# Case No. D67/88

Profits tax – sale of land – development of premises held as capital assets – original intention to sell the development property – whether profits were trading gains or realization of capital – s 14 of the Inland Revenue Ordinance.

Profits tax – joint venture – whether profits were trading gains or realization of capital – whether joint venturers can have different intentions and tax positions – s14 of the Inland Revenue Ordinance.

Panel: Denis Chang Khen Lee QC (chairman), John Haggerty and Richard Mills-Owens.

Dates of hearing: 13 to 15 September 1988.
Date of decision: 13 February 1989.

The taxpayer had purchased a house in 1954 as a residence. In 1956, she erected apartments on part of the land for rental purposes. In 1962, she sold part of the land to a family company in exchange for shares. In 1974, she entered into a joint venture with the company to demolish the apartments and her house and to develop the site into four houses.

The company borrowed necessary funds from a bank, and these (and other banking facilities of the company) were secured by a mortgage over the whole of the land. At one stage, 72% of such financing was used to support the company's other activities at a time when the prime rate was 16%. No steps were taken to obtain long-term financing. Repayment of the development loan and other facilities was to be made from the proceeds from the sale of the houses.

The first two houses were sold upon completion, and the proceeds were partially used to finance the construction of the remaining two houses. The proceeds from the sale of the third house were used to repay the bank loan.

During the construction of the first two houses, an estate agent was instructed to find buyers, and sales advertisements were placed. No steps were ever taken to find tenants.

Of the last two houses, the taxpayer and the company took one each, and the taxpayer sold her house immediately. The other house was retained by the company as a residence for its directors (including the taxpayer), and for this purpose the building plans for the fourth house were amended during its construction.

The company made the decisions with respect to the joint venture, but the taxpayer did not take an active part in the management of the company.

The company submitted to a profits tax assessment on its profits. The taxpayer, however, claimed that her intention had been to hold the four houses for residence and rental purposes, but that her intention had changed during the course of the redevelopment.

Held:

The gains were of a trading nature and were therefore taxable.

(a) Trading would not necessarily be inferred merely because property, was sold in the course of construction or shortly thereafter, and it is not always necessary for a taxpayer to show that supervening events outside its control forced a sale. Length of retention and circumstances of sale are only factors, and each case depends on its facts.

(b) Subjective feelings or wishes of a taxpayer as to its intention are not determinative if it did not have the means to bring that intention about or if it took no steps to enable that intention to be implemented.

(c) The taxpayer's intention from the outset was to sell all of the four houses. The fact that the fourth house was retained was the result of a change of plans. The original intention had been to sell it upon completion.

(d) It is possible for one party to a joint venture to have a different intention and tax position from the other party. However, the intention of one party may be relevant to ascertain the other's intention, for example, if one party has left decision-making to the other of if one practically has little choice but to go along with the other's decisions.

    On the facts, the taxpayer has left decision-making to the company. Also, the taxpayer's portion of the land had been mortgage to secure the company's substantial borrowings unrelated to the development. These factors showed that the taxpayer's fortunes and plans were linked to those of the company and that the company's intentions were bound to prevail.

Appeal dismissed.

Cases referred to:

D11/80, IRBRD, vol 1, 374
D60/87, IRBRD, vol 3, 24
Californian Copper Syndicate Ltd v Harris (1905) 5 TC 159

Wong Chi Wah for the Commissioner of Inland Revenue.

Denis Yu instructed by Charles Yeung Clement Lam & Co for the taxpayer.

Decision:

The taxpayer contends that profits amounting to some $10,880,000 which she had made on the sale of certain properties were not assessable to tax because they were of a capital nature. The agreed facts are as follows:

1. In 1954, the Taxpayer purchased a pre-war old house ('the old house') erected on Hong Kong Island ('the Land').

2. From 1954 until 1977, the Taxpayer occupied the old house as her family residence.

3. In 1956, the Taxpayer erected a three-storey apartment block on part of the Land.

4. The apartment block upon completion was leased out for rental income.

5. In July 1962, the Taxpayer and members of her family incorporated a private company ('the company') of which the Taxpayer and her husband, Mr A, have been and are permanent directors.

