INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D74/91

Profits tax – Holding company – sale of shares in subsidiaries – whether profit taxable.

Panel: Willaim Turnbull (chairman), Andrew J Halkyard and Joseph E Hotung.

Dates of hearing: 11, 12, 13 & 16 December 1991.
Date of decision: 10 March 1992.

The taxpayer was a Hong Kong public company which did not carry on business itself but used a number of subsidiary companies for this purpose. The taxpayer embarked upon a major property development using a number of subsidiary companies. The taxpayer disposed of shares in some of the subsidiary companies at a profit to third parties and received a substantial deposit paid in respect of the sale of shares in another subsidiary. The profits including the received deposit were assessed to profits tax. The taxpayer appealed and submitted that it had not traded in the shares of its subsidiaries and accordingly was not liable to profits tax.

Held:

On the evidence before it the Board found as a fact that the taxpayer had not embarked upon trading in shares in subsidiaries and had not engaged in an adventure in the nature of trade.

Appeal allowed.

Cases referred to:

Beautiland Co Ltd v CIR [1991] STC 467
D13/87, IRBRD (unreported)
Simmons v IRC 53 TC 461
Ransom v Higgs 50 TC 1
Taylor v Good 49 TC 277
Wing On Cheung Investment Co Ltd v CIR [1987] 3 HKTC 1
Cooper v C & J Clark Ltd 54 TC 670
IRC v Dr CHANG Liang-jen 1 HKTC 975
IRC v Fraser 24 TC 498
Waylee Investment Ltd v CIR [1990] 3 HKTC 410
Leeming v Jones 15 TC 333
IRC v Reinhold 34 TC 389
IRC v Livingston 11 TC 538

D31/87, IRBRD, vol 2, 409
D19/88, IRBRD, vol 3, 255
D30/87, IRBRD (unreported)
CIR v IRBR and Aspiration Land Investment Ltd [1988] MP 1504
Californian Copper Syndicate v Harris [1904] 5 TC 159
Tebrau (Johore) Rubber Syndicate Ltd v Farmer 5 TC 658
Rhodesia Metals Ltd v TC [1940] AC 774
D65/87, IRBRD, vol 3, 66
Fundfarms Developments Ltd v Parsons 45 TC 707
Marson v Morton [1986] WLR 1343
The Hudson's Bay Co Ltd v Stevens 5 TC 424
FCT v Whitfords Beach Pty Ltd [1982] 12 ATR 692
CIR v Waylee Investments Ltd [1988] 2 HKTC 483
Fraser (Glasgow) Bank Ltd v CIR [1963] 40 TC 698
Associated London Properties Ltd v Henriksen [1944] 26 TC 46
BR 12/74, IRBRD, vol 1, 233
Pickford v Quirke [1927] 13 TC 251
Income Tax Case No 1187 [1972] 35 SATC 141
D19/85, IRBRD, vol 2, 182
Overseas Textile Ltd v CIR [1987] 3 HKTC 29
D30/87, IRBRD (unreported)

D Milne, QC for the Commissioner of Inland Revenue.
John Gardiner instructed by Woo, Kwan, Lee & Lo for the taxpayer.

Decision:

This is an appeal by a Hong Kong public company against two assessments to tax wherein the assessor had assessed to tax certain gains or profits which had been made when the shares in two subsidiary companies were sold and a third subsidiary was unsuccessfully sought to be sold. At the hearing of the appeal, the parties tabled before the Board a statement of facts which were not in dispute. For convenience we set out the statement, edited for the purposes of this decision, as follows:

Statement of facts not in dispute

1. The Taxpayer has objected to the profits tax assessments raised on it for the years of assessment 1983/84 and 1985/86. By these assessments, as varied on objection by the Commissioner it is sought to charge to profits tax the following:

   (1) Year of assessment 1983/84

(a) The surplus arising on the disposal of the whole of the share capital of Subsidiary One: $74,536,155.

(b) The amount in respect of the deposit received on the cancellation of the agreement for the sale of the whole of the share capital of Subsidiary Two: $41,285,670.

(2) Year of assessment 1985/86

The surplus arising on the disposal of the whole of the share capital of Subsidiary Three: $195,626,193.

2. The Taxpayer is a public company incorporated in Hong Kong in early 1970's and whose shares are quoted on The Stock Exchange of Hong Kong Limited. Its memorandum and articles of association were tabled before the Board. It is the holding company of a group of companies. In its directors' report (which formed part of its published accounts) for all the years ended from and including 30 June 1977 to 30 June 1987 under 'principal activities' it is stated that:

> 'The principal activity of the company [the Taxpayer] is investment holding and those of its subsidiaries are as shown in note (1a) to the accounts.'

Note (1a) gives a brief description of the activities of each subsidiary. The Taxpayer's published annual reports and accounts for the years of assessment 1973 to 1991 and the Taxpayer's detailed profit and loss accounts for the nine years ended 30 June 1987 were tabled before the Board. In the Taxpayer's balance sheets, its holdings in subsidiaries are included under the heading 'interest in subsidiaries' and this included the holdings in the three subsidiaries subsequently mentioned herein.

3. The Taxpayer's main sources of income are dividend and interest income received from its subsidiaries and associated companies. Apart from the present assessments, the Taxpayer has never been assessed to profits tax in respect of any surplus arising on the disposal of shares in subsidiaries and associated companies.

