Decision

Held: Judgement for the Commissioner.

(1) There was no legal right to substitute the taxpayer's actual repairs and outgoings for the 20% statutory allowance.

EXEMPTIONS AND RELIEF FROM TAX: CORPORATIONS

2-0450 Harley Development Inc & Anor v CIR

PRIVY COUNCIL (1996) HKRC ¶90-079

Author's Notes

Harley Development Inc & Anor v CIR (1996) HKRC ¶90-079 concerns the taxpayers' entitlement to exemptions from property tax and the right of the CIR to issue assessments for property tax. The taxpayers instituted proceedings for Judicial Review of the Commissioner's decision not to grant exemptions from property tax. The case deals with the availability of the property tax exemption when a taxpayer is also subject to profits tax.

The Privy Council refrained from commenting on the taxpayers' arguments as to the requirements of sec 25 of the *Inland Revenue Ordinance*. The Privy Council did state however that sec 5(2)(a) was a purely administrative provision and that the rights conferred upon the taxpayer under sec 25 were unaffected by the provisions in sec 5(2)(a).

Preliminary

This was an appeal by the taxpayers to the Privy Council in the United Kingdom against a decision of the Court of Appeal, which is reported at (1994) 1 HKRC ¶90-071. The Court of Appeal dismissed the taxpayers' application for judicial review and, consequently, the claim for exemptions from property tax.

History

The taxpayers' application to the High Court for Judicial Review of the Commissioner's decision to assess property tax on properties acquired by the companies was unsuccessful. It was determined that property tax was payable by the taxpayers because they did not satisfy the relevant conditions for the exemption. The conditions required that the taxpayers would be entitled to a set-off of property tax, if imposed, against any profits tax chargeable on profits derived from the trade or business carried on by the taxpayers. Here the taxpayers derived a capital gain from the property that did not form part of the

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profits from the trade or business. Furthermore, as the Commissioner did not represent to the taxpayers that they were exempt from property tax, there were no grounds on which the application for judicial review could be allowed.

The High Court's decision was upheld by the Court of Appeal. The Court of Appeal found that the taxpayers had an effective remedy for dispute resolution other than a judicial review under the *Inland Revenue Ordinance* (via an appeal to the Board of Review). The matter at hand was not one for judicial review as it had not been clearly shown that the Commissioner had acted *ultra vires* or unreasonably or unfairly.

Facts and Arguments

The taxpayers comprise two appellant companies, Harley Development Inc ("Harley") and Trillium Investment Ltd ("Trillium"). Both companies were members of the Hutchison Whampoa Group and were involved in an agreement relating to the use of parts of the China Building. Harley, which owned the Crown lease for part of the building, granted a 30-year lease of the premises to the Hong Kong and Shanghai Banking Corporation ("the Bank") for a premium. Trillium, which owned the Crown lease for another part of the building, also granted the bank a 30-year lease for a premium.

The facts for each of the appellant companies as regards the events pertaining to their property tax and profits tax assessments are as follows—

Harley

The Inland Revenue Department sent Harley a property tax return form several times for different years of assessments. The first time Harley received the property tax form, Harley returned the form for cancellation and applied for property tax exemption. However, the Inland Revenue did not respond to this exemption application. In the profits tax return forms for 1985–86 and 1986–87, Harley's accounts showed that it received a premium. This was the first time the Inland Revenue received information about the premium receipt. Subsequently, the Inland Revenue sent property tax forms to Harley again. Once more, Harley replied that it was exempt from property tax. Meanwhile, on the profits tax front, the premium receipt was, after some correspondence and submissions by Harley, accepted by the Inland Revenue to be a non- taxable capital gain.

Inland Revenue assessed Harley to property tax for 1985–86, 1986–87, 1987–88 and 1988–89. Harley objected on the basis that the Inland Revenue had represented that Harley was exempted from property tax and Harley had relied on this representation to its detriment.

Trillium

In 1981, Trillium was exempted from property tax on the building because it was let for rental. Profits tax was paid on the rental income. In correspondences dated 1985 with the Inland Revenue, Harley informed the Inland Revenue that it was under new ownership. In its profits tax return for the basis period 1 January 1985 to 30 September 1985, Trillium stated that it was dormant after selling the 30-year underlease.

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Decision

Held: Judgement for the appellant.

(1) It is a well established rule that the subject is not to be taxed without clear words for that purpose.

(2) The occupation of a house rent free is not income. However, the possession of a house that may be used for purposes of profit is property and taxable.

(i) Although the taxpayer, by occupying the property rent free, was put into the advantageous position of being able to spend more of his income, the issue before the court was whether the taxing statute taxed such advantage.

(ii) The advantage of occupying a house rent free does not fall within the terms "perquisites", "profits" or emoluments" as the words are used or explained by the word "payable".

(iii) The Act refers to monetary payments or things capable of being turned into money.

(iv) The appeal was, therefore, reversed.

COMMON LAW INCOME PRINCIPLES: BENEFICIAL RECEIPT; MONEY OR MONEY'S WORTH

3-1450 FC of T v Cooke & Sherden

FULL FEDERAL COURT (1980) 80 ATC 4140

Author's Notes

The case of *FC of T v Cooke & Sherden* (1980) 80 ATC 4140 further demonstrates that a payment which does no more than save the taxpayer from incurring expenditure is not regarded as income because income is what "comes in" and not what is saved from going out.

Preliminary

This was an appeal by the Commissioner against a decision of the Victorian Supreme Court that the taxpayers ("home delivery soft drink retailers") were not taxable on the value of free holidays provided by manufacturers of drinks.

History

The Commissioner assessed the taxpayers (two couples) to tax on the value of holidays provided to and enjoyed by them in the early seventies.

The taxpayers objected, and the two cases were heard together in the Supreme Court of Victoria. The Supreme Court held in favour of the taxpayers.

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Facts and Arguments

The taxpayers entered into similar agreements with drink manufacturers. The manufacturers had a discretionary and gratuitous holiday scheme for its retailers who were self-employed franchise operators. The holiday scheme was to motivate the retailers and reward their efforts. The holidays