INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D92/01

Profits tax – properties transferred between closely related companies – whether properties held as agent or on long term basis.

Panel: Ronny Wong Fook Hum SC (chairman), Patrick James Harvey and Andrew Mak Yip Shing.

Dates of hearing: 9, 10 and 11 July 2001.
Date of decision: 31 October 2001.

Company A-HK was a subsidiary of Company A-Korea. In December 1988, Company A-HK bought some properties. The Foreign Exchange Regulations then in force in Korea discouraged heavy overseas property investment.

In December 1990, Company A-HK sold the properties to Company H, the appellant, which was closely related to Company A-HK. However, the transaction was only completed in November 1994.

In March 1995, the appellant sold part of the properties at profits.

The appellant contended that they were not liable for profits tax. The main grounds being they held the properties as agents for Company A-HK and on long term basis.

Held:

1. The Board found Company H acquired the beneficial interest in the properties in December 1988 and their intention should be ascertained then. Having considered all the documentary evidence, the Board rejected the contention that Company H held the properties as agent for Company A-HK.

2. Having considered the Korean Regulation then in force, the Board also concluded that Company H did not intend to hold the properties on long term basis when they acquired them in December 1990 for fear that the Korean Government might detect the true beneficial interest in it.

Appeal dismissed.

Cases referred to:

Lionel Simmons Properties Limited v The Commissioner of Inland Revenue [1980] 53 TC 461

CIR v Waylee Investment Limited [1990] 1 HKLR 107

Waylee Investment Ltd v CIR [1991] 1 HKLR 237

All Best Wishes Ltd v CIR 3 HKTC 750

Victor Gidwani instructed by Department of Justice for the Commissioner of Inland Revenue.
Dennis Law Shiu Ming instructed by Messrs Chu & Chu, Certified Public Accountants, for the taxpayer.

Decision:

Background

1. Company A-HK is a company incorporated in Hong Kong on 23 December 1977.

(a) The following Korean nationals were directors of Company A-HK at the material times

Name	From	To
Mr B	20-9-1985	30-11-1994
Mr C	20-9-1985	1-11-1990
Mr D	23-4-1985	10-1-1990
Mr E	10-1-1990	11-2-1992
Mr F	30-4-1990	15-7-1995

(b) At the material times, the issued share capital of Company A-HK consisted of 2,340 shares. 2,339 shares were registered in the name of Company A-Korea, a company incorporated in Korea. As at 14 October 1987, the remaining one share in Company A-HK was registered in the name of Mr D who held the same on trust for Company A-Korea. On 6 August 1990, Mr D transferred the one Company A-HK share to Mr E. Mr E acknowledged that he holds the one Company A-HK share upon trust in favour of Company A-Korea by a declaration of trust of the same date.

2. By an agreement dated 21 December 1988, Company A-HK acquired from Bank G 15/F and 16/F of Bank G Tower together with eight car parking spaces on 4/F (hereinafter referred

to respectively as 'the 15/F', 'the 16/F' and 'the car parking spaces') for $143,000,000. The purchase was subject to eight tenancies on the 15/F and a single tenancy in respect of the 16/F. The purchase was duly completed on 3 February 1989.

3. This acquisition by Company A-HK was made pursuant to resolutions passed at a meeting of its directors held on 3 February 1989. Mr B, Mr C and Mr D were the directors present at this meeting. They resolved that 'the company should purchase the property for its own use as a long term investment'.

4. Company A-HK moved into Bank G Tower in about October 1989. They occupied 80% of the 15/F for its own office use. They rented more than 60% of the 16/F to a related company of Company A-Korea.

5. Under clauses 14-24 and 14-25 of the Foreign Exchange Regulations then in force in Korea, loans by a Korean company to its overseas subsidiary were confined to loans in the nature of trade finance. Such loans should be 'limited to 12 months and cannot exceed total 18 months including inevitable extensions'. These regulations reflect the then government policy of the Republic of Korea in discouraging heavy overseas property investment. It is the case of the Appellant ('Company H') that these regulations were loosely monitored prior to the 'June Fourth Event' in 1989. They were tightened up after that event. Hong Kong was regarded as unstable at that time.

