

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D68/00

Profits tax – sale of shares in private company – whether investment or trade.

Panel: Anna Chow Suk Han (chairman), Berry Hsu Fong Chung and Anthony So Chun Kung.

Date of hearing: 24 May 2000.

Date of decision: 17 October 2000.

The taxpayers are husband and wife and they were the shareholders of Company C. Company C purchased a property in July 1996. In December 1996, the taxpayers sold their shares in Company A at profits. For the sale of shares in Company C, the assessor raised profits tax assessment for the year of assessment 1996/97 on the taxpayers.

Held:

The Board found the taxpayers purchased the property with the intention to resell it. The sale of the shares was in pursuance of a profit making scheme and the profit realized was thus income.

Appeal dismissed.

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Chiu Kwok Kit for the Commissioner of Inland Revenue.

Taxpayer in person.

Decision:

The appeals

1. Mr A and Madam B have respectively objected to the profits tax assessment for the year of assessment 1996/97 raised on them. They respectively claim that the profits which they derived from the sale of their respective shares in a private company, Company C, should not be assessed to profits tax as a trading profit. The two appeals have raised from the same facts and circumstances and were therefore consolidated and heard as one appeal.

The background facts

2. Mr A and Madam B are husband and wife.

3. For many years, Mr A and Madam B had been employed as senior assessors in the Inland Revenue Department. On 1 June 1996, Mr A ceased his employment with the government and commenced a new employment as an audit manager with an accountancy firm called Company D.

4. All long, Mr A and Madam B have been residing at the quarters provided by the government in the Hong Kong Island.

5. (a) On 14 May 1996, Company C was incorporated as a private company in Hong Kong.

(b) Company E and Company F were the two subscribers of the two \$1 ordinary shares issued by Company C.

(c) Company E and Company F by a certificate confirmed that before 11 June 1996:

(i) Company C had never commenced business since its incorporation;

(ii) Company C had not incurred any liability;

(iii) Company C had not owned landed properties or stock investment since its incorporation.

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6.
 - (a) On 3 July 1996, Company C purchased at a price of \$6,018,400 a property known as Property 1 at Housing Estate G. Mr A as a director of Company C signed the purchase agreement.
 - (b) On 23 July 1996, Bank H wrote to Company C for the attention of Mr A that it was prepared to offer the company a banking facility of \$4,200,000 which was to be secured by:
 - (i) an equitable mortgage in the bank's favour on Property 1 and
 - (ii) a jointly and severally personal guarantee given by Mr A and Madam B.
 - (c) On 12 August 1996, an equitable mortgage was created on Property 1 in favour of Bank H. Mr A as a director of Star Company C executed the deed.
 - (d) On 23 December 1996, the occupation permit of Property 1 was issued.
 - (e) On 27 March 1997, the certificate of compliance of Property 1 was issued.
7.
 - (a) On 15 October 1996, by an agreement Mr A and Madam B as vendors sold the shares they held in Company C (' the Shares ') at a price of \$7,000,000.
 - (b) On 22 October 1996, Mr A and Madam B signed a formal agreement to sell the Shares in the following terms:
 - (i) their shares in Company C at a consideration of \$650,002; and
 - (ii) their rights and benefits in the loan of \$6,349,998 (a director's loan of \$2,165,989.85 and a bank loan of \$4,184,008.15) advanced to Company C at a consideration of an equal amount.
8.
 - (a) On 15 November 1996, the contract notes and transfer forms effecting the sale and the transfer of the Shares were executed.
 - (b) On 15 November 1996, by an assignment Mr A and Madam B, as beneficial owners, assigned to the purchasers their Shares and the loan of \$2,165,989.85 due and owing to them from Company C.
9. On 15 November 1996, at a meeting of the directors of Company C, it was resolved that:

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- (i) the transfer to the purchasers of the two shares previously held by Company E and Company F be approved and registered;
- (ii) the assignment of the directors' loan be acknowledged and confirmed;
- (iii) new directors and secretary be appointed;
- (iv) the resignation by Mr A and Madam B of their directorship be accepted and approved; and
- (v) the authority given to Mr A and Madam B to operate the company's bank account be withdrawn.

