Property investment versus trading involving a change of intention

Patrick Kwong and **Kathy Kun** explain the highly complicated matter of a recent tax dispute

The recent court case, *CIR v. Perfekta Enterprises Limited* (HCIA 1/2016), indicates that instead of arguing a sum received by an original investor-owner under a redevelopment agreement for sales as a non-taxable capital receipt, there could be an alternative argument focusing on the cost side of the investor-owner-turned trader.

Facts of the case

The taxpayer had owned and used an old factory building (the land) for its toy manufacturing business for a long period of time from 1977 to 1994.

On 30 July 1994, the taxpayer and a developer entered into a redevelopment agreement for the redevelopment of the land into a new composite industrial or office building for sale purposes.

In addition to making an initial payment of HK$165 million (the initial payment) to the taxpayer, under the redevelopment agreement the developer was also responsible for paying the land premium of HK$61 million to the government and the construction costs of the said redevelopment. The developer was however entitled to first recoup the land premium and construction costs paid from the sale proceeds of the redeveloped composite industrial or office building before the taxpayer and the developer could share the net profit of the said redevelopment on a 50:50 basis.

On 14 November 1994, the taxpayer transferred the land to its subsidiary at a consideration of HK$314 million. On 24 November 1994, the subsidiary and the developer entered into a new agreement. Presumably, the new agreement was to allow the subsidiary to step into the shoes of the taxpayer as regards the rights and obligations of the taxpayer under the redevelopment agreement.

Ultimately, upon the completion of the sales of the said redevelopment in 2007, the subsidiary only shared and received about HK$386,000 of the net profit of the said redevelopment under the new agreement. As a result, the subsidiary suffered an almost total loss of the purchase price that the subsidiary paid to the taxpayer on 14 November 1994 for the land of HK$314 million.

Even when the financial position of the taxpayer and the subsidiary are combined, they could also be said to have suffered substantial loss from the joint venture if the market value of the land in April 1994 of HK$418 million (exclusive of the land premium) was taken as their notional cost base for the said redevelopment (their combined receipt from the said redevelopment being only about HK$165 million plus HK$386,000).

The Commissioner of Inland Revenue (CIR) accepted the gain on the transfer of the land to the subsidiary of about HK$311 million (i.e. sale proceeds of HK$314 million minus the historical book cost of the land of about HK$3 million) as being a non-taxable capital receipt. However, the CIR assessed the taxpayer in respect of the gain of HK$163 million (i.e. the initial payment of HK$165 million minus related legal and professional fees of about HK$2 million) from its granting of the redevelopment right of the land to the developer as being a taxable trading receipt.

The taxpayer appealed against the tax assessment of the said gain of HK$163 million to the tax tribunal of the Board of Review (BOR) arguing that the amount was also its non-taxable capital receipt.

Decision of the Board of Review

Minority decision of the BOR

The minority of the BOR found that (i) there was a change of intention on the part of the taxpayer from holding the land as a capital asset to holding the asset for trading purposes when the taxpayer signed the redevelopment agreement with the developer on 30 July 1994; and (ii) consequent upon that change of intention, the land became trading stock of the taxpayer.

Thus, the minority of the BOR held that the initial payment of HK$165 million, derived from the redevelopment agreement which signified the commencement of a trade of property redevelopment, was a taxable trading receipt of the taxpayer.

Majority decision of the BOR

The majority of the BOR however held that notwithstanding there was a change of intention on 30 July 1994, the taxpayer had not injected the entire value of the land of HK$418 million into the joint venture (or trading) project. In the opinion of the majority of the BOR, the initial payment of HK$165 million was a balancing payment made by the developer to the taxpayer in order to equalize the contribution of the two parties before trading commenced. As such, the initial payment of HK$165 million was a non-taxable capital receipt of the taxpayer, derived by the taxpayer from its "carving out of part of a capital asset which was larger than that required to contribute to a joint venture project where profits was to be shared equally." This conclusion is referred to below as a "re-investment" decision of the majority of the BOR.