4. The facts relating to the three subsidiaries are set out hereunder.

5. (A) Subsidiary One

(1) Subsidiary One was a private company incorporated in Hong Kong in mid-1973. The whole of its share capital was acquired by the Taxpayer on incorporation and it remained a

wholly-owned subsidiary of the Taxpayer until it was disposed of as set out at paragraphs (A)(8) and (13) below.

(2) At all material times, Subsidiary One's issued share capital was $200.

(3) Subsidiary One acquired a property in Hong Kong ('Y property') in late 1975.

(4) Y property was at all material times classified in Subsidiary One's audited accounts under the heading 'current assets'.

(5) In the Taxpayer's annual reports and accounts the following references are made to Y property:

(i) 1979

'Site formation work has commenced on this site, on which a residential block will be built.'

(ii) 1980

'Site formation and foundation for this property have been completed. Work on the superstructure has commenced for the development of a block of flats which when completed will be retained for rental income.'

(iii) 1981

'The development of this block of flats is progressing according to schedule and is expected to be completed by the end of 1981. The group has entered into an agreement for the sale of this development instead of retaining it for rental income.'

(iv) 1982

'This block of flats has a total gross floor area of about [area mentioned]. The entire block has been leased to the Hong Kong Government. Agreement was reached for the sale of the subsidiary company owning this property in mid-1982 at a satisfactory price.'

(6) In 1981, X Ltd, a wholly-owned subsidiary of the Taxpayer wrote letters offering to arrange for Y property to be leased to the Hong Kong Government, following negotiations between X Ltd and the Rating & Valuation Department.

(7) In mid-1981, C Ltd made an offer to acquire the whole of the share capital of Subsidiary One. The Taxpayer replied a month later.

(8) In late 1981, the Taxpayer entered into an agreement with I Ltd and O Ltd for the sale and purchase of the whole of the issued share capital of Subsidiary One.

(9) The development of Y property was carried out by and at the expense of Subsidiary One.

(10) In late 1981, the Taxpayer requested a certificate of compliance from the Crown Lands and Survey Office, Modification Division, in respect of the conditions of modification of the Crown Lease in respect of Y property. The Modification Division replied to this request in early 1982, indicating that no such certificate was in fact required, and that none would therefore be issued.

(11) Subsidiary One entered into a tenancy agreement with the Colonial Treasurer incorporated in early 1982 for the rental of the whole of Y property.

(12) No dividend was paid by Subsidiary One throughout the period under consideration.

(13) The sale of the shares in Subsidiary One was completed in mid-1982.

(14) The 3,900,000 shares in I Ltd and 900,000 warrants to subscribe for shares in I Ltd which the Taxpayer received pursuant to the agreement as part of the consideration for the sale of shares in Subsidiary One were disposed of by the Taxpayer at a profit of $3,063,155.03 (including dividend income from I Ltd received before disposal).

(15) It is agreed that the surplus arising from sale of shares in Subsidiary One is $74,536,155 which is arrived at as follows:

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Sales Proceeds			104,240,800.00
Less:	Cost of investment	200.00	
	Amount advanced to Subsidiary One	30,348,725.82	
	Sales commission	1,138,000.00	
	Professional charge	100,635.00	
	Stamp duty	221,679.00	31,809,239.82
			72,431,560.18
Add:	Profit on disposal of I Ltd's shares		3,063,155.03
			75,494,715.21
Less:	Dividend from I Ltd's shares		958,560.00
			74,536,155.21

(16) The said surplus of $74,536,155.21 together with dividend from the I Ltd's shares of $958,560 were included in the Taxpayer's profit and loss account in the year ended 30 June 1983 as an extraordinary item.

(17) The Taxpayer did not offer the said surplus arising on the disposal of Subsidiary One for assessment to profits tax in its tax computation for the year of assessment 1983/84 and the assessor accepted that computation.

(18) Subsequently, upon reviewing the profits tax position of the Taxpayer for the year of assessment 1985/86, the assessor

raised a profits tax assessment on the Taxpayer for the year of assessment 1983/84 which included an amount of $75,494,715, arising on the sale of Subsidiary One. The Commissioner determined that only the said surplus of $74,536,155 which excluded dividend from the I Ltd's shares should be assessed to tax.

(19) Subsidiary One's financial statements for the seven years ended 30 June 1982 were tabled before the Board. No financial statements have been prepared from incorporation to the year ended 30 June 1975.

(B) Subsidiary Two

(1) Subsidiary Two is a private company which was incorporated in Hong Kong in late 1972. At all relevant times, it had an issued share capital of $10,000. The Taxpayer acquired the whole of its share capital on incorporation.

(2) Subsidiary Two acquired various properties in Road X, the details of which are:

Inland Lot No (Road X No)	Date acquired	Acquired from	Consideration
A (#14)	late 72	S Ltd	$2,658,420
B (#12A)	mid 73	E Ltd	$4,710,110
C (#18)	late 81	Subsidiary Three	$14,631,835* (part)
D (#18)	late 81	Subsidiary Three	*
E (#17 and 17A)	late 81	Subsidiary Three	*
F (#21)	late 81	Subsidiary Three	*
G (#19)	late 81	B Ltd	$57,240,000

H (#16)	late 81	P Ltd	$5,994,947
I (#15)	late 81	P Ltd	$6,241,780

(3) Sometime in 1979 or 1980, the Taxpayer's group reached agreement with the Government for a modification of the Crown Lease conditions relating to the properties held by the Taxpayer's group in Road X (including the above properties and properties held by Subsidiary Three). These properties were subsequently surrendered in exchange for Inland Lot No Q in mid-1982. Subsidiary Two's properties in Road X are referred to as site B.