6. At a meeting held on 21 July 1962, the Taxpayer and her husband as directors of the company passed, among others, the following resolutions:

   (1) Mr A and the Taxpayer be appointed respectively managing director and deputing managing director;

   (2) their son, Mr B, and their daughter, Miss D, be appointed directors;

   (3) the company should purchase part of the Land from the Taxpayer for $265,000;

   (4) a total of 2,658 shares in the company be allotted for cash as follows:

| | |
|---|---|
| Mr A | 698 |
| Taxpayer | 660 |
| Mr B (son) | 450 |
| Mr C (son) | 450 |

| | |
|---|---:|
| Miss D (daughter) | 200 |
| Miss E (daughter) | 200 |
| | 2,658 |

7. The Taxpayer duly sold and assigned part of the Land to the company for $265,000. The said sale was not assessed for profits tax.

8. By a letter dated March 1972, the government informed the company that certain structures erected on the Land encroached upon an area beyond the boundary of the Land but indicated that it was prepared to grant at a premium an extension area of 7,280 square feet adjoining the Land for garden purposes.

9. After negotiations conducted through the company's architect, Mr X, the government's offer of the extension area was accepted for a premium of $124,800.

10. The minutes of an extraordinary meeting of the company held on 3 June 1974 and attended by the Taxpayer recorded among other things the following resolutions passed by the company:

    (1) to purchase the extension area from the government in the joint names of the company and the Taxpayer, to demolish the existing buildings on the Land, and to develop the entire site jointly with the Taxpayer in two phrases into four houses for long-term investment under joint ownership;

    (2) to appoint Mr X as architect for the project; and

    (3) to secure banking facilities to finance part of the redevelopment costs.

11. In compliance with the conditions of grant of the extension area, the Taxpayer entered into a deed of exchange with the company for unification of the title of the whole lot which was simultaneously surrendered to the government on the same day in exchange for a new re-named lot comprising the Land and the extension area.

12. The premium of $124,800 for the grant of the new lot was paid in October 1976 and shared equally between the Taxpayer and the company.

13. The redevelopment commenced in 1977 with the demolition of the old house and was carried out in two phases comprising two detached houses in each phase.

14. The four new houses had originally been designated at 19C and 19D (Phase I), and 19A and 19B (Phase II), but were subsequently re-numbered as 19B and 19C (Phase I), and 19 and 19A (Phase II).

15. The total construction costs were shared equally between the Taxpayer and the company.

16. The cost of constructing Phase I totalled $2,019,204 and was partly financed by a bank loan.

17. The total cost of construction for Phase I of $2,019,204 as assessed by the Commissioner comprised the following items:

| | Total<br>$ | 50% share<br>$ |
|---|---|---|
| Property development | 1,898,944 | 949,472 |
| Commission paid | 52,000 | 26,000 |
| Bank Interest | 60,944 | 30,472 |
| Legal Fee | 7,316 | 3,658 |
| | 2,019,204 | 1,009,602 |

18. An occupation permit for Houses 19B and 19C in Phase I was issued in 1978.

19. By a letter dated June 1978, the company instructed an estate agent to find buyers for Houses 19B and 19C. Advertisements were also placed in newspapers in August 1978 for the sale of Houses 19B and 19C.

20. At an extraordinary meeting held in September 1978 which the Taxpayer attended, the company resolved to sell Houses 19B and 19C.

21. House 19C was sold in October 1978 for $3,700,000, and House 19B was sold in February 1979 for $3,900,000.

22. The proceeds from the sale of Houses 19B and 19C were shared equally between the company and the Taxpayer.

23. The construction of Phase II commenced in late 1978 after the completion of Phase I.

24. The actual cost of construction of Phase II as assessed by the Commissioner totalled $3,466,854. This was financed partly by the sale proceeds of the 2 houses in Phase I and partly by a bank loan.

