



Hong Kong Tax Law: Cases and Materials

Seventh Edition

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isolated transaction? And what about a transaction which does not appear to be in the ordinary course of carrying on a business? These questions are normally decided by the application of the so-called 'badges of trade'. These are useful indicia, but they should not be taken to be applicable in every case, or accorded equal weight in each case. Whether a person carries on a trade will ultimately be determined by reference to its specific circumstances.

[2-18] Final Report of the Royal Commission on the Taxation of Profits and Income

Cmd 9474 (1955)

Each case must be decided according to its own circumstances. The general line of enquiry that has been favoured by appeal Commissioners and encouraged by the Courts is to see whether a transaction that is said to have given rise to a taxable profit bears any of the 'badges of trade'. This seems to us the right line, and it has the advantage that it bases itself on objective tests of what is a trading adventure instead of concerning itself directly with the unravelling of motive. At the same time we have noticed that there has been some lack of uniformity in the treatment of different cases according to the tribunals before which they have been brought. This seems to us unfortunate and, for the sake of clarity, we have drawn up and set out below a summary of what we regard as the major relevant considerations that bear upon the identification of these 'badges of trade'.

- (1) *The subject matter of the realisation.* While almost any form of property can be acquired to be dealt in, those forms of property, such as commodities or manufactured articles, which are normally the subject of trading are only very exceptionally the subject of investment. Again property which does not yield to its owner an income or personal enjoyment merely by virtue of its ownership is more likely to have been acquired with the object of a deal than property that does.
- (2) *The length of the period of ownership.* Generally speaking, property meant to be dealt in is realised within a short time after acquisition. But there are many exceptions from this as a universal rule.
- (3) *The frequency or number of similar transactions by the same person.* If realisations of the same sort of property occur in succession over a period of years or there are several such realisations at about the same date a presumption arises that there has been dealing in respect of each.
- (4) *Supplementary work on or in connection with the property realised.* If the property is worked up in any way during the ownership so as to bring it into a more marketable condition, or if any special exertions are made to find or attract purchasers, such as the opening of an office or large-scale advertising, there is some evidence of dealing. For when there is an organised effort to obtain profit there is a source of taxable income. But if nothing at all is done, the suggestion tends the other way.
- (5) *The circumstances that were responsible for the realisation.* There may be some explanation, such as a sudden emergency or opportunity

calling for ready money, that negatives the idea that any plan of dealing prompted the original purchase.

- (6) *Motive.* There are cases in which the purpose of the transaction of purchase and sale is clearly discernible. Motive is never irrelevant in any of these cases. What is desirable is that it should be realised clearly that it can be inferred from surrounding circumstances in the absence of direct evidence of the seller's intentions and even, if necessary, in the face of his own evidence.

3.2.1 Subject matter of the realisation

[2-19] By looking at the property which has been bought and sold, some indications can be obtained as to whether the transaction is a trading one. For example, if a person buys a bottle of cognac, it is probably to drink; but if that person buys 10,000 litres of cognac, one would assume that there is an intention to sell. The test in this case is whether the person intends to enjoy the property or dispose of it for profit.

[2-20] Enjoyment could be by way of personal consumption as in the case of cognac, private accommodation or the receipt of rent in the case of a flat, or pure pleasure from admiring a painting. For example, if a person buys a flat and rents it out, that person enjoys it in the sense that an income is obtained from it. Getting a regular income is the reason for purchase, not an intention to make a profit by resale. But if that person buys a flat 'off the plan', borrows the purchase price, and resells prior to the issue of the occupation permit, the implication is that the person did not buy with the intention of having an income, but rather with the intention to profit by reselling at a higher price.

[2-21] Rutledge v IRC

Court of Session (Scotland) (1929) 14 TC 490, 496-497

A businessman went to Germany for one of his business ventures – specifically, to obtain a film for his cinema. While there, he bought one million toilet rolls. He shipped them back to the United Kingdom and made a profit which the Revenue sought to tax. He argued that this was a one-off transaction, whereas a trade normally requires continuity.

LORD PRESIDENT CLYDE: The question in the case is whether the profits thus assessed are, or are not, profits of an 'adventure ... in the nature of trade' ...