(4) At all material times, the properties in Road X were classified as 'fixed assets' in Subsidiary Two's audited accounts.

(5) Subsidiary Two received rental from the properties. The following were disclosed in its accounts:

Year ended	Rental Income $
30 June 1979	76,006
30 June 1980	30,173
30 June 1981	171,114
30 June 1982	51,431

No rental was received after mid-1982, development having commenced prior to that date.

(6) The particulars and conditions of exchange in respect of site B were tabled before the Board. Special condition (11) thereof had the effect of preventing Subsidiary Two from disposing of site B without the consent of the Registrar General (Land Officer) until it had complied with the requirements of special condition (4), relating to the provision of roads and other ancillary services to the site.

(7) In the Taxpayer's annual reports and accounts the following references were made to the properties along Road X owned by Subsidiary Two (and Subsidiary Three).

(i) 1978

'Plans for the redevelopment of these properties are being considered and agreement has been reached with the Government to widen [Road X].'

(ii) 1979

'Plans have been approved by the Government for the widening of [Road X]. Phase 1 of the road construction work has commenced. Development plans of the group's properties along [Road X] are well under way.'

(iii) 1980

'The group owns several properties along this road, and in order to achieve a desirable development package the group had undertaken to improve the road to modern standards. Work has already started on the road improvement and planning of the project is well advanced. The overall concept has already been considered and approved by the Governor in Council and the Town Planning Board … It is our intention to retain the flats, in order to further strengthen our rental portfolio.'

(iv) 1981

'The group owns the majority of properties fronting Road X, and in order to achieve a desirable development package the group has undertaken to improve the road to standards laid down by the public works. The first phase of the road improvement contract has already been completed and work is about to start on the second and final phase. Planning for the development of the site is well advanced and the completed project will produce [area mentioned] comprising flats with all amenities.'

(v) 1982

'The group owns the majority of sites along Road X. Three clusters of sites with [area mentioned] are now being redeveloped. In order to increase their development potential, the group has an undertaking with the Government to widen the road in two phases. The first phase of the road widening has been completed and the second phase is progressing on schedule and is expected to be completed in 1984. Site formation work for these sites is being carried out and it is anticipated that the development of these three sites into residential apartment blocks with [area mentioned] will be completed in 1985.'

(vi) 1983

'Altogether there are three different sites (A, B and C sites) with [area mentioned] along [Road X]. The final phase of the road improvement work, which is required under the surrender and regrant arrangement with the Government, is expected to be completed in mid-1984. An agreement has been entered into for the development of a block of apartments on site C for M Ltd. The total gross floor area is [area mentioned]. The progress of the development is on schedule and it is expected that completion will take place in mid-1984.

Site B was previously pre-sold to a third party at a very favourable price at the height of the property market boom in 1981. Due to financial difficulty experienced by that third party, the presale was cancelled and the deposit was forfeited.'

(vii) 1984

'The improvement of the road works at [Road X] was finalised in mid-1984 as scheduled and, of the company's three different sites at this location, the development of site C was completed in late 1984 and the block of apartments on the site was handed over to M Ltd in late 1984. The development of sites A and B is proceeding on schedule.'

(viii) 1985

'As reported in the interim announcement, the sale of Subsidiary Three, which owned [Road X] site C, to M Ltd was satisfactorily completed in late 1984.'

(ix) 1986

'In the construction work in [Road X Building L and Building R] is proceeding.'

(x) 1987

'Construction work is progressing well on our remaining residential projects under development, site B (phase II), site A and another property.'

(8) In late 1981, C Ltd wrote to the Taxpayer in the terms of the letter tabled before the Board. On 26 September 1981, the Taxpayer and F Ltd entered into an agreement for the sale and purchase of the whole of the share capital of Subsidiary Two. F Ltd was 50% owned by I Ltd and 50% owned by H Ltd. In turn H Ltd was a wholly-owned subsidiary of the Taxpayer.

(9) By an agreement in early 1983 the Taxpayer and F Ltd agreed to cancel the agreement of late 1981. In consequence, the Taxpayer was entitled to retain the deposit paid.

(10) The minutes of directors' meetings approving the proposed sale of the Subsidiary Two and its subsequent cancellation were tabled before the Board.

(11) It is agreed that the surplus arising to the Taxpayer from the cancellation of the agreement is $41,285,670 which is arrived at as follows:

		$	$
Deposit received			95,826,675
50% thereof			47,913,337
Less :	Commission paid	6,582,667	
	Professional and Consultant fee	45,000	6,627,667

41,285,670
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(12) The said surplus was included in the Taxpayer's profit and loss account for the year ended 30 June 1983 as an extraordinary item.

(13) In late 1985, the board of directors of Subsidiary Two approved the transfer of site B from fixed assets to current assets at the then value of $260,000,000. Subsidiary Two sold the whole of site B in the year to mid-1987.

(14) The Taxpayer continues to own the whole of the share capital of Subsidiary Two which is now dormant, having distributed the whole of its profits from development by way of dividend.

(15) Subsidiary Two's financial statements from incorporation to the year ended 30 June 1983 were tabled before the Board.