25. An occupation permit for Houses 19 and 19A in Phase II was issued in June 1980.

26. In August 1980, the Taxpayer entered into a sale and purchase agreement for the sale of House 19A for $11,500,000.

27. By a deed of exchange dated September 1980 between the Taxpayer and the company, House 19A was allotted to the Taxpayer and House 19 was allotted to the company.

28. An assignment of House 19A pursuant to the sale and purchase agreement was also executed by the Taxpayer in September 1980.

29. The sum of $3,466,854 referred to in paragraph 24 above does not include any commission paid on the sale of House 19A.

30. For many years prior to 1980, the Taxpayer had been suffering from Parkinsonism. In June 1980, she was suspected to be suffering from aplastic anaemia. In October 1981, after extensive investigation, it was eventually discovered that the cause of her anaemia was due to a leiomyosarcoma of the small bowel, for which an operation was performed in 1981. She has continued to suffer from Parkinsonism.

The Taxpayer, aged 66, was not in good physical condition at the date of the hearing and did not give evidence herself. However, her daughter Miss D was called as a witness. She said, among other things, that 'the original idea' was for the parents to live in one house; for the three other houses to be rented out and from such rental to pay off the bank loan needed to finance the building costs; and that each child would end up owning one house. She said that, after they had started on Phase I, there was a change of plans but only to the extent that, instead of the parents living alone in one house, two of the children would stay with them but that the other houses would still be rented out.

She maintained that neither the company nor her mother intended to sell; that even though the company instructed an estate agent in June 1978 to find buyers, they really had no intention of selling but only wanted to obtain, free of charge, a rough estimate of market value from which they could work out the rental; that the Phase I houses were later sold only because the company was in need of cash as a result of an expansion of its business, a rise in interest rates, and an increase in the estimated costs of construction of Phase II to a figure in excess of $3,000,000 compared with some $2,000,000 quoted back in 1977. The Taxpayer, she maintained, had always wanted to keep her old family property (or

'lo ka' in Cantonese) and agreed to sell the Phase I houses only reluctantly after being apprised of the necessity to do so in August 1978.

As regards Phase II, it is the Taxpayer's case that House 19A was sold only because she and her family were led to believe that she was dying from a serious illness originally diagnosed, mistakenly, as aplastic anaemia.

The Taxpayer relies, among other things, on the resolutions recorded in the minutes referred to in agreed fact 10 and on what was alleged to have occurred at the extraordinary meeting referred to in agreed fact 10.

The minutes of the said extraordinary meeting held in September 1978 recorded the Chairman (the Taxpayer's husband) as saying that 'funds were badly needed for the repayment of the bank loan and for the completion of the development' and that 'because of the time lag it was expected that the construction cost of Phase II would exceed the original budget considerably'. Two resolutions were recorded to have been unanimously passed (1) to the effect that either or both of the Phase I houses should be sold 'though it was against the wish of the company' and (2) to the effect that the Taxpayer 'dissented in the first instance as the disposal of these two houses of which she owned half a share was against her wish and contradicted the intention originally laid down by the company' but that, after she was convinced that she had no alternative, she finally agreed to the proposal 'though with reluctance'.

The Revenue disputes the Taxpayer's basic contention that the property was developed for long-term investment. It contends that, notwithstanding expressions of 'wishes' or declarations of intent recorded in the company's minutes, the realities must be looked at, including the financing arrangements and the ability of the parties to develop and hold the property as a long-term investment. The Revenue says that everything in the joint development points in the opposite direction and that there was no intention to develop the property for rental income. Indeed (and this is an undisputed fact), the company for its part has never denied liability to pay profits tax arising from sales in the joint development. The only objection it ever made was in relation to the date at which the property was to be valued for the purpose of computing the cost, suggesting in effect that the property should be valued at a date just prior to the resolutions of 3 June 1974. The assessment thus computed and levied was paid by the company without further objection. The Revenue naturally contended that this was tantamount to acceptance by the company that its development of the property was an adventure in the nature of trade and that (despite what appeared on the face of relevant resolutions) the trading venture began with or just prior to the company's resolutions of 3 June 1974.