6. In the financial report of Company A-HK for the year ended 31 December 1989, Company A-HK described its 'Principal Activity' as importers and exporters. Note 8 to the financial statements for that year indicates that 'Debtors and prepayments include a receivable of US$19,065,844 representing the proceeds from the disposal of the company's property which is due for completion on or before 3 February 1991.' The financial statements were audited by an accounting firm and signed by a director of Company A-HK on behalf of its board on 6 July 1990.

7. Company H is a company incorporated in Hong Kong on 28 October 1988.

(a) On incorporation, its authorised share capital was $10,000 divided into 10,000 shares. Two subscriber shares were issued and held in the names of Company I and Company J.

(b) On 24 October 1990, the authorised share capital of Company H was increased to $30,000. 29,998 shares were issued and allotted with 28,499 shares in favour of Company I and 1,499 shares in favour of Company K. Company J also transferred the one subscriber share standing in its name to Company K. Company K therefore held a total of 1,500 Company H shares and Company I held a total of 28,500 Company H shares including the one subscriber share.

(c) By a declaration of trust dated 24 October 1990, Company K declared that it held the 1,500 Company H shares upon trust for Mr E.

(d) By another declaration of trust also dated 24 October 1990, Company I declared that it held the 28,500 Company H shares upon trust for Company A-HK.

8. At a meeting of the board of directors of Company H held on 17 December 1990 and attended by Companies I and J, it was resolved that Company H should purchase the 15/F, the 16/F and the car parking spaces from Company A-HK for $148,800,000. Those directors approved the terms of a sale and purchase agreement and a supplemental agreement between Company H and Company A-HK. The minutes of this meeting made no reference to the reasons leading to Company H's acquisition of these properties.

9. By a sale and purchase agreement dated 17 December 1990 ('the 17 December 1990 Agreement'), Company A-HK sold to Company H the 15/F, the 16/F and the car parking spaces on the following terms and conditions:

(a) The consideration for the sale was $148,800,000 which had to be paid by Company H to Company A-HK upon the signing of this agreement.

(b) The purchase was to be completed on the working day immediately following the expiry of a seven-day notice in writing to be served by Company H on Company A-HK that Company H requires to complete.

10. By a supplemental agreement dated 17 December 1990 ('the 17 December 1990 Supplemental Agreement'), it was agreed between Company H and Company A-HK that Company A-HK will have the right to occupy such parts of the 15/F, the 16/F and the car parking spaces that are not subject to any tenancy and Company A-HK will pay Company H a monthly fee of $999,360 in respect of such occupation. Should completion of the sale and purchase be effected within two years from 17 December 1990, Company H is to grant a tenancy to Company A-HK in respect of the properties for the remainder of the two years' period. The 17 December 1990 Supplemental Agreement was amended by an agreement dated 17 December 1992 ('the 17 December 1992 Supplemental Agreement'). The monthly fee was revised to $638,480. Should completion take place within three years from the 17 December 1992 Supplemental Agreement, Company H is to grant a tenancy to Company A-HK for the remainder of the three years' period.

11. It is Company H's case that the consideration of $148,800,000 did not reflect the market value of the 15/F, the 16/F and the car parking spaces but was arrived at in the light of the costs incurred by Company A-HK computed as follows:

Nature of expenditure	**Amount** $

Purchase price at cost	143,000,000
1% agent fee on the purchase price	1,430,000
2.75% stamp duty on the purchase price	3,932,500
Solicitors fee and other expenses	437,500
Total	148,800,000

12. As pointed out in paragraph 10 above, the 17 December 1990 Agreement provided that the consideration of $148,800,000 be paid by Company H to Company A-HK upon signing of that agreement. The amount so paid by Company H was used by Company A-HK to offset the account receivables carried forward from the year 1989 as referred to in paragraph 6 above.

13. Company H did not raise the consideration of $148,800,000 payable under the 17 December 1990 Agreement by any mortgage finance. Instead, Company H utilised a US$20,000,000 facilities granted by Bank L at the request of Company A-HK. Those facilities were secured by a letter of indemnity from Company A-HK to Bank L dated 10 December 1990 and by a letter of awareness from Company A-Korea to Bank L of the same date. The facilities from Bank L were increased to US$40,000,000 on 16 December 1991 secured by a fresh letter of awareness from Company A-Korea. Bank L further revised the US$40,000,000 facilities on 16 December 1992. Bank L made it clear in their facility letter of 16 December 1992 that the facilities so extended were subject to their overriding right to terminate the facilities on demand whereupon the facilities would become immediately due and payable.