(C) Subsidiary Three

(1) Subsidiary Three was incorporated in Hong Kong in late 1976. It was a wholly-owned subsidiary of the Taxpayer from incorporation to late 1984. At all relevant times its authorised and issued share capital was $10,000. Its principal activity was property investment and development.

(2) In late 1977, Subsidiary Three completed the purchase of a number of properties along Road X.

(3) Subsidiary Three earned rental income from these properties up to the year ended mid-1979 when the redevelopment of the properties commenced.

(4) No dividend was paid by Subsidiary Three throughout the period under construction.

(5) 4 of the properties forming part of site B were subsequently transferred to Subsidiary Two in late 1981 to comply with the conditions for the modification and regrant of sites A, B and C. Subsidiary Three was then left with the remaining 2 properties, which is referred to as site C.

(6) The particulars and conditions of exchange in respect of site C were tabled before the Board. Special condition (12) thereof had the effect of preventing Subsidiary Three from disposing

of site C without the consent of the Registrar General (Land Officer) until it had complied with the requirements of special condition (5), relating to the provision of roads and other ancillary services to the site.

(7) The references in the Taxpayer's annual report and accounts to the development of Road X properties and the intention in respect of the same are set out under paragraphs (B)(7)(i) to (x) above. References to site C are references to Subsidiary Three's property.

(8) At all material times, properties at Road X were classified under the heading, 'fixed assets' in Subsidiary Three's accounts.

(9) In late 1980, M Ltd wrote a letter offering to purchase from the Taxpayer the property to be built on site C. This offer was accepted in principle by the Taxpayer 2 days later. In mid-1981, M Ltd confirmed that it would purchase the shares in Subsidiary Three instead of the property itself.

(10) In late 1981, the Taxpayer entered into an agreement with M Ltd for the sale of the whole of the share capital of Subsidiary Three. That agreement was supplemented by an agreement between the same parties in mid-1983.

(11) The sale of the shares in Subsidiary Three was completed in late 1984 after the completion by Subsidiary Three of its development.

(12) Resolutions of the board of directors of the Taxpayer and Subsidiary Three approving the two agreements were tabled before the Board of Review.

(13) It is agreed that the surplus arising from the sale of shares in Subsidiary Three is $159,612,193 which is arrived at as follows:

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Proceeds on disposal	
Cash	30,000,000.00
Promissory notes (of which $357,000,000 was discounted	

to bank)		407,000,000.00
		437,000,000.00
Less:	Interest on $357,000,000 promissory notes discounted	67,424,444.18
	Net proceeds	369,575,555.82
	Book cost of investment	(171,379,247.43)
	Other costs	
	Professional fees for agreement of sale	(282,543.60)
	Discount facility agreement	(36,346.00)
	Supervising the completion of sale	(150,560.00)
	Others	(9,565.00)
	Bank charges	
	Commitment fee on discount facility	(241,438.36)
	Commission on guarantee	(281,250.00)
	Management fee on discount facility	(592,850.00)
	Charges on letters of guarantee for payment of interest	(975,561.64)
	Provision for contingency	(36,014,000.00)
		159,612,193.79

(14) The said surplus was included as an extraordinary item in the Taxpayer's profit and loss account for 1985.

(15) The Commissioner has determined that the sum of $36,014,000 being a provision for contingency which he has disallowed for tax purposes, should be added to the said surplus and the total amount of $195,626,193 should be assessable to tax.

(16) In the Taxpayer's annual report for the year ended 30 June 1986, certain items included as extraordinary items in the consolidated profit and loss account for the year ended 30 June 1985 have been reclassified and included as ordinary items under operating profit as to conform with the new guideline published by the Hong Kong Society of Accountants in late 1985 regarding the interpretation of extraordinary items. These certain items are as follows:

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Provision for diminution in value of unquoted investment associates – K Ltd	(32,800,000.00)
Other investments – T Ltd	(25,700,000.00)
Gain on disposal of a subsidiary - Subsidiary Three	159,612,193.79
Gain on disposal of unquoted investments	
Other investments –	
W Ltd	227,736.88
N Ltd	473,722.70
	$101,813,653.37

(17) Subsidiary Three's financial statements from incorporation to the year ended 30 June 1977 and seven years ended 30 June 1985 were tabled before the Board.

At the hearing the Taxpayer tabled before us a number of documents which comprised the memorandum and articles of association of the Taxpayer, the audited accounts and reports of the Taxpayer for the relevant years, the audited accounts of the three

subsidiaries for the relevant years, and some correspondence relating to the sale of Subsidiary One and Subsidiary Two.

Two witnesses were called to give evidence on behalf of the Taxpayer. The first was the partner of the firm of auditors who had been responsible throughout the period in question for the audit of the accounts of the Taxpayer and its subsidiaries and the other was the deputy managing director of the Taxpayer who had also been a director of all of the three subsidiary companies.

The auditor gave clear evidence and had a very good recollection of the accounting affairs of the Taxpayer and its subsidiaries. His evidence was given with precision. It was clear from his evidence that he had a close association with the Taxpayer and its subsidiaries throughout the history of the Taxpayer from the time when it first became a listed public company in Hong Kong. Counsel for the Commissioner submitted that the evidence of the auditor and of the audited accounts does not change the fundamental facts and is not binding as a matter of fact upon this tribunal. He also submitted that the evidence given by the auditor was in effect hearsay evidence because he could do no more than tell the Board what he had been informed by the directors of the Taxpayer when he was doing the audit.