Of course, what we are concerned with here is the liability to tax not of the company but of the Taxpayer as an individual. Even in a joint development, the intentions and tax position of one party may be quite different from those of another. D60/87, IRBRD, vol 3, 24 is a recent example of a case where an individual party to a joint venture intended to retain his share therein for rental purposes (with the exception of selling sufficient flats so

as to recover his cost of the redevelopment) despite the fact that it was his understanding that the other party (a property development company) at all times intended to sell its entire share in the venture as soon as possible at a profit.

However, this does not mean that the intention of one party is never a relevant factor to be considered when ascertaining the intention of another party to the joint development. One of two parties to a joint development may, for example, have deliberately left the decision-making to the other or may have in some other way put himself in such a position that he will have little choice but to go along with critical decisions of the other party in matters affecting the development or the eventual disposition of the developed property.

In the present case, we find as a fact that the Taxpayer was not the decision-maker in relation to the joint development. The decision-maker was the other party to the joint development, namely, the company. Although the Taxpayer was both a shareholder and a director of the company and was apparently kept generally informed as to the progress of the development, she did not take an active part in its management. Those who did take an active part at one time or another were her husband, their son Mr B and their daughter Miss D (the witness). It was the company which procured a building loan from a bank in respect of the Phase I development and bridging finance from the same bank in conjunction with (though not tied to) the Phase II development. The company was able to and did make use of the entire property (including the Taxpayer's interest therein) for the purpose of providing security not only for the loans but also for the purpose of supporting guarantees furnished by the company to the bank in respect of overdraft and other facilities granted to subsidiaries of the company. In this way, the Taxpayer had all along put herself in a position where her share in the property was very much bound up with the fortunes of the company generally and with the company's plans in relation to the development.

The following are among the facts we find clearly established on the evidence:

1. Soon after the demolition of the old house, the company in about February 1977 obtained from a bank a building loan of $1,500,000 in respect of Phase I. As evidenced by the bank's letter dated 17 February 1977 addressed to a subsidiary of the company which traded in plastic raw materials, the terms included a provision for repayment of the loan to be effected 'from the sale proceeds of the two houses or by 31 March 1978, whichever [was] the sooner.' The date 31 March 1978 was subsequently extended to 30 September 1978. The agreed lending rate was 2.5% over prime, subject to fluctuations. The prime rate was 5.5% per annum in February 1977 and 8.5%, 9.875% and 13% per annum in June, August and December 1978 respectively.

2. Prior to the issue of the occupation permit in respect of the Phase I houses, steps were taken to find buyers for the two houses. An estate agent was instructed by the company in June 1978 to use its best efforts to obtain buyers for unit

19B at $3,600,000 and unit 19C at $4,000,000, and advertisements were placed in August 1978.

3. By September 1978 (the date of the relevant sale and purchase agreement according to the records at the Land Registry, that is, just one day after the extraordinary meeting of the company referred to in agreed fact 20), a buyer had already been found for House 19C at the price of $3,700,000, although the sale was not completed until later.

4. On 5 December 1978, as evidenced by a letter of that date from the bank to the company's said subsidiary, the bank when renewing the facilities stipulated that repayments on one of the loans granted to the company were 'to be effected from full sale proceeds of the remaining house No 19B built under Phase I of the project or by 23 March 1979, whichever [was] the earlier'. (House 19B was subsequently sold on 12 February 1979 for $3,900,000.)