10. Mr A and Madam B when selling their shares in Company C approved the following:

- (a) a profit and loss account made up to 15 November 1996 from the date of incorporation; and
- (b) a balance sheet made up at 15 November 1996.

11. In their respective individual tax returns for the year of assessment 1996/97, Mr A and Madam B;

- (a) did not declare they had derived an income from their office of director in Company C; and
- (b) did not disclose they had derived a profit from the sale of their shares in Company C.

12. Having reviewed the facts of the case, the assessor formed the view that Mr A and Madam B had derived a profit from the sale of the shares in Company C in the course of a trading venture. On 2 February 1999, the assessor raised the following profits tax assessments for the year of assessment 1996/97:

- (a) on Mr A
Assessable profits \$325,000
- (b) on Madam B
Assessable profits \$325,000

Note:

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Mr A and Madam B had elected for personal assessment for the year of assessment 1996/97 and their assessable profits were transferred thereto.

13. On 23 February 1999, Mr A and Madam B objected to the profits tax assessments and wrote to the assessor in the following manners:

- (a) ‘ The estimated assessable profit to \$650,000 is actually a premium on transfer of unquoted shares to compensate the shareholders for their loss of office of directorship but not profit on disposal of property. As it is a capital gain, it is not assessable.’
- (b) ‘ This transfer of shares involved the sale of an investment business which included capital, bank mortgage loan, other liabilities, fixed asset (investment property), current asset (bank account) and etc.’
- (c) ‘ The trading of property which claimed by you should involve only the sale of a trading stock (the property). As it is not the case as claimed by you, it should not be taken as that.’
- (d) ‘ Our intention of purchase of the property for the company is for rental income as a long term investment. This intention is clearly proved by our taking the trouble to arrange a long-term mortgage of the property with the bank. Under the terms of payment offered by the developer, the purchaser might elect to pay only 30% of the price during construction and the balance upon completion, or 100% within one month of the acquisition. If our intention was to sell the property for a quick profit before the completion, we should have elected the former term of payment because it was simple and acceptable to the next prospective purchasers. To facilitate the sale of the property before completion it would be foolish for a trader to select the latter term by mortgaging the property to a bank for a loan to finance the balance of 70% of the payment because the subsequent sale of either the property or the shares would involve the change or transfer to both the bank loan and the director’s guarantee, which would be normally not acceptable to the prospective purchasers and the bank concerned. All purchasers would prefer to buy property with the former term of payment. Moreover, penalty interest should be paid for early repayment of mortgage loan.’
- (e) ‘ All the properties purchased and presently held by us are for rental income as long term investments. You may check our records with your department. We entirely have no history of sale of any property.’

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- (f) ‘ As we are able to pay the 30% deposits and obtain the bank loan to finance the possession of the property, we are capable of holding the property as a long term investment.’

14. On 8 August 1999, in response to the assessor’s enquiry, Mr A and Madam B provided the following further particulars:

- (a) Computation of compensation

- ‘ If we were still the shareholders of the company, we should be its directors who had the right to manage the company, its prospective business, its bank loan and other liabilities, its investment, the property and other assets. The figure of \$650,000 was negotiated and arrived at as we were compensated for loss of our directorship to manage all of the aforesaid.’

- (b) Documentary evidence

- ‘ Please refer to (a) above as well. As it is only a small private family company, no such document was prepared.’

- (c) Other business operations

- ‘ Normal business operations for an investment limited company, such as financing and banking transactions, were carried on and company secretarial services were to be carried on by Company C, other than the mere holding of the property in question, since incorporation to date of transfer of the shares.’

- (d) Reasons and circumstances for the sale of shares in Company C

- (i) ‘ No client who required company secretarial services was found.’

- (ii) ‘ The transferees of the shares were able and wishing to purchase the bank loan and all the assets and liabilities of the company other than the mere investment property.’

- (iii) ‘ The market price of the investment property rose so much and so fast to an unreasonable level during the period of ownership that we believed that the booming of the property market had already come to an end and up to the top of the hill and would go downwards with no good prospect in due course. As a good investor, we should try our best to keep our investments at the highest value.’