It is well established law that the manner in which assets are treated in accounts does not and cannot change the actual nature of the assets. However, the manner in which the assets are treated in audited accounts is not something which can simply be ignored. Assuming that the accounts are genuine and have not been prepared for a particular tax or other specific purpose, they are evidence of how the individuals concerned at the material time viewed the nature of the assets. Although this does not make a trading asset into a capital asset or vice versa, it is strong evidence of what the individuals thought at the time and what was their intention at the time. In the case of a public company, the accounts gain greater significance because if a statement is made in the accounts which is not correct, it can have serious consequences for those who make or approve the statement. Likewise we feel that the auditor was not repeating hearsay evidence but was giving actual evidence of his own state of mind at the time and giving evidence as to the due diligence which he had carried out at the relevant time in the course of his audit work to confirm that statements which had been made by others were in his opinion true and correct. If the directors of the Taxpayer had sought to shelter behind the evidence of the auditor, then we would have some hesitation in giving great weight to the evidence of the auditor because the best evidence of the company's intention must usually be that which is given by its directors. However, in the present case, a senior director of the Taxpayer was called to give evidence and to offer himself for cross-examination.

Though there were some inconsistencies in the evidence given by the director, we accept the evidence given by him. He was giving evidence about matters which had happened many years ago. Furthermore, when hearing and assessing evidence, it is always necessary to consider what a witness says in the light of the uncontrovertible objective facts.

From the evidence of the two witnesses we find the following additional facts:

1. The modus operandi of the Taxpayer in carrying on its property business was to acquire sites for development in the name of separate subsidiaries. The Taxpayer did not itself carry on any property development or trading activities in its own name. It was purely a holding company holding shares in subsidiaries.

2. Each subsidiary was both owned and controlled by the Taxpayer and accounted to the Taxpayer for the profits which it made in the business which it carried on by way of declaring and paying dividends to the Taxpayer.

3. The Taxpayer was a substantial company which had a significant number of subsidiaries at any one time. For the two years of assessment under appeal, the Taxpayer had a number of principal subsidiary companies.

4. From the time when the Taxpayer came into existence and commenced business up to the date of the hearing of the appeal before the Board, the Taxpayer had on only five occasions disposed (or attempted to dispose) of shares in any of the subsidiary companies owned by it. At the time when the Taxpayer acquired or formed subsidiary companies, it was never its intention to trade in the shares of any such subsidiary company.

5. Apart from the three subsidiary companies in question, the Taxpayer disposed of subsidiary companies on only two occasions. The first was when a shell or shelf company was sold to a director of the Taxpayer for his own personal business purposes. The second was when the Taxpayer went into joint venture with a third party on a 50/50 basis and subsequently the joint venture partner wished to acquire the entire industrial building which had been built and developed as a joint venture and the third party acquired 100% of the joint venture company by purchasing the 50% then owned by the Taxpayer. Accordingly, apart form those two occasions and the three occasions which are the subject matter of this appeal, the Taxpayer from the date when it commenced its business in early 1970's up to the end of 1991 had not sold or disposed of any of its shares in any of its subsidiary companies.

6. At the time when Subsidiary One acquired Y property, it was the intention of Subsidiary One to demolish the existing building and redevelop the site. Subsidiary One had not at the time of acquisition of Y property decided whether or not the redevelopment would be with a view to sale or with a view to retention for rental income. Accordingly the property was classified by Subsidiary One as a current asset. In the course of the redevelopment, which was delayed over a number of years because of problems relating to acquiring legal title and rights of way, Subsidiary One decided to retain the property for long-term rental purposes. With a view to achieving this objective, Subsidiary One entered into negotiations with the Hong Kong Government for the leasing of the entire new building which it was then constructing. The negotiations

with the Hong Kong Government were conducted by another subsidiary of the Taxpayer on behalf of Subsidiary One. In the course of the negotiations with the Hong Kong Government, I Ltd made an approach to the Taxpayer with a view to acquiring Y property from Subsidiary One. Negotiations took place which resulted in an offer being made by I Ltd to the Taxpayer for the purchase of all of the issued share capital of Subsidiary One with the price based on the value of Y property owned by Subsidiary One. The reason why I Ltd offered to purchase the shares in Subsidiary One and not Y property is not known to the Taxpayer.

7. The Taxpayer formed the intention of acquiring as many sites as it could in Road X with a view to rebuilding and upgrading Road X and redeveloping the sites which would have a much greater development potential as a result of the rebuilding and improvement of Road X. It was the intention that the Taxpayer would retain the various new buildings which it constructed in Road X for long-term rental purposes. In accordance with the policy of the Taxpayer, the various properties in Road X were acquired in the names of various subsidiaries of the Taxpayer. The first sites in Road X were acquired by various subsidiaries of the Taxpayer (including Subsidiary Two) in late 1972. The Taxpayer continued to implement its objective by acquiring additional sites in Road X in the name of other subsidiaries including Subsidiary Two and Subsidiary Three in 1970's and thereafter required further properties in Road X in 1979 and 1981. Neither of these latter properties relate to this appeal.

8. The Taxpayer was successful in implementing its objective and through its subsidiaries it was able to acquire sufficient sites in Road X to enable it to negotiate on behalf of its subsidiaries with the Hong Kong Government for the exchange of land and the reconstruction and improvement of Road X. In summary, the Taxpayer through various subsidiaries acquired various sites in Road X in one form or another which ultimately became five separate and major developments, each owned by one single subsidiary. Two of the subsidiaries in question were Subsidiary Two and Subsidiary Three which are the subject matters of this appeal.

