy of which T Company and its directors were responsible with criminal sanctions for any misstatements therein. The statement in the prospectus concerning this project contrasts with the treatment there of the other commercial/residential project of C Company as a development project. This dichotomy in treatment of the two projects is maintained in the audited accounts of C Company before us; the C property was classified as fixed assets and the other property as current assets. In our judgement, there are no materials before us to affect the unequivocal statement in the prospectus.

Did the C property subsequently change into trading stock? In January 1976, at the same time as the decisions of A Company and B Company, C Company did decide to sell. By this time its building plans had been amended to provide for lighter loading. This was done in mid 1974. But as we have found, the amended building plans still provided for use as factory/godown, the latter for lighter storage. There was considerable delay in construction in 1973 and 1974 mostly due to the intervention of MTR works. By January 1976, C Company had incurred about 16% of the eventual total construction costs. Construction was progressing, caisson plans having been approved in September 1975. Once again, it is important to examine the reasons for the change. These were identical to

those in the A Company and B Company cases. Hong Kong was still in recession although there were signs of improvement. Containers were becoming popular and this site was particularly unsuited by reason of its unsuitable access road. In these circumstances, it became clear that this project would not yield the expected income which were funds required for the Y project. C Company decided to sell as it was commercially sensible not to continue to hold this project as a long term investment and to realize it and use the funds from such realization for the Group's purposes in particular the Y project.

In our judgement, C Company did not form any intention to trade and did not embark on an adventure in the nature of trade in respect of the C property. Matters such as the sub-division of units, the modification of plans for that purpose, the advertisements, the sale of units prior to completion, the continued construction of the building and its completion in mid 1978 did not establish an adventure in the nature of trade. They were done to enhance the value of the assets in question and to achieve the most advantageous realisation of such assets.

Accordingly, we conclude that the C property remained a capital asset of C Company throughout. The surplus arising from sales is not chargeable to profits tax and C Company is entitled to the rebuilding allowance in question.

The K Company shares

The Revenue submitted that there was an adventure in the nature of trade in respect of the K property and that the C Company chose to realise its interest in the property by disposal of the shares rather than a sale of the property.

C Company submitted: First, this was a sale of shares which must be distinguished from a sale of the property held by K Company. Whilst C Company did admittedly sometimes trade in property, before it could be chargeable for the profits on the sale of the K Company shares it would have to be found that C Company engaged in an adventure in the nature of trade in respect of the K Company shares (as opposed to the property). It should be held that C Company did not engage in such an adventure. Secondly, in any event, even if the Revenue's approach is correct, there was no adventure in the nature of trade in respect of the property.

We shall for the moment assume that the Revenue's approach is the correct one. Did C Company engage in an adventure in the nature of trade in respect of the property held by K Company, namely the K property?

C Company purchased the K Company shares in January 1977 as a result of two major considerations. First it was a good site suitable for handling containers and close to a major container terminal. Secondly, the Group in January 1977 was expecting a substantial cash flow from the sales of units in the A, B and C properties. C Company resolved to sell the K Company shares some 2½ years later in June and the agreement was entered into in September 1979. Progress was delayed between 1977 and 1979 with difficulties over the

foundation on the site which was on reclaimed land. In mid 1979, the Building Authority had approved the superstructure plans.

The submission of C Company that the K property was throughout held and retained as a long term investment is supported by the oral evidence before us, the board minutes of C Company on 7 January 1977 and 13 June 1979 and the statement in T Company's annual report.

Whilst such evidence is of considerable weight, the critical factor here appears to us to be whether in January 1977 the Group could reasonably and realistically have held the view that it had sufficient resources to deal with the project on the K property as well as the substantial Y project. On our findings of fact, we have found that the Group held such a view and that this was a reasonable and realistic assessment. What led to the subsequent decision in June 1979 to sell was the escalation in construction costs between January 1977 and June 1979 which was not foreseen and it is doubtful whether it could have been foreseen. This led to a revision of the original assessment that both the Y and K Company projects were within the Group's capacity to the view that the Group should not continue with both projects, bearing in mind Mr Z's conservative policy of keeping external borrowing to a minimum.

Having regard to the above matters, in our judgment there was no adventure in the nature of trade in respect of the property. There was never any intention whilst owned by the Group for K Company to trade in respect of the property. It was acquired as a long term investment and the escalation in building costs which was unforeseen led to the decision to realize this investment in June 1979.

We turn to the alternative submission of C Company referred to above that the correct approach is whether C Company engaged in an adventure in the nature of trade in respect of the K Company shares. It is submitted that the K Company shares should be distinguished from the property held by K Company.

In a decision dated 11 August 1987, the Board of Review (Litton QC, H J Dickson and M Olesnicky) in D30/87 (unreported) upheld a similar submission. At paragraph 68 of that decision, the Board said:

> 'The distinction between the shares in a company and the assets of the company is one which is fundamental to the law. As Lord Russell of Killowen observed in EBM Co Ltd v Dominion Bank (1937) 3 AER 555 (Privy Council) at page 564, it is 'of supreme importance that the distinction should be clearly marked, observed and maintained between an incorporated company's legal entity and its actions, assets, rights and liabilities on the one hand, and the individual shareholders and their actions, assets, rights and liabilities on the other hand.' The formulation of the Commissioner' case ... seems to us to be fundamentally unsound. It involves us, as the Board of Review, in wholly disregarding the

> corporate existence of [the subsidiary] and to pretend, contrary to the facts, that the transaction was not a sale of shares but of the assets of [the subsidiary].'

We are content to follow that decision and hold that the correct approach is whether C Company engaged in an adventure in the nature of trade in respect of the K Company shares. On the evidence before us, we are satisfied that it did not. Indeed the Revenue did not seriously argue that it did, in respect of the shares (as opposed to the property). There is no evidence that C Company ever traded in shares generally which might have led us to a different conclusion.

We wish to add a few comments of our own to the decision in D30/87. The practice of using companies to own and develop one property only is of course widespread. The liability of that company to profits tax will depend on whether it engaged in an adventure in the nature of trade in respect of the property. When shares in that company are sold (and this is often preferred to a sale of the property in order to save stamp duty), the bargain struck between the vendor and purchaser of the shares will take into account the potential tax liability of the company. It will be reflected in the price. If the company is liable or appears liable for profits tax in respect of an adventure in the nature of trade in respect of the property, the price paid to the vendor of shares is likely to take this into account. If the vendor of the shares is liable to profits tax on the surplus on disposal of the shares if it could be established that there is an adventure in the nature of trade in respect of the property, there would be an element of 'double taxation' in this sense. The property owning company continues to be liable for profits tax for its adventure in the nature of trade in respect of the property based on the property's original value, and the vendor of the shares is also liable on the surplus on disposal of the shares also for the adventure in the nature of trade in respect of the property. In our view, that cannot be right. It is indeed important to maintain the fundamental distinction between shares in a company and the assets owned by that company.

However, we wish to make clear that even if our decision following D30/87 is wrong, and the correct approach is that contended by the Revenue, we have already held that there was no adventure of trade in respect of the property.

Accordingly, we hold that the K Company shares were capital assets of C Company and that the surplus from their sale represents a capital gain arising from the realization of a capital asset and is not chargeable to profits tax.

Conclusion

We are satisfied that, in their respective appeals, A Company, B Company and C Company have discharged the onus under section 68(4) of proving that the assessments appealed against are incorrect. Accordingly, we allow these appeals and annul the assessments appealed against in each of the appeals.