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(iv) ‘ After the purchase of the property, I/my husband met my/his client who had lived in Housing Estate G and sold his residence of there for the following reasons:

- As compared with its price, the surrounding living conditions were not up to his expectations;
- It was quite noisy because trains were running nearby the buildings. Whenever the train passed by, the buildings vibrated slightly. This was often quite annoying. Moreover, the sound pollution from the nearby highway was also unacceptable;
- There was rumour from reliable source that with the change of air routes to suit the new Hong Kong airport, the noise of many aeroplanes flying over the buildings even at night would be a great disturbance to normal life;
- Although the factory area was not quite near to the buildings, occasionally whenever the wind changed its direction, bad odour from the factories might be smelt;
- The shuttle buses running between the buildings and the railway station were not always punctual. The waiting time for the next bus was often too long, making it very inconvenient for the residents.’

(v) ‘ In the circumstances as stated in (above), it was anticipated that it would be impossible to solicit a prospective good tenant with reasonable rent and return of capital.’

(e) Solicitation of purchasers

‘ The transferees of the shares were not solicited by us. Instead we were solicited by them who sought for a good investment company through their agent, Company I.’

(f) Services provided by Company I

‘ The amount of \$70,000 was paid to Company I because they negotiated a better compensation for us than that we expected.’

15. To allow for deduction the service fee paid to Company I, the assessor has decided to revise the profits tax assessment for the year of assessment 1996/97 as follows:

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(a)	Mr A	
	Revised assessable profit (\$325,000 - \$35,000)	<u>\$290,000</u>
(b)	Madam B	
	Revised assessable profits (\$325,000 - \$35,000)	<u>\$290,000</u>

The Taxpayer's contentions

16. The Taxpayer contended that the profits which they derived from the sale of the Shares were capital gains and were therefore not assessable to profits tax. The bases of their contentions are detailed in a written statement submitted to the Board at the hearing. They are essentially the same as those advanced to the assessor during the course of investigation, and those contained in the grounds of appeal.

The Respondent's contentions

17. The respondent contended that profits derived from the sale of the shares in Company C were trading profits since they were derived from a trading venture or profit making scheme in that the Taxpayers acquired the Shares of the company, arranged a bank loan for the company, injected loan capital into the company, caused the company to purchase a property and sold the Shares of the company once the value of the property increased.

The law

18. The relevant provisions of the Inland Revenue Ordinance ('IRO') are:

Section 14:

' Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on any person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or deriving from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this part.'

Section 2:

' In this Ordinance, unless the context otherwise requires-

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“assessable profits” means the profits in respect of which a person is chargeable to tax for the basis period for any year of assessment, calculated in accordance with the provisions of Part IV

“profits arising in or derived from Hong Kong” for the purposes of Part IV shall, without in any way limiting the meaning of the term, include all profits from business transacted in Hong Kong, whether directly or through an agent

“trade” includes every trade and manufacture, and every adventure and concern in the nature of trade.’

The evidence

19. Mr A attended the hearing of these appeals in the absence of Madam B. He presented this Board with a written statement which was signed by him and Madam B and gave evidence on behalf of himself and Madam B. He was cross-examined by Mr Chiu for the Respondent. On the basis of the evidence given and various documents produced before us, we find the following additional facts.

20. There were no service contracts between the Taxpayers and Company C. Company C had never paid the Taxpayers director fees.

21. There was no provision for payment of compensation to the Taxpayers for loss of directorship in the provisional sale agreement of Shares of 15 October 1996 nor in the formal sale agreement of Shares of 22 October 1996.

22. The Taxpayer did not present the respective transfers and sold and bought notes of the shares in Company C from Company E and Company F to the Taxpayers, for stamping until 2 August 1996. Upon presentation of the said documents for stamping the Stamp Office refused to accept them for stamping for the lack of a balance sheet and profit and loss accounts of Company C. The said documents were therefore not stamped.

23. Technically the Taxpayers had never been the shareholders of Company C as their names had never been registered as shareholders on the members register of Company C.