9. At the same time that I Ltd approached the Taxpayer with a view to acquiring Y property, I Ltd indicated an interest to the Taxpayer of also acquiring part of the Road X development. Subsequent to the completion of the purchase of Subsidiary One, I Ltd made an offer to the Taxpayer to purchase the share capital of Subsidiary Two at a very high price which was the highest price which at that time had ever been offered to any property in Hong Kong. It was not possible for the Taxpayer to cause Subsidiary Two to sell the property owned by Subsidiary Two because it was at that time subject to restrictions in the conditions under which it was held from the Crown. Accordingly it was necessary that the Taxpayer sell and I Ltd buy the whole of the issued share capital of Subsidiary Two.

10. A sale and purchase agreement was entered into with a subsidiary of or company nominated by I Ltd for the sale of the entire issued share capital of Subsidiary Two and a deposit was paid. Subsequently I Ltd were unable to complete the sale and purchase and the deposit paid was forfeited to the Taxpayer.

11. Following the failure of the sale to I Ltd, the Taxpayer caused Subsidiary Two to continue and to complete the development. In 1985 the Taxpayer decided in view of the then current market conditions to sell the property owned by Subsidiary Two and Subsidiary Two proceeded in 1986 to sell the property which it had redeveloped. Subsidiary Two made significant profits which it paid to its parent by way of dividend.

12. The Commissioner of Inland Revenue accepted that Subsidiary Two had acquired the property which it owned in Road X for long-term capital purposes and did not tax the profits made by Subsidiary Two when it sold the completed development.

13. Subsidiary Three, like Subsidiary Two was one of the subsidiaries of the Taxpayer which was used to acquire sites in Road X, to surrender the same to the Hong Kong Government as part of the road rebuilding and improvement project and to acquire a new grant of land for redevelopment purposes.

14. At the time when the Taxpayer was negotiating with the Government on behalf of its subsidiaries regarding the Road X project, an approach was made by a third party to the Taxpayer with a view to purchasing the redeveloped property in Road X owned by Subsidiary Three for the purpose of housing the senior staff of the third party company. An attractive price was offered for the property owned by Subsidiary Three but it was not possible for the Taxpayer to cause Subsidiary Three to sell the property because of the then current negotiations with the Government which had not been finalised. The matter was discussed with the lawyers concerned and the prospective purchaser suggested proceeding on the basis of a sale of the whole of the issued share capital of Subsidiary Three. In late 1981, a sale and purchase agreement was entered into by the Taxpayer to sell all of the issued shares in Subsidiary Three and, subject to certain amendments made subsequently to the terms of the sale and purchase which are not material to this appeal, the Taxpayer sold all of the share capital of Subsidiary Three at a substantial profit.

15. The Commissioner of Inland Revenue accepted that the intention of Subsidiary Three when it acquired its property in Road X was for the purpose of long-term investment and not as a trading asset.

16. So far as the other three properties in Road X which were acquired by other subsidiaries of the Taxpayer are concerned, and the property owned by Subsidiary Two is concerned, the properties owned by three of them including

Subsidiary Two have been sold by the subsidiaries with substantial profits to the subsidiaries which have been paid to the Taxpayer by way of dividend or loan to the parent. With the exception of Subsidiary Three, all of the other four subsidiary companies which owned property in Road X are still subsidiaries of the Taxpayer and have not been sold.

At the hearing of the appeal, the Taxpayer was represented by leading counsel who addressed the Board at considerable length as to the merits of his client's case. Having taken the Board through the statement of facts not in dispute and outlined the facts which the Taxpayer proposed to adduce in evidence and having taken the Board through the extensive number of agreed documents which were tabled before the Board, counsel for the Taxpayer addressed the Board with regard to the legal aspects of the case. Counsel for the Taxpayer referred us to the following authorities:

Beautiland Co Ltd v CIR [1991] STC 467

D13/87, IRBRD (unreported)

Simmons v IRC 53 TC 461

Ransom v Higgs 50 TC 1

Taylor v Good 49 TC 277

Wing On Cheung Investment Co Ltd v CIR [1987] 3 HKTC 1

Cooper v C & J Clark Ltd 54 TC 670

IRC v Dr CHANG Liang-jen 1 HKTC 975

IRC v Fraser 24 TC 498

Waylee Investment Ltd v CIR [1990] 3 HKTC 410

Leeming v Jones 15 TC 333

IRC v Reinhold 34 TC 389

IRC v Livingston 11 TC 538

D31/87, IRBRD, vol 2, 409

D19/88, IRBRD, vol 3, 255

D30/87, IRBRD, (unreported)

CIR v IRBR and Aspiration Land Investment Ltd [1988] MP 1504

Californian Copper Syndicate v Harris [1904] 5 TC 159

Tebrau (Johore) Rubber Syndicate Ltd v Farmer 5 TC 658

Rhodesia Metals Ltd v TC [1940] AC 774

D65/87, IRBRD, vol 3, 66

Associated London Properties Ltd v Henriksen [1944] 26 TC 46

Fundfarms Developments Ltd v Parsons 45 TC 707

Pickford v Quirke [1927] 13 TC 251

Marson v Morton [1986] WLR 1343

The Hudson's Bay Co Ltd v Stevens 5 TC 424

Counsel for the Taxpayer submitted that the shares which the Taxpayer sold in the three subsidiaries all constituted capital assets because they were capital assets when they were acquired by the Taxpayer. He further submitted that in any event their acquisition and disposal did not constitute a trade or an adventure or concern in the nature of trade within the meaning of the Inland Revenue Ordinance. He pointed out that the Taxpayer was a holding company with subsidiaries and that it did not carry on business in its own name but acted as a holding company with its subsidiaries carrying on their own respective businesses. He pointed out that the shares owned by the Taxpayer in the three subsidiaries in question were acquired by it in the normal way and in accordance with the corporate policy of acquiring and holding shares in subsidiaries as investments which were part of the capital structure of the Taxpayer.