An adventure it certainly was; for the Appellant made himself liable for the purchase of this vast quantity of toilet paper obviously for no other conceivable purpose than that of re-selling it at a profit; and that is just what he did. The element of adventure accordingly entered into the purchase from the first. It has been said, not without justice, that mere intention is not enough to invest a transaction with the character of trade. But, on the question whether the Appellant entered into an adventure or speculation, the circumstances of the

purchase, and also the purchaser's object or intention in making it, do enter, and that directly, into the solution of the question. An adventure, then, the Appellant's speculation certainly was, and a most successful adventure.

The question remains whether the adventure was one 'in the nature of trade'. The Appellant's contention is that it could not be such, because it is essential to the idea of trade that there should be a continuous series of trading operations; and an observation made in the course of my opinion in *IRC v Livingston* (1926) 11 TC 538 was founded on, according to which 'a single transaction falls as far short of constituting a dealer's trade, as the appearance of a single swallow does of making a summer. The trade of a dealer necessarily consists of a course of dealing, either actually engaged in or at any rate contemplated and intended to continue'. But the question here is not whether the Appellant's isolated speculation in toilet paper was a trade, but whether it was an 'adventure ... in the nature of trade'; and in the opinion referred to I said that, in my opinion, the profits of an isolated venture ... may be taxable under Schedule D provided the venture is 'in the nature of trade'. I see no reason to alter the opinion. It is no doubt true that the question whether a particular adventure is 'in the nature of trade' or not must depend on its character and circumstances, but if – as in the present case – the purchase is made for no purpose except that of re-sale at a profit, there seems little difficulty in arriving at the conclusion that the deal was 'in the nature of trade', though it may be wholly insufficient to constitute by itself a trade.

... Reverting to the facts of the present case, it seems to me to be quite plain (1) that the Appellant, in buying the large stock of toilet paper, entered upon a commercial adventure of speculation; (2) that this adventure or speculation was carried through in exactly the same way as any regular trader or dealer would carry through any of the adventures or speculations in which it is his regular business to engage; and therefore (3) that the purchase and re-sale of the toilet paper was an 'adventure ... in the nature of trade' within the meaning of the relevant UK statutory provision. If that is right the appeal cannot succeed.

[2-22] Compare *Cooke v Haddock*.¹¹ In that case, a solicitor with a history of dealing in land bought a 72-acre farm. He borrowed money to finance the purchase and the mortgage payments were more than the rent he received. He did not live there. The property was unsuitable for personal occupation. He sold it piecemeal over five years. The fact that the property was unsuitable for his own use or as an income producing investment was relied upon by the court in holding that the solicitor had engaged in a trading transaction.

[2-23] Land, buildings and shares, which are capable of producing a stream of income and therefore capable of being characterised as investment assets, raise special problems.¹² These various categories of assets are examined in detail below.

¹¹ *Cooke v Haddock* (1960) 39 TC 64.

¹² Contrast *Wisdom v Chamberlain* (1968) 45 TC 92, a case involving commodity speculation, discussed below at [2-94].

3.2.2 Length of period of ownership

[2-24] The longer a given asset is held, the more likely it is that the asset in question was bought for use as capital rather than for resale. If the asset is sold quickly after purchase, the implication is that it was bought to make a profit on resale, and that is trading.

[2-25] *Johnston v Heath*

Chancery Division [1970] 1 WLR 1567, 1572

An employee was offered by his employer the right to purchase six acres of land for £15,000. He could not afford it. So he first agreed with a third party to resell it for £25,000. He then bought it.

GOFF J: In the first place, it was found as a fact that the land was undeveloped and non-income producing. Secondly, finding No (5) is, 'Mr Heath was unable to finance the purchase himself', and details are then given of his capital resources and his salary. Thirdly, it is clear that his means would not service a loan to allow retention. Fourthly, in finding No (7) it was held that he had no intention to develop the land himself; and, indeed, he had not the means to do so. Fifthly – and in my judgment this is extremely important – he had actually contracted to resell the land before he entered into any contract to buy it. In the circumstances, there was no use to which he could put it, unlike a picture or a piece of furniture, or even a house in which he could live or which he could let. It is true that the commissioners found in finding No (5) that he 'investigated the possibility of borrowing the purchase price from relatives with the idea of selling when the problem of drainage' referred to in the case 'was solved'. If he had done that, different considerations might have obtained, but he did not, and that was abandoned when he contracted to resell before he had a contract to purchase. [Mr Heath obviously had no intention to hold, develop or obtain an income from the land because he had previously arranged to sell it. The court therefore concluded that this was an adventure in the nature of trade.]