5. The bridging finance obtained from the bank was in the sum of $1,800,000 and was fully drawn down by 1 July 1980. Only a part of the money was directly applied towards payment of the building costs of Phase II, and the rest totalling some $1,300,000 was utilised as loans to the said subsidiary and another fully-owned subsidiary of the company. In other words, the drawdown of the bridging loan, not tied to the redevelopment, was generally available for the company's business. The Taxpayer's interest in the property under development in Phase II, however, formed part of the security for this and other facilities granted. The terms of the bridging finance, as evidenced by a letter from the bank dated March 1980, included a provision that full repayment would be effected from sale proceeds of the development by September 1980 and, in the event that no sale was made by that date, repayment would be by 30 equal monthly instalments commencing in October 1980. The lending rate was 2.5% above prime, subject to fluctuations. The prime rate in March 1980 was 16% per annum.

7. House 19A was sold prior to the said date of September 1980 and the bridging loan was repaid out of the proceeds of sale. This was the third and last of the houses sold. Upon completion of the sale, the Taxpayer no longer retained any interest in the development. Her half share in the fourth house (House 19) – the only house which remains unsold – had already been made over to the company in exchange for the company's half share in House 19A, thus enabling her as sole owner to assign House 19A to the purchaser.

8. The houses which were sold were all substantially identical in design as was originally the fourth house. It was only in late 1977, when the redevelopment of Phase I was in progress and some months after the demolition of the old house, that the plan for the fourth house was changed to incorporate three self-contained areas. Still later, the number of the fourth house, originally designated 19A, was changed to 19 being the address by which the property was collectively known. On its

completion and after the house became wholly-owned by the company, it was used as a residence of the directors. Miss D and her family were the first to move in, followed shortly by the parents and Mr B. They have all since vacated, Miss D having emigrated to Australia with her family in 1985 (fulfilling a long-standing desire) and the parents and Mr B having subsequently moved to other quarters of the company in Hong Kong Island. All the children, incidentally, are Australian citizens and have been so since the 1960s. Two of them were living in Australia at the time of commencement of the redevelopment, but one returned to Hong Kong subsequently.

It is not the Taxpayer's case that she or the company had envisaged selling some of the houses while retaining for family occupation, say, the fourth house. The Taxpayer's case is that all the houses were intended from the very outset to be retained, one for self-occupation during the parents' lifetime and the rest rented out for long-term investment. The Revenue, on the other hand, suggests that all the houses were intended to be sold, and that the use of fourth house as a directors' residence came about as a result of matters arising subsequent to the commencement of the joint development and did not affect the character of the enterprise embarked upon as a whole.

It is necessary, in our view, to look at the development both as a whole and in its phases. We have done so and, on the whole of the evidence before us, we are not satisfied that the Taxpayer or the company intended to develop the property for rental income. We find, as a fact, that at no time did the company or the Taxpayer take any steps to obviate the need to sell units in the development. They did not, for example, seek to obtain from the bank adequate long-term financing. Nor are we satisfied that they were able and willing to develop the property for long-term investment without such financing. No steps were taken to find prospective tenants: the instructions which they gave to the estate agents, and other steps such as advertising, were all confined to obtaining buyers.

We do not, incidentally, believe that when the estate agent was instructed there was no intention to sell the Phase I houses. Miss D's explanation of how this came about was not credible and her general credibility suffers as a result of the Revenue's cross-examination on this and other matters. We find that the instructions given were part of a series of steps taken by the company on behalf of the parties to the development and were as a whole consistent with, and in fact represented, an implementation of a pre-existing intention to sell, ensuring compliance with the terms of the loan obtained in February 1977 that repayment would be effected from the sale proceeds of the two houses or by the date stipulated whichever was the sooner. A buyer was found for House 19C even before the occupation permit was issued.

The Revenue cites case D11/80, IRBRD, vol 1, 374 where the Board of Review said:

> 'When an owner of land exploits it by the development and construction of a multi-storey building and in the course of construction or shortly thereafter he sells units in the building, the inference that would be drawn is that the building

> was not erected for retention as an investment but for the purpose of resale. If the owner's case is that he intended to retain the property as a long term investment but supervening events outside his control forced him to dispose of the property, then before such a claim can succeed he must satisfy the Board that it was his intention to keep it as an investment or capital asset.'