He drew our attention to the decision of the Privy Council in the Beautiland case and pointed out that the shares in all of the three subsidiaries concerned in this appeal had been owned by the Taxpayer for a number of years. He said that the objective facts made it clear that it was not the intention of the Taxpayer to trade in the shares of its subsidiaries and that this was in accordance with the subjective evidence given by the witnesses.

He said that it is necessary to look at the intention of the Taxpayer when it acquired the shares in the three subsidiary companies and ask whether they were acquired in the same way as the many other subsidiaries of the Taxpayer which were never sold or traded or whether they were acquired for the purpose of embarking upon a trade of dealing in shares of those subsidiaries. He submitted that it was obvious that there was no such intention to trade.

He pointed out that on the authorities which he was citing, particularly Simmons v IRC, 'an investment does not turn into trading stock because it is sold'.

He then drew our attention to the particular facts of Subsidiary Two. In this case the shares were acquired by the Taxpayer in 1972 and then subsequently there was an aborted sale during the period 1981 to 1983. He asked the question as to what was the status of these shares throughout the period from the beginning up to the present date. According to the Commissioner, the shares were trading stock when they were sold during the years 1981/1983. He asked if this meant that they were trading stock when they were acquired in 1972 and are still trading stock in 1991 or did they somehow become trading stock during the years 1981/1983 but not before and after. He submitted that such a situation was not realistic and that in truth they had remained as long-term investments from 1972 up to and including the present date and throughout the period 1981/83.

He pointed out that the determination of the Commissioner was given before the Privy Council decision in the Beautiland case. It had apparently been the view of the Commissioner that the Taxpayer had embarked upon a profit making scheme of land dealing carried out by dealing in the relevant shares in the three subsidiaries. The Privy Council in Beautiland had made it clear that there was no such concept as dealing in land through shares of a subsidiary company and that the Commissioner had been mis-guided accordingly.

He drew our attention to the fact that the land owned by two of the subsidiaries, namely, Subsidiary Two and Subsidiary Three had been accepted to be fixed assets so far as those two companies were concerned and that any disposal of the properties by those two subsidiary companies was a realisation of a capital asset with no liability to profits tax.

He submitted that on the facts before the Board, it could not be said that the Taxpayer had traded in the shares of its subsidiaries or had embarked upon a venture in the nature of trade in relation thereto.

The Commissioner was also represented by leading counsel who cross-examined the two witnesses called on behalf of the Taxpayer. He referred us to the following cases:

Californian Cooper Syndicate v Harris [1904] 5 TC 159

FCT v Whitfords Beach Pty Ltd [1982] 12 ATR 692

CIR v Waylee Investment Ltd [1988] 2 HKTC 483

Waylee Investment Ltd v CIR [1990] 3 HKTC 410

Fraser (Glasgow) Bank Ltd v CIR [1963] 40 TC 698

Associated London Properties Ltd v Henriksen [1944] 26 TC 46

BR 12/74, IRBRD, vol 1, 233

Pickford v Quirke [1927] 13 TC 251

Income Tax Case No 1187 [1972] 35 SATC 141

D19/85, IRBRD, vol 2, 182

Overseas Textile Ltd v CIR [1987] 3 HKTC 29

Beautiland Co Ltd v CIR [1991] STC 467

D30/87, IRBRD (unreported)

D65/87, IRBRD, vol 3, 66

Counsel for the Commissioner submitted that the Taxpayer had embarked on a scheme of profit making which in each case involved acquiring a subsidiary company which was then made into an entirely different company by injecting into it a piece of land with development potential. He said that the Taxpayer had done everything necessary to maximise the value of its shareholdings in its three subsidiaries with a view to either selling the shares as soon as it could after maximising their value or by procuring the sale of the land. He said that on this basis the profit which was made by the Taxpayer from the sale of the shares and from the forfeiture of the deposit on the aborted sale was a profit from an adventure in the nature of trade and was not a capital profit and was accordingly liable to profits tax.

Alternatively he submitted that the profit made was not a capital profit and being a profit made in the course of business was taxable under the provisions of section 14 of the Inland Revenue Ordinance.

He conceded that if we accepted the evidence of the director of the Taxpayer then the profit was a capital profit. With due respect we feel that this concession may go too far because though, as we have said above, we accept the evidence given by the two witnesses, this is not in our opinion a complete answer to the case one way or the other. It is necessary to analyze the facts both subjectively and objectively to find out the true nature of what the Taxpayer actually did and intended to do.