[Goff J also held that the size of the property indicated a trading motive since he could not afford to purchase it without substantial borrowing.] In my judgment six acres of undeveloped land [in the present case] is like the large quantity of toilet rolls in *Rutledge v IRC* (1929) 14 TC 490.

[Finally, Mr Heath also argued that trading involves an element of risk which was not present here because he had already arranged to sell the property at a profit. Goff J rejected this argument.]

3.2.3 Recurrence and history

[2-26] The more often a person undertakes a commercial activity, the more likely it is that the person is trading. If a person buys a flat and sells it after ten years, that does not suggest trading. But if that person buys 20 flats and sells them all for profit, the implication is clear.

[2-27] Pickford v Quirke

Court of Appeal (1927) 13 TC 251, 269

A syndicate was formed to buy and sell cotton mills. It made a profit on the first transaction. It then repeated this transaction three times. The court indicated that an isolated transaction would have given rise to a capital gain. But what was the result when the four transactions were looked at together?

LORD HANWORTH MR: It must be remembered that [the definition of trade] 'includes every trade, manufacture, adventure or concern in the nature of trade'. When, however, you come to look at four successive transactions you may hold that what was, considered separately and apart, a transaction to which the words 'trade or concern in the nature of trade' could not be applied, yet when you have that transaction repeated, not once nor twice but three times, at least, you may draw a completely different inference from those incidents taken together. [Accordingly, the court held that *each* of the four transactions constituted trading.]

[2-28] Recurrence is evidence of trading, but the inference can be rebutted by establishing a good reason for selling consistent with investment objectives.

[2-29] CIR v Dr Chang Liang-Jen

High Court (1977) 1 HKTC 975, 1009–1010

The taxpayer, a doctor of economics, had a huge portfolio of listed shares. He sold some shares quickly after purchase but had good reasons to do so (eg the price of Hutchison shares began to fluctuate significantly, the San Miguel shares stopped paying dividends, and his cotton company shares became too risky after swings in the price of cotton). The taxpayer made substantial profits from purchasing and selling shares over a number of years. The Commissioner argued that trading was an irresistible inference given the fact of short term ownership, the quantities bought and sold and the taxpayer's personal characteristics. The Board of Review concluded that the taxpayer was not a trader but an investor. The Commissioner appealed.

LIU J: The Board was greatly impressed by the fact that he had caused registration of all purchases to be duly completed and that no loan was secured to finance his transactions. ... The Board accepted the explanations of the [taxpayer] in respect to the transactions in South Sea Textile, Hutchison International and San Miguel Brewery shares. The Board explicitly declared that the explanations for the apparently transient ownership of some of the shares were satisfactory ...

The extent of the [taxpayer's] share activities was a prominent issue ... [to which] the Board duly gave full consideration.

[2-30] The court was apparently influenced by the fact that the taxpayer registered all the shares in his name to receive dividends thereon, and held many of the shares for a long time. The decision does not, however, offer

much in the way of principle – in essence, the court concluded that there was no error of law to justify its overturning the decision of the Board of Review because there was evidence upon which the Board could have reasonably arrived at its decision.¹³ Nonetheless, *Chang's* case is very important from a practical viewpoint, because it shows how difficult it is to conclude that an *individual* has engaged in share trading, a conclusion emphatically highlighted by the Court of Final Appeal's decision in *Lee Yee Shing v CIR*.¹⁴ The court noted that the result might have been different if the taxpayer had been a corporation.

[2-31] If a person has a history of trading, the court will not ignore this. Thus, if a property dealer has 99 flats for trading and argues that one flat is held as an investment, it may be difficult for the court to accept the argument. In *Harvey v Caulcott*,¹⁵ the court noted the heavy burden of proof faced by an acknowledged trader to show that a purchase and sale of what would otherwise be trading stock is not a trading transaction.