14. Company M is a company incorporated in the British Virgin Islands on 19 October 1993. Its share capital consisted of one bearer share evidenced by a certificate dated 2 November 1993.

15. By an instrument of transfer dated 29 December 1993, Company I transferred the 28,500 Company H shares then registered in its name to Company J. By a declaration of trust dated 29 December 1993, Company J declared that it holds the 28,500 Company H shares upon trust in favour of Company M.

16. By an assignment dated 1 November 1994, Company A-HK and Company H completed the sale and purchase of the 15/F, the 16/F and the car parking spaces pursuant to the 17 December 1990 Agreement.

17. By an agreement for sale and purchase dated 15 March 1995, Company H sold the 16/F and four car parking spaces to Company N for $212,500,000.

18. The issue before us is whether Company H is liable for profits tax in respect of the gains it made upon sale of the 16/F and the four car parking spaces.

The pre-hearing correspondence between Company H, Company A-HK and the Revenue

19. Mr Gidwani for the Revenue laid considerable emphasis on the fact that Company A-HK and Company H projected in the pre-hearing correspondence a drastically different case from the one being advanced before this Board. Wholly misleading information was furnished to the Revenue on various crucial aspects of this case.

20. In relation to its relationship with Company A-HK

(a) By letter dated 30 December 1996, Company H informed the Revenue that it 'has no direct relationship with [Company A-HK] or its directors'.

(b) By letter dated 29 May 1997, Company H informed the Revenue that it 'belongs to some Korean investors who had very close relationship with [Company A-HK]'.

(c) By letter dated 23 December 1998, Company H asserted that they 'traded' with Company A-HK in the years 1990 to 1992.

(d) By letter dated 27 March 1998, Company A-HK maintained that it 'belongs to some Korean investors who have close business relationship with the company. However, both [Company A-HK] and [Company H] were unrelated'.

(e) It was only on 23 December 1998 that Company H disclosed for the first time that Company H was beneficially owned by Company A-HK.

21. In relation to the reasons leading to the sale by Company A-HK to Company H

(a) On 27 March 1998, Company A-HK represented to the Revenue that their disposal was attributable to 'the political instability and the uncertainty of Hong Kong's economy' after the June Fourth Event. It was not suggested that the disposal was related in any way to Korean governmental regulations.

(b) On 23 December 1998, Company H explained to the Revenue that 'after the June Fourth incident in 1989 and upon the approaching of 1997 handover the management in the [Company A] group decided not to be seen as holding Hong Kong properties so as to reduce the political risk as exhibited in their Korean financial report'.

(c) It was only on 26 April 1999 that Company H asserted that '...later on in 1989, the Korean government suddenly imposed restrictions on all overseas Korean companies of purchasing overseas properties. Consequently, [Company A-HK]

needed to transfer the ownership of the premises to someone who held the same on [its] behalf so as to maintain its property investments in Hong Kong'.

22. In relation to the consideration depicted in the 17 December 1990 Agreement

(a) By letter dated 27 March 1998, Company A-HK represented to the Revenue that 'In view of the political instability and the uncertainty of Hong Kong's economy at that time, [Company A-HK's] management decided to dispose of the property. The properties were disposed of at cost and [Company A-HK] did not make any profits but had to suffer the loss for expenses on purchase and disposal of the property'.

(b) There was no suggestion in the letter of 27 March 1998 that the consideration was an artificial one fixed in the context of a transaction between related parties.

23. In relation to the reasons for postponing completion under the 17 December 1990 Agreement

(a) By letter dated 29 May 1997, Company H represented to the Revenue that 'The only reason why the assignment was on 1 November 1994 was because [Company H] had no extra fund to pay off huge stamp duty for the assignment as they borrowed heavily from bank to finance the purchase of the property. Not until their financial position is strengthened in 1994, they, with the permission of the seller, [Company A-HK], delay the signing of assignment for cash flow consideration.'

(b) There was no suggestion that the delay in completion was attributable to the fact that the sale was an internal property transfer without any change of beneficial interest.

24. In relation to lifting of Company H's corporate veil

(a) By letter dated 29 May 1997, Company H asserted that '...the relationship between the buyer and seller and [Company H] is irrelevant as to determine whether the disposal is capital in nature'.

(b) By letter dated 9 April 1998, Company H reiterated that '...great effort in trying to lifting the corporate veil seems not appropriate to determine whether the gain in question is capital or revenue in nature...'.