24. Under the formal agreement for sale and purchase of Property 1 of 3 July 1996, Company C agreed to pay the balance of the purchase price of Property 1 on or before 2 August 1996.

25. The developer of ‘Housing Estate G’ offered discounts on the purchase prices to purchasers who chose the method of full payment of the purchase price prior to completion of the sale and purchase of a property.

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26. Company C did not have any income up to 15 November 1996, the date when the sale and purchase of the Shares were completed. Company C had no assets other than Property 1 and a small cash balance at the bank up to 15 November 1996. Company C only had a working capital of \$4 up to 15 November 1996.

27. While the Taxpayers were the directors of Company C, Company C had no business activities other than acquiring Property 1 and obtaining a mortgage loan to satisfy the purchase price. Company C did not have business machineries, plants or equipments. Company C did not have goodwill or a trade name. Company C did not have any income.

28. Company C did not advertise any secretarial services.

29. After the Taxpayers disposed of their shares in Company C, they did not acquire shares in another company to provide secretarial services. Neither did they purchase another landed property.

Our findings

30. A number of authorities were cited to us by the Respondent. We have considered them. We do not find it necessary to refer to them as each case depends on its own facts.

31. The legal principles are well settled. The stated intention cannot be decisive and the actual intention can only be determined upon the whole of the surrounding circumstances, including things said and things done at the time, before and after. Often it is rightly said that actions speak louder than words. Our task is to ascertain the intention of the Taxpayers at the time of their acquisition of the shares in Company C and Property 1. In doing that, we also take into consideration of the things said and done by the Taxpayers before, at the time and after the acquisition of the Shares and Property 1.

32. The Taxpayers claimed that they acquired the shares in Company C for the purpose of running a business for providing secretarial services and also holding a landed property for rental income and that they sold the Shares because they could not find clients for their secretarial services, the purchasers of the Shares were willing to take over Company C's bank loan and Property 1. They said that the prices of landed properties had then risen so high and unreasonable that they expected them to fall soon and they did not think they could find a good tenant with a reasonable return for Property 1 in view of the unfavourable features of 'Housing Estate G' pointed out by Mr A's client.

33. On the Taxpayers' claim that the shares in Company C were acquired for a business of providing secretarial services, we are unable to find evidence to support this claim. The Taxpayers acquired the shares of Company C on 11 June 1996. Mr A claimed that he was busy and did not

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take steps to stamp and register the transfers of the Shares until 2 August 1996. Under the formal agreement for the purchase of Property 1 of 3 July 1996, Company C was required to pay the balance of the purchase price on 2 August 1996. It appears that the Taxpayers did not find it necessary to register the Shares in their names until Company C was required to settle the purchase price of Property 1. Mr A gave evidence that Company C never advertised its business for provision of secretarial services. He said that he only informed clients of Company D of Company C's business of providing nominee directors and nominee shareholders. He explained that, as an accountant, he could not advertise for business. We do not accept this reason for not advertising. If there were business to be advertised, the party to advertise would be Company C and the business to be advertised would be the provision of secretarial services. Thus, the question of breaching accountants' professional rules by the Taxpayers did not arise. The conduct of the Taxpayers did not indicate a genuine desire on the part of the Taxpayers to provide secretarial services as claimed. Under the circumstances, we are not convinced that the Shares were acquired by the Taxpayers for the purpose of a business of providing secretarial service. It was merely an assertion on the part of the Taxpayers.

34. As to the Taxpayers' claim that the Shares were acquired also for the purpose of holding a property for rental income, we find that the Taxpayers have also failed to discharge the burden placed upon them to prove that Property 1 was acquired as a long term investment for rental purpose.

35. This Board is unable to accept that Property 1 was purchased by the Taxpayer's as an income producing investment. When Property 1 was acquired on 3 July 1996, it was still under construction. Until a certificate of compliance was issued, Property 1 could not be let out for rental income. The certificate of compliance was issued on 27 March 1997. But the Taxpayers entered into an agreement to sell the Shares on 15 October 1996 and completed the sale on 15 November 1996. This action was inconsistent with their expressed intention of acquiring the Shares for the purpose of holding a property for rental purpose. Property 1 was sold soon after it was acquired and long before it could produce income.