[2-32] Compare *Richfield International Land and Investment Co Ltd v CIR*,¹⁶ a Hong Kong case decided by the Privy Council. In that case, consistent accounting treatment in relation to certain flats and the voluntary payment of tax on the sale of some of those flats virtually ensured that the remaining flats, which were later sold many years after acquisition, were also treated by the court as the company's trading stock. Note, however, that accounting treatment is not determinative. It is well established that classification of an item of property in a taxpayer's accounts as a fixed (and thus capital) asset – even for a lengthy period since purchase – is only one of many factors which must be considered in ascertaining the taxpayer's intention when acquiring the property.¹⁷

[2-33] Absence of trading history can, however, operate in favour of the taxpayer: see, eg *Taylor v Good*,¹⁸ where the court noted that the taxpayer owned other properties, but that none of them were trading stock.

3.2.4 Supplementary work before sale

[2-34] There is an inference of trading if a person has to perform some work (eg extensive renovation) on goods before reselling them, or if the person has to set up an organisation to sell them. The use of selling staff,

¹³ The court applied the well-known administrative law case of *Edwards v Bairstow* [1956] AC 14.

¹⁴ *Lee Yee Shing v CIR* [2008] 2 HKC 436, [2008] 3 HKLRD 51.

¹⁵ *Harvey v Caulcott* (1952) 33 TC 159.

¹⁶ *Richfield International Land and Investment Co Ltd v CIR* [1989] STC 820.

¹⁷ See *Real Estate Investments (NT) Ltd v CIR* (2008) 11 HKCFAR 433, [2008] HKCU 82.

¹⁸ *Taylor v Good* (1974) 49 TC 277.

large-scale advertising and establishing a sales office all point to more than mere sale: see, eg *Martin v Lowry* (1926) 11 TC 297, where an office was rented and an organisation set up to dispose of a large quantity of linen and *Cape Brandy Syndicate v IRC*,¹⁹ where a large quantity of brandy was blended, recasked and sold in lots. In both cases, the taxpayer was held to be trading. The facts disclosed far more than merely buying something cheaply and then reselling it. The question often posed in this type of case is: was there an organised effort to resell?

[2-35] Edwards v Bairstow

House of Lords [1956] AC 14, 37–38

The taxpayers bought and sold a cotton spinning plant. They made a profit which the Revenue assessed to tax.

LORD RADCLIFFE: It is said that there was no organisation for the purposes of the transaction. But in fact there was organisation, as much of it as the transaction required. It is true that the plant was not advertised for sale, though advertisements asking for plant were answered by the [taxpayers]. But why should they incur the cost of advertising if they judged that they could achieve the sale of the plant without it? It is said that no work had been done on the maturing of the asset to be sold. But such replacement and renovation as were needed were in fact carried out, and I can see no reason why a dealer should do more work in making his plant saleable than the purposes of sale require.

... There remains the fact which was avowedly the original ground of the commissioners' decision – 'this was an isolated case'. But, as we know, that circumstance does not prevent a transaction which bears the badges of trade from being in truth an adventure in the nature of trade. The true question in such cases is whether the operations constitute an adventure of that kind, not whether they by themselves or they in conjunction with other operations constitute the operator a person who carries on a trade. Dealing is, I think, essentially a trading adventure, and the [taxpayers'] operations were nothing but a deal or deals in plant and machinery ...

[2-36] BR 12/74

Board of Review (1976) 1 IRBRD 233, 236

The taxpayer inherited property consisting mainly of run-down buildings which were subject to rent control. Worried about the falling value, he borrowed money and redeveloped the property. He then sold all the redeveloped units both prior to and after the issue of the occupation permit.

REASONS: The publicity and advertising expenses to bring about sales amounted to over \$36,000. This together with the fact that the Appellant had laid out substantial sums to enable him to proceed with his plan for development followed by sales of the properties puts this case beyond the pale of mere realisation of inherited property into the category of acts done which amount to the carrying on or carrying out of a business.

¹⁹ *Cape Brandy Syndicate v IRC* [1921] 2 KB 403.

The frequency and multiplicity of sales, the organised efforts, the supplementary work on the properties to bring them into marketable condition to turn them, by disposal, into profitable account, and the amount of expenditure incurred for such purpose are features which, in our view, give rise to the inference that what was inherited has changed its character and become part of the raw material and stock-in-trade of the Appellant's business.