Counsel for the Commissioner submitted that there was little value in considering the intention of the Taxpayer when it acquired the shares in the three subsidiaries because the Taxpayer had no positive intention with regard thereto at that date. We see the force of this submission but at the same time on the evidence before us we find that the Taxpayer as a matter of fact had formed an intention with regard to the shares in the three subsidiaries at the time when the subsidiaries were acquired by it even though they were shelf companies. On the evidence before us we can find s a fact that when the

Taxpayer acquired the shares in these three subsidiaries, it did so in the ordinary course of carrying on its business which was to form or acquire subsidiaries with a view to such subsidiaries carrying on their own independent business as independent entities under the overall umbrella of the Taxpayer. We find as a fact that when the Taxpayer acquired the shares in these three subsidiaries, it had no intention of subsequently disposing of the shares in the three subsidiaries and it intended to hold them as capital assets.

We do, however, note that the facts of this case are in many ways unique. We would not go so far as counsel for the Taxpayer would like and accept that a company cannot trade in the shares of its unlisted subsidiaries or cannot embark upon an adventure in the nature of trade in respect of the shares in one or more of its subsidiaries. It appears to us that a company is able to either trade in shares of subsidiaries or embark upon a single adventure in the nature of trade in respect of one or more subsidiaries. If the evidence before us had been to the effect that the Taxpayer, in the course of its business, had formed subsidiaries with no fixed view as to whether to cause those subsidiaries to sell their properties at a profit or alternatively to sell the shares which it owned in such subsidiaries at a profit, then we would not hesitate to find in favour of the Commissioner. However, the facts before us go all the other way. The Taxpayer did not as a matter of custom and practice sell shares in its subsidiaries. Over a period of very many years starting in the year when the Taxpayer was first incorporated and started business, right up to the actual hearing of this appeal, the Taxpayer had only disposed of shares in four of its subsidiaries and attempted to dispose of shares in one further subsidiary. In each case there were specific reasons why the Taxpayer disposed of it shares which demonstrated that it was contrary to its normal practice so to do. The company director giving evidence made reference to the fact when shares are sold as opposed to the sale of the underlying assets, it is necessary for the vendor to give warranties or guarantees of an ongoing nature with regard to the shares which are being sold. He said that it was contrary to the policy of the Taxpayer to give such onerous undertakings or guarantees. We accept this evidence.

This is not a case of a company which formed subsidiaries in the hope that someone would come forward at an appropriate time to purchase either the shares in the subsidiary from the parent or the property from the subsidiary. We have no doubt that there are many companies which when they form subsidiaries have this intention. Indeed, it is common knowledge at the present time in Hong Kong that many people who speculate in the property market do so by forming companies which own property with the intention that the shares in the company and not the property will be sold at profit. We have no hesitation in saying that in such circumstances the profit which arises on the sale of the shares in such a company would be subject to profits tax as being either trading in the shares of such companies or an adventure in the nature of trade.

Counsel for the Commissioner put forward a cogent argument based on the proposition that when the Taxpayer acquired each of the three subsidiaries in question, it had no specific intention with regard to such subsidiaries. He developed his submission by saying that the intention of the Taxpayer did not become manifest or was not decided until the time when the Taxpayer decided to inject a property into the particular subsidiary. He submitted that at this moment in time the subsidiary took on a totally different character and

that the intention of the Taxpayer must be considered at that moment in time. He submitted that until then the parent had not formed any specific intention with regard to its subsidiary. As we have mentioned this submission is cogent and if the facts were such, it would carry great weight. However, in the present case, there is no indication that at the time when the Taxpayer decided to inject a particular property into one of the three subsidiaries in question, there was any change of intention or any intention on the part of the Taxpayer to trade in the shares of that subsidiary. As we have said the Taxpayer in this case is in many ways unique. Some property developers in Hong Kong would find it difficult to substantiate, as a matter of fact, the proposition that they did not trade in the shares of subsidiaries or had not formed a specific subsidiary with the intention of disposing of the shares in that subsidiary. However, in the present case we find that, as a matter of practice and of fact, the Taxpayer did not embark upon trading in shares in subsidiaries or engage in an adventure in the nature of trade in relation to the shares of any one or more subsidiary.

It would be possible as suggested by counsel for the Commissioner for a person to form a shelf or shell company as a capital asset and then subsequently have a change of intention to convert the shares of such company to trading stock, for instance at the time a property development project is injected into the company. However, clear evidence of such a change of intention is necessary. In the present case we have no such evidence. On the evidence before us and the facts found by us, it was the intention of the Taxpayer at the time when it caused its three subsidiaries to acquire property that it would retain the shares in such subsidiaries.

In reaching our decision we have also taken note of an apparent incongruity if we accepted the submission made on behalf of the Commissioner. Apparently the Commissioner accepts that the properties owned by Subsidiary Two and Subsidiary Three are or were capital assets. Obviously it is possible for a person to form a subsidiary with the intention of selling the shares in the subsidiary and at the same time give the subsidiary the intention that the subsidiary itself will hold the underlying property as a long-term investment. However, such facts would indeed be unusual in Hong Kong and there would have to be clear evidence of such different intentions. In the present case, not only do we have no clear evidence of such a conflicting intention, but actually we have evidence to the contrary.

On the facts before us we find in favour of the Taxpayer. We find that the shares in the three subsidiary companies in question were all capital assets when they were acquired by the Taxpayer and that there was no subsequent change of intention and, in particular, there was no change of intention at the time when the Taxpayer caused the three subsidiaries to acquire valuable properties.

For the reasons given this appeal is allowed and the assessments appealed against are referred back to the Commissioner to be reduced accordingly.