36. The Taxpayers claimed that their stated intention of acquiring Property 1 as a long term investment was supported by the fact that they elected to pay the purchase price in full and had a mortgage on Property 1, prior to completion of the purchase. They contended that an uncompleted property financed by a mortgage loan prior to completion, would only benefit end-users or investors like themselves because only end-users or investors would find comfort in the mortgage loan in case the property market fell upon completion. They argued that had they been traders intending to make a quick profit before completion, they would have elected to pay the purchase price in full upon completion. They claimed an uncompleted property with a mortgage loan, would hinder the sale of the property because prospective purchasers, especially if they were traders, would prefer a simple and quick transaction not involving a change or transfer of the mortgage loan and directors' guarantee; purchasers would have the disadvantage of being restricted to a mortgage loan based on the original purchase price and not the subsequent one; traders would not

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want to bear the burden of the mortgage loan, or perhaps they would not be able to obtain one; and, penalty would be payable upon early repayment of the mortgage loan. In addition, they claimed that especially at that time most of the prospective purchasers were traders. However, we do not accept the Taxpayers' contentions. In cross-examination, Mr A admitted that by making full payment prior to completion, they obtained a discount of the purchase price of Property 1. We find that this is a compelling reason for electing a full payment before completion. Also, though the property market was robust at the time, we have no evidence and we do not accept that most of the prospective purchasers were traders. Even if they were, we take the view that there are various types of traders. Some are financially healthier, less risk-taking or longer-ranged than the other. Thus, there is no hard and fast rule that traders in selecting properties would necessarily discriminate an uncompleted property with a mortgage attached.

37. In addition, we find the Taxpayer's reasons for selling Property 1 not convincing. The Taxpayers claimed that they decided to sell Property 1 after they learnt of the unfavourable conditions of Housing Estate G from a client of Mr A. If indeed those unfavourable conditions did exist as claimed, they were conditions already existed at the time when the Taxpayers acquired Property 1. Those conditions should have been taken into account by the Taxpayers. Further, it is inconceivable that the Taxpayers' assessment of Property 1 could instantly be changed by one person's views. They claimed that the other reason prompted the sale, was the sharp rise in the property market. Realizing a quick profit is a predominant objective of a speculator. The Taxpayers were acting typically of a speculator.

38. The Taxpayers contended that the sum of \$650,000 received by them from the purchasers of the Shares was compensation for their loss of directorship in Company C. This contention is totally unfounded. There were no service contracts between the Taxpayers and Company C and Company C never paid the Taxpayers director fees. Hence, there was no reason for payment of compensation for loss of office to the Taxpayers. Further, under both the provisional sale agreement of 15 October 1996 and the formal sale agreement of 22 October 1996, not only that there was no provision for payment of compensation, the sum of \$650,000 in fact formed part of the consideration for the Shares.

39. We conclude from the facts of this case that the Taxpayers bought Property 1 with the intention to resell it. We are in no doubt that the sale of the Shares did not, on the facts, represent the realization of an investment but must be regarded as something done in the course of an operation of business, undertaken in pursuance of a profit making scheme and that the profit realized was accordingly income and not accrual of a capital nature.

40. Accordingly, the appeals must fail. We hereby dismiss the appeals and confirm the determinations.

Order under section 68(9) of the IRO

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41. Under section 68(9) of the IRO, where after an appeal the Board does not reduce or annul the assessment, the Board may order the Taxpayer to pay costs of the hearing up to a maximum amount of \$5,000. The Taxpayers, as an assessor or an ex-assessor, must be fully aware of the provision of section 68(9). By bringing these appeals before the Board, they must also be prepared for an order of costs to be made against them in case of an unsuccessful appeal. Thus, pursuant to section 68(9), we now order each of the Taxpayers to pay the sum of \$3,000 as costs under their respective appeals, which sums, they no doubt realize, represent only a small portion of the costs of these proceedings.