[2-37] The property in *BR 12/74*,²⁰ was inherited. It was thus originally acquired as a capital asset. The case therefore raises the issue of change of intention, a topic examined below at **[2-96]** et seq.

[2-38] Contrast *Taylor v Good*,²¹ where the Revenue argued that obtaining planning permission for redevelopment was supplementary work showing that the taxpayer had engaged in an adventure in the nature of trade. The court decided that the taxpayer was simply enhancing the value of the property so as to obtain the best price. But if the taxpayer had gone further and redeveloped the property for resale, a different result would have been reached.

[2-39] Ultimately, the difference in these cases is one of degree. This is illustrated by the High Court decision of *Crawford Realty Ltd v CIR*.²² In that case, a long term owner of property was held taxable on its share of profits from the sale of the property which it developed through a joint venture formed for the purpose of redeveloping and selling the property. The property owner argued that it simply realised a capital asset, albeit a considerably enhanced capital asset. The Commissioner argued that the property owner embarked upon a trade of property development at the time it entered into the joint venture agreement. At page 693 Barnett J held:

Enhancement of an asset, making it as attractive and saleable as reasonable expenditure of time and money can achieve, is one thing. The end product remains substantially the same. Substitution, however, is another matter. It is the taking of one's old car, removing the bodywork, engine and suspension from the chassis and replacing them with the latest styling and mechanical components. And that is effectively what happened here. The [property owner] obtained a price for the old car far in excess of its apparent value (about which no complaint is made by the Commissioner) but then went on to participate in the expenditure of time and money on rebuilding the car with new components in the hope of another profit therefrom. The [property owner] was actively involved in this process. [On this basis, Barnett J concluded that the property owner did more than merely realise a capital asset; rather, when entering and participating in the joint venture it commenced a trade of property development for sale.]

[2-40] A related question is whether and, if so, to what extent, the way that the taxpayer deals with the proceeds is relevant. In *D 70/94*,²³ the

²⁰ *BR 12/74* Board of Review (1976) 1 IRBRD 233.

²¹ *Taylor v Good* (1974) 49 TC 277.

²² *Crawford Realty Ltd v CIR* (1991) 3 HKTC 674.

²³ *D 70/94* (1995) 10 IRBRD 16.

Board of Review accepted the taxpayer's direct evidence that the property had been bought for self-residence and the sale was done to effect a change in investment as the proceeds were used to buy another property for rental purposes. Nevertheless, as the Board put it in *D 42/95*:²⁴ 'If the purchase of the property was by way of trading, it cannot become an investment because the proceeds of sale is invested in a capital asset.' On the other hand, if the subsequent property is acquired with an intention inconsistent with investment, profits from the sale of that subsequent property are liable to be charged.²⁵

3.2.5 Circumstances responsible for realisation

[2-41] If a person sells to make a profit, that is an indication of trade. But suppose that a person needs funds for an emergency, such as a medical operation? Or interest rates rise substantially and it becomes impossible to finance the borrowing costs? In such cases, there is a reason to sell which is unrelated to a trading motive. Factors such as these negative the implication that the original purchase was prompted by a plan of dealing. Likewise, where property is acquired otherwise than by way of purchase and is later sold, a finding of trading is less likely than in the normal case of purchase and sale.²⁶

[2-42] *The Hudson's Bay Co v Stevens*

Court of Appeal (1909) 5 TC 424, 436

Over a number of years, the taxpayer sold a large quantity of land which it had acquired in return for the surrender of its charter.

SIR HH COZENS-HARDY MR: The real question is whether this money can be regarded as profits or gains derived by the Company from carrying on a trade or business. In my opinion it cannot. The Company are doing no more than an ordinary landowner does who is minded to sell from time to time, as purchasers offer, portions suitable for building of an estate which has devolved upon him from his ancestors. I am unable to attach any weight to the circumstance that large sales are made every year. This is not a case where land is from time to time purchased with a view to resale; the Company are only getting rid by sale as fast as they reasonably can of land which they acquired as part of a consideration for the surrender of their Charter.