Case of Company H before us

25. Company H submitted for our consideration written statements from Mr E and Mr F. Mr F also gave sworn viva voce evidence before us. Mr F's evidence may be summarised as follows:

(a) He is the current vice-president of Company A-Korea. He was the director of Company A-HK between 30 April 1990 and 15 July 1995.

(b) He referred to the minutes of Company A-HK dated 3 February 1989 and said that Company A-HK intended to purchase the 15/F, the 16/F and the car parking spaces as a long term investment.

(c) In order to continue Company A-HK's holding of the properties as capital assets but not to expose their presence in the financial reports which would be subject to review by the Korean government, it was decided to set up Company H as a shell company to hold the properties on Company A-HK's behalf. The re-classification in the finance report for the year ended 31 December 1989 was for like purpose.

(d) 'The management of [Company A-HK] considered that the relationship between Company H and [Company A-HK] should be kept highly confidential so as to avoid any risk of exposing to the Korean government that [Company A-HK] were holding properties investment in Hong Kong through Company H. Hence, even in the initial replies to the enquiries of the Inland Revenue Department in relating [*sic*] to the capital gains made by Company H, the relationship between Company H and [Company A-HK] was not disclosed. It was also because the directors of [Company A-HK] considered that such information might not be relevant to the Inland Revenue Department in making their decision'.

(e) The provision in the 17 December 1990 Agreement requiring payment of the purchase price upon signing of that agreement was to enable Company A-HK to offset the account receivables carried forward from the year 1989. The provision in that agreement postponing completion was to enable completion to be delayed 'to a date when both [Company A-HK] and Company H consider appropriate to complete'.

(f) During the material years, Company A-HK continued to occupy more than 50% of the 15/F. They also rented out a majority portion of the 16/F to a related company of Company A-Korea. In order to minimize the disturbance to tenants, no action was taken by either Company A-HK or Company H to inform the tenants of the 'paper change' of properties owner.

(g) As Company H was only a shell company used for holding the properties, Company A-HK only allowed minimum cash holdings to be retained by Company H. The fees due under the 17 December 1990 Supplemental Agreement and the 17 December 1992 Supplemental Agreement were intended to leave Company H with sufficient fund for Company H to cover its necessary expenses.

(h) In late 1993, Company A-Korea expressed concern on possible risk of exposure if the properties were held by Company H on behalf of Company A-HK. There was further concern in relation to reporting and remittance of the proceeds from disposal of the properties because the investments had not been registered with the Korean government under the then prevailing foreign exchange regulations. Company M was therefore acquired. The sole bearer share in Company M was and is held by Company A-HK.

(i) In view of the political climate in Hong Kong in 1994, 'we decided to dispose about half of our property holding in Hong Kong to minimize investment risk'.

(j) The 16/F was disposed of in favour of Company N. Company N was related to Company A-Korea. Company N had hitherto been occupying part of the 16/F.

26. Mr Law, counsel for Company H, submitted that:

(a) In order for a tax liability to arise, a profit must be derived in Hong Kong from a trade.

(b) As pointed out by Lord Wilberforce in Lionel Simmons Properties Limited v The Commissioner of Inland Revenue [1980] 53 TC 461 at page 491 *'trading requires an intention to trade and the question to be asked is whether this intention existed at the time of the acquisition of the asset.'*

(c) Company H is a group of company headed by Company A-Korea. In ascertaining its intention, one must have regard to the intention of the group and not that of Company H viewed in isolation. Our attention was drawn to the judgment of Kempster JA in CIR v Waylee Investment Limited [1990] 1 HKLR 107 where his Lordship pointed out at page 111 that:

'Where are we to look in order to ascertain the relevant intention and purpose? I think that in Coates v Arndale Properties Ltd [1984] 1 WLR 1328 the House of Lords, followed by the English Court of Appeal in Overseas Containers (Finance) Ltd v Stoker [1989] 1 WLR 606 provided the answer. When a transaction is carried out by a company (the taxpayer company) being one of a group the relevant purpose is that of the group

and not of the particular company viewed in isolation. Further, due attention must be paid to the context in which the acts of the particular subsidiary were performed.'