This passage, however, should not be read as suggesting that an inference of trading will in every case be drawn from the mere fact of sale in the course of construction or shortly thereafter, or that to discharge his onus the taxpayer must show that there were supervening events outside his control which 'forced him to dispose of the property'. Each case must depend on its own facts: the length of retention of the property and the circumstances of the sale are among the factors to be considered and the inferences to be drawn vary from case to case.

In ascertaining the intention of the Taxpayer, it is not enough merely to look at the subjective feelings or wishes of the Taxpayer. In D11/80 (above), the Board of Review said: '"intention" connotes an ability to carry it into effect. It is idle to speak of '"intention" if the person so intending did not have the means to bring it about or had made no arrangements or taken any steps to enable such intention to be implemented ... The absence of any arrangements for adequate long term financial facilities to enable the Appellants to retain the property and the creation of a short term building mortgage to finance the project with knowledge that recourse must be had to sales to discharge the mortgage debt and to meet development costs bear the imprint of a course of action pursued with a motive that militates against retention for investment.'

In the present case, whatever emotional attachment the Taxpayer might have had for her old family home, we are not satisfied that she or the company was able and willing without resorting to sales of units in the development to repay the bank facilities. The probabilities are that the Phase I houses would have been sold irrespective of whether or not interest rates had risen or the building costs had increased or the business of the company had expanded. From the beginning, the Taxpayer intended to go along with the company's plans. Those plans, we find, from the outset envisaged sales of units in the development in furtherance of a scheme of profit-making and for purposes not confined to the joint development but embracing the general business of the company and trading activities of its subsidiaries. Miss D referred to an acquisition by the company during the year ended 31 March 1979 (she was unable to say precisely when) of a supermarket business as reflected in an item of just over $500,000 shown in the notes to the accounts of the company for the year ended 31 March 1979. We do not, however, accept that it was because of this or any other business expansion that the Phase I houses were sold.

As regards Phase II, we have mentioned above that a substantial part (some 72%) of the bridging finance obtained on the security of the property comprised in the Phase II development was actually used to support trading activities of subsidiaries of the company and that, at the time of this particular loan, the prime rate was as high as 16% per annum. We find that the intention all along was that the Taxpayer should resort to the sale of House

19A to pay off the loan. She did so and, in so doing, she also paid off her share of the building cost vis-a-vis the company.

In all the circumstances, we do not believe that this sale which took place some two and a half months after the issue of the occupation permit was due to the mistaken diagnosis of the Taxpayer's illness. We note in passing the fact that, by at least 7 July 1980, which was before any sale had been negotiated, the family already knew that the diagnosis of aplastic anaemia was not supported by specialist opinion obtained although the precise cause of the bleeding was not discovered until later. In any event, whilst it would be perfectly natural for the family to be concerned whatever the true cause of the illness, we do not think it was that concern which brought about the sale notwithstanding the fact that, following receipt and out of the net profits, the Taxpayer made generous gifts to family members (although it should also be noted that she retained for herself a substantial sum of over $3,000,000 and continued to hold on to her shares in the company).

All in all, we find that the sale of House 19A was just as much a part of a profit-making scheme as were the sales of the Phase II houses. The fact that House 19 was not sold and came to be used as a directors' residence in the circumstances aforesaid was the result of an idea or hope which came into existence after the development had commenced and did not, in our view, change the character of the scheme as a whole. We find that the profits made on the houses which were sold represented 'a gain made in an operation of business in carrying out a scheme of profit-making': Clerk L J in Californian Copper Syndicate Ltd v Harris (1905) 5 TC 159. In other words, the profits arose out of a trade or adventure in the nature of trade.

We therefore dismiss the appeal and confirm the assessments accordingly.