[2-43] A typical Hong Kong case illustrating this badge of trade involves financing the cost of a property redevelopment by pre-sales. Consider the arguments that could be advanced in such a case to support a finding of no

²⁴ *D 42/95* (1995) 10 IRBRD 292, 297.

²⁵ See eg *D 37/96* (1996) 12 IRBRD 264.

²⁶ See *McClelland v FCT* [1971] 1 WLR 191 (PC) (profit from the sale of inherited property; held, non-taxable).

trade. In this regard, contrast *BR 11/80*,²⁷ with *D 60/87*.²⁸ Are these decisions consistent if one focuses upon the level of sales in each respective case?²⁹

[2-44] A change of circumstances out of the taxpayer's control rendering it impracticable to continue to hold the property can assist the taxpayer's case. In *D 59/97*,³⁰ the properties were sold due to (1) economic recession in the home country of the founder of the taxpayer company, and (2) his prolonged illness (leading to his death after the sale). The profits on sale were held not to be trading profits.

3.2.6 Motive

[2-45] This badge of trade involves the following question: what was the taxpayer's motivation for buying and selling? In this regard, a subjective intention to resell at a profit should be the most important factor.³¹ But even this factor is not necessarily decisive.

[2-46] *Iswera v IRC*

Privy Council [1965] 1 WLR 663, 667-668

The taxpayer wanted to live near the school which her daughters were attending. She tried to buy part of a large block of land but the seller was unwilling to sell only part. She thus bought the whole site, sub-divided it into 12 lots, retained two lots and sold the rest. She used the money derived from the sub-sales to complete the original purchase.

LORD REID: Clearly she did not buy the whole site as a capital investment ... No doubt she acquired the part of the site which she retained as a capital investment, but in order to acquire it she had to buy, divide, and immediately resell the rest of the site ... If, in order to get what he wants, the taxpayer has to embark upon an adventure which has all the characteristics of trading, his purpose or object alone cannot prevail over what he in fact does. [On this basis, the Privy Council found that she had entered into an adventure in the nature of trade.]

[2-47] *Taylor v Good*

Court of Appeal (1974) 49 TC 277, 296-297

The taxpayer purchased a house and land at auction. He intended to live there. His wife was delighted until she saw it - it was run down, had no electricity, was far from town but close to vandals and a rubbish dump, and generally too big to look after. Three years later, the taxpayer got planning permission and eventually sold the property at a profit.

²⁷ *BR 11/80* (1980) 1 IRBRD 374.

²⁸ *D 60/87* (1987) 3 IRBRD 24.

²⁹ See also Halkyard, 'Tax on Land Held for Investment? Mere Sale is Not a Change of Intention' (1989) 19 HKLJ 216-217.

³⁰ *D 59/97* (1997) 12 IRBRD 360.

³¹ *Simmons v IRC* [1980] 2 All ER 798, 800.

RUSSELL LJ: All these cases [such as *Hudson's Bay Co v Stevens* (1909) 5 TC 424 and *Pilkington v Randall* (1966) 42 TC 662], it seems to me, point strongly against the theory of law that a man who owns or buys without present intention to sell land is engaged in trade if he subsequently, not being present a developer, merely takes steps to enhance the value of the property in the eyes of a developer who might wish to buy for development ...

[In this case there was], we must assume, no purchase at all with an eye on realisation ... [Moreover] there is no question at all of absorption into a trade of dealing in land of lands previously acquired with no thought of dealing ... [There] is no ground at all for holding that activities such as these in the present case, designed only to enhance the value of land in the market, are to be taken as pointing to, still less as establishing, an adventure in the nature of trade. [On this basis, the court concluded that the taxpayer had not entered into an adventure in the nature of trade. The court was most influenced by the fact that the taxpayer had no intention of reselling the property when he bought it.]

[2-48] Waylee Investment Ltd v CIR

Privy Council [1991] 1 HKLR 237, 242-243, [1991] HKCU 370

LORD BRIDGE: The clearest indication that an investment was acquired as a capital asset would be an indication that [the taxpayer] intended to hold the investment as such for an indefinite period. The clearest indication that an investment was acquired as trading stock would be an indication that it was held by [the taxpayer] as available to meet the demands of the depositors [the taxpayer was the wholly-owned subsidiary of the Hongkong Bank] whenever necessary.