This case was further considered by the Privy Council in Waylee Investment Ltd v CIR [1991] 1 HKLR 237. At page 241B, Lord Bridge pointed out without disapproval the common ground between the parties that *'the taxpayer's purpose in relation to the transaction cannot be distinguished from the purpose of those who effectively controlled its activities.'*

(d) The following overt acts indicate that the 16/F was held as long term investment:

(i) It was held by the group between December 1988 and March 1995.

(ii) During the period of ownership, more than 60% of the 16/F was used by a company related to Company A-Korea with the rest being rented out to tenants.

(iii) No supplemental work was done to enhance the value of either the 15/F or the 16/F.

(iv) The Revenue accepted Company H's claim for commercial building allowance from November 1990 onwards.

(v) The purchase and disposal was a one-off transaction.

(vi) The 16/F was disposed of because of Hong Kong's political uncertainty.

(vii) With the financial support of Company A-Korea, Company H was in a position to hold the properties on a long term basis.

(viii) Company H is still holding the 15/F for long term investment.

Our decision

27. We reject the Revenue's case that Company H's intention should be ascertained as at 1 November 1994 when Company H and Company A-HK completed the sale and purchase of the 15/F, the 16/F and the car parking spaces. We are of the view that the relevant time is 17 December 1990. By the 17 December 1990 Agreement, Company H acquired a beneficial interest in those properties. It would not be realistic to conclude otherwise given the common grounds between the parties that Company H paid the consideration upon signing of that agreement.

28. We reject Company H's contention that it held the properties as agent for Company A-HK. There is no evidence to indicate that Company H and Company A-HK did not intend that the 17 December 1990 Agreement and the 17 December 1990 Supplemental Agreement should not have effect in accordance with their terms. On the contrary, both parties acted pursuant to those terms. Company H paid Company A-HK the consideration under the 17 December 1990 Agreement and the fees under the 17 December 1990 Supplemental Agreement. In the pre-hearing correspondence, the case projected was that Company H and Company A-HK were dealing at arm's length. There is no evidence to indicate that Company H was acquiring these properties as agent of Company A-HK. Such alleged agency would render the documentation between the parties wholly nugatory.

29. We accept that Company A-Korea and Company A-HK controlled the shares and the board of Company H. We further accept that the intention of Company H cannot be distinguished from those who controlled its activities. The question then is what the intention of those persons as at 17 December 1990 was.

30. The oft-quoted statement of Mortimer J (as he then was) in All Best Wishes Ltd v CIR 3 HKTC 750 once again provides useful guidance:

> *'It is trite to say that intention can only be judged by considering the whole of the surrounding circumstances, including things said and things done. Things said at the time, before and after, and things done at the time, before and after. Often it is rightly said that actions speak louder than words.'*

31. We are of the view that the intention of Company H cannot be divorced from the manner whereby its acquisition of the properties was financed. Whilst its introduction was for the purpose of representing to the outside world an ostensible segregation between Company H and the group, the success or otherwise of such pretence depends on the probability of the Korean government detecting the true beneficial ownership in Company H and the actual mode whereby Company H financed its acquisition. This risk was recognised by those who controlled Company H's activities. Flexibility was therefore the essence of the arrangement. Completion was deferred so as not to incur any stamp duty and not to vest the legal title in Company H. In the event of a heightened risk of detection, Company H would have disposed of the property. We have referred above to the re-classification by Company A-HK of the property investment to account receivables in their audited accounts for the year ended 31 December 1989. We have no doubt that the same device would have been adopted by those in control of Company H in order to justify the propriety of the transaction should the same be called into question in the light of the Korean foreign exchange regulations.

32. In these circumstances, the nature of Company H's interest is a precarious one. Its tenure was dictated by the need, if any, to justify to the Korean government that the facilities it received from Bank L with the help of Company A-Korea was in the nature of trade finance so as

to avoid any repercussion to Company A-Korea. Given the admitted tightening by the Korean government after 4 June 1989, the need was not one that could be wholly ignored. Company H therefore did not have the ability nor a settled intention to hold the properties on a long term basis.

33. We would also point out that the minutes of Company H sanctioning the purchase made no reference to acquiring the properties for long term investment purpose. Had that been Company H's intention, one would expect repetition of the views expressed at Company A-HK's board of directors meeting dated 3 February 1989.

34. For these reasons, we do not attach great weight to the factors which Mr Law urged upon us. We are not satisfied that Company H has properly discharged the onus of proof resting upon them.

35. We dismiss Company H's appeal.