BOR's refusal of the taxpayer's application to add an additional ground of appeal at the last minute

In addition to the above argument that the initial payment was a non-taxable capital receipt, on the last day of the hearing at the BOR, the taxpayer applied for permission to add the following ground of appeal: *"If there was a change of intention so that the land became trading stock, the calculation of the trading profit must take into account all expenses and outgoings of any nature, including the value of the land which the company disposed of in the relevant year and, after deducting the value of the land, the company made no profit."*

However, all three members of the BOR refused to grant permission, noting that this additional ground of appeal was a fact-sensitive contention of the taxpayer. The BOR also noted that there was a lack of details as to the amount and nature of the alleged expenses and outgoings, the date they were incurred, or the disposal referred to in the additional ground of appeal.

Thus, by a majority, the BOR allowed the taxpayer's appeal. Not satisfied, the CIR appealed against the majority decision of the BOR to the Court of First Instance (CFI).

Decision of the Court of First Instance

The CFI overturned the majority decision of the BOR, holding that there was no evidential and legal basis for the majority to conclude that there was an assumption that the value of the contribution of two parties in a joint venture who shared profit would be equal. Specifically, the CFI noted that none of the terms of the redevelopment agreement nor the witness evidence of the taxpayer at the BOR hearing expressly indicated that the taxpayer "re-invested" by injecting only part of the value of the land into the redevelopment and only leaving the said redevelopment to be carried out by the subsidiary.

The CFI held that based on the terms of the redevelopment agreement signed between the taxpayer and the developer on 30 July 1994, and other circumstantial evidence of the case, the taxpayer did not merely sell the right to redevelop the land to the developer. The taxpayer itself had also since 30 July 1994 undertaken with the developer to jointly redevelop the land for sale or trading purposes. As such, the initial payment was a taxable trading receipt of the taxpayer from the joint redevelopment.

As regards the BOR's refusal of the taxpayer's application to add the additional ground of appeal at the last minute, the CFI simply agreed with the CIR's submission that the BOR's reason for the refusal was correct.

The taxpayer has appealed against the CFI's decision to the Court of Appeal.

Commentary

Instead of arguing that the initial payment was not a trading receipt, there could be an alternative argument focusing on the cost side of the taxpayer such that the relevant cost could be used to offset against the initial payment.

As a matter of the case-law principle espoused in the case of *Sharkey v. Wernher* (36 TC 275), the taxpayer could have perhaps argued that the land was notionally appropriated by it from its capital assets to trading stock at the open market value of the land of HK$418 million, at the moment the change of intention occurred on 30 July 1994.

As such, while the notional income of HK$418 million could be contended as being a non-taxable capital receipt, the same amount of HK$418 million should be treated as the deemed tax cost of the land for the taxpayer as its trading stock.

Based on the facts of the case, conceivably such a deemed tax cost of HK$418 million of the land as trading stock of the taxpayer could be apportioned as to (i) HK$253 million forming the cost for the taxpayer's transfer of the land to the subsidiary at HK$314 million in November 1994; and (ii) HK$165 million to exactly match and offset against the receipt of the initial payment of the same amount.

In fact, had, as a matter of arguably more appropriate transfer pricing, the taxpayer transferred the land to the subsidiary at HK$253 million instead of HK$314 million, the taxpayer would have no assessable profits for the year of assessment 1994-95 under this alternative argument.

While the additional ground of appeal raised by the taxpayer at the last minute at the BOR hearing may be wide enough to conceivably cover the alternative argument discussed above, it appears that the terms of the additional ground of appeal were not precise enough and lacked specificity as to the notional basis of the disposal referred to or the case-law principle involved.

Otherwise, the BOR might not have rejected the additional ground of appeal as being a fact-specific contention which was devoid of particular details, given that the application of the relevant case-law principle to the factual context of the case appears to be involving more a point of law than fact.

It remains to be seen whether, and how, the taxpayer would argue in the Court of Appeal that the BOR's refusal of its application to add the additional ground of appeal was wrong.

Another perspective of the case is that the tax dispute might have been avoided altogether had the said redevelopment been structured by way of the taxpayer transferring the land to the subsidiary at HK$418 million and having the subsidiary, instead of the taxpayer itself, receive the initial payment from the developer.

The case indicates that the manner of structuring a transaction, and how a tax dispute concerning property investment versus trading involving a change of intention is argued, could be a highly complicated matter.

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