[2-49] Returning now to one of the initial examples set out at the beginning of this Chapter, it should be clear what the distinction is between a person who purchases one painting and an art dealer who purchases and sells paintings regularly. The dealer buys more, owns a painting for a shorter period, frequently buys and sells, and has a profit motive. There are no special circumstances suggesting otherwise. There is probably supplementary work – a sales organisation, and advertising. Most importantly, the dealer buys with the intention of resale at a profit.

[2-50] Consider the following fact situation. A company wishes to expand its activities in order to undertake property dealing but it needs to obtain funds for this by allotting more shares. Another company agrees to subscribe for the shares but insists that payment be made by way of an exchange of shares. The first company agrees and, in order to obtain the required cash, sells the shares received from the other company at a profit. Are the profits derived from the sale of the shares chargeable to profits tax? In this regard, contrast *BR 11/76*,³² (profit held non-taxable) with *Wing*

32 *BR 11/76* (1977) 1 IRBRD 239.

Tai Development Co Ltd v CIR,³³ (profit held taxable). How significant was it that in the latter case the taxpayer (1) had an extensive history of share trading and (2) did not investigate the possibility that it may have obtained the required funds otherwise than through a share swap? Would it have made any difference in that case if the taxpayer established a special purpose company to carry out the swap transaction?

3.3 The 'badges of trade' – summary and restatement

[2-51] Lee Yee Shing v CIR

Court of Final Appeal [2008] 2 HKC 436, [2008] 3 HKLRD 51, paragraphs 59-62

MCHUGH NPJ (RIBEIRO PJ AND POWER NPJ AGREEING): The intention to trade to which Lord Wilberforce referred [in the *Simmons* case] is not subjective but objective: *Isvera v IRC* [1965] 1 WLR 663 at 668. It is inferred from all the circumstances of the case, as Mortimer J pointed out in *All Best Wishes Ltd v CIR* (1992) 3 HKTC 750 at 771. A distinction has to be drawn between the case where the taxpayer concedes that he or she had the intention to resell for profit when the asset or commodity was acquired and the case where the taxpayer asserts that no such intention existed. If the taxpayer concedes the intention in a case where the taxing authority claims that a profit is assessable to tax, the concession is generally but not always decisive of intention: *IRC v Reinhold* (1953) 34 TC 389. However, in cases where the taxpayer is claiming that a loss is an allowable deduction because he or she had an intention to resell for profit or where the taxpayer has made a profit but denies an intention to resell at the date of acquisition, the tribunal of fact determines the intention issue objectively by examining all the circumstances of the case. It examines the circumstances to see whether the 'badges of trade' are or are not present. In substance, it is 'the badges of trade' that are the criteria for determining what Lord Wilberforce called 'an operation of trade'.

What then are the 'badges of trade' that indicate an intention to trade or, perhaps more correctly, the carrying on of a trade? An examination of the many cases on the subject indicates that, for most cases, they are whether the taxpayer:

- (1) has frequently engaged in similar transactions?
- (2) has held the asset or commodity for a lengthy period?
- (3) has acquired an asset or commodity that is normally the subject of trading rather than investment?
- (4) has bought large quantities or numbers of the commodity or asset?
- (5) has sold the commodity or asset for reasons that would not exist if the taxpayer had an intention to resell at the time of acquisition?
- (6) has sought to add re-sale value to the asset by additions or repair?
- (7) has expended time, money or effort in selling the asset or commodity that goes beyond what might be expected of a non-trader seeking to sell an asset of that class?

33 *Wing Tai Development Co Ltd v CIR* (1979) 1 HKTC 1115.

- (8) has conceded an actual intention to resell at a profit when the asset or commodity was acquired?
 (9) has purchased the asset or commodity for personal use or pleasure or for income?

In some cases, the source of finance for the purchase may also be a badge of trade, particularly where the asset or commodity is sold shortly after purchase. But borrowing to acquire an asset or commodity is usually a neutral factor. [McHugh NPJ then referred to the judgment of Browne-Wilkinson VC in *Marson v Morton* [1986] 1 WLR 1343, the next case excerpted below.]

[2-52] **Marson v Morton**

Chancery Division [1986] 1 WLR 1343, 1348-1349

This case sets out nine 'badges' in the form of questions. Basically these questions mirror those discussed above. In the final analysis, the issue is simply whether the taxpayer was an investor or was carrying out a business operation in the form of a scheme for profit making.

SIR NICOLAS BROWNE-WILKINSON VC: It is clear that the question whether or not there has been an adventure in the nature of trade depends on all the facts and circumstances of each particular case and depends on the interaction between the various factors that are present in any given case. The most that I have been able to detect from the reading of the authorities is that there are certain features or badges which may point to one conclusion rather than another. In relation to transactions such as this, that is to say a one-off deal with a view to making a capital profit, there do seem to be certain things which the authorities show have been looked at. For convenience I will refer to them in a moment. But I would emphasise that the factors I am going to refer to are in no sense a comprehensive list of all relevant matters, nor is any one of them, so far as I can see, decisive in all cases. The most they can do is provide common sense guidance to the conclusion which is appropriate. The matters which are apparently treated as a badge of trading are as follows:

- (i) That the transaction in question was a one-off transaction. Although a nature of trade, obviously the lack of repetition is a pointer which indicates there might not be trade but something else.
- (ii) Is the transaction in question in some way related to the trade which the taxpayer otherwise carries on? For example, a one-off purchase of silver cutlery by a general dealer is much more likely to be a trade transaction than such a purchase by a retired colonel.
- (iii) The nature of the subject matter may be a valuable pointer. Was the transaction in a commodity of a kind which is normally the subject matter of trade and which can only be turned to advantage by realisation, such as referred to in the passage that the chairman of the commissioners quoted from *IRC v Reinhold* (1953) 34 TC 389. For example, a large bulk of whisky or toilet paper is essentially a subject matter of trade, not of enjoyment.
- (iv) In some cases attention has been paid to the way in which the transaction was carried through: was it carried through in a way typical of the trade in a commodity of that nature?

- (v) What was the source of finance of the transaction? If the money was borrowed that is some pointer towards an intention to buy the item with a view to its resale in the short term; a fair pointer towards trade.
- (vi) Was the interest which was purchased resold as it stood or was work done on it or relating to it for the purposes of resale? For example, the purchase of second-hand machinery which was repaired or improved before resale. If there was such work done, that is again a pointer towards the transaction being in the nature of trade.
- (vii) Was the item purchased resold in one lot as it was bought, or was it broken down into saleable lots? If it was broken down it is again some indication that it was a trading transaction, the purchase being with a view to resale at profit by doing something in relation to the object bought.
- (viii) What were the purchasers' intentions as to resale at the time of purchase? If there was an intention to hold the object indefinitely, albeit with an intention to make a capital profit at the end of the day, that is a pointer towards a pure investment as opposed to a trading deal. On the other hand, if before the contract of purchase is made a contract for resale is already in place, that is a very strong pointer towards a trading deal rather than an investment. Similarly, an intention to resell in the short term rather than the long term is some indication against concluding that the transaction was by way of investment rather than by way of a deal. However, as far as I can see, this is in no sense decisive by itself.
- (ix) Did the item purchased either provide enjoyment for the purchaser, for example a picture, or pride of possession or produce income pending resale? If it did, then that may indicate an intention to buy either for personal satisfaction or to invest for income yield, rather than do a deal purely for the purpose of making a profit on the turn.

I will consider in a moment the question whether, if there is no income produced or pride of purchase pending resale, that is a strong pointer in favour of it being a trade rather than an investment.

I emphasise again that the matters I have mentioned are not a comprehensive list and no single item is in any way decisive. I believe that in order to reach a proper factual assessment in each case it is necessary to stand back, having looked at those matters, and look at the whole picture and ask the question – and for this purpose it is no bad thing to go back to the words of the statute – was this an adventure in the nature of trade? In some cases perhaps more homely language might be appropriate by asking the question, was the taxpayer investing the money or was he doing a deal? If that approach is right, then it seems to me that this is essentially a case which falls in the 'no-man's-land' where different minds might reach different conclusions on the facts found. It was a one-off deal and it was a deal for land which was right outside the ordinary trade of the taxpayers as wholesale potato merchants. The taxpayers to an extent used their own money which had recently become available to them as a result of the profit in the company. On the other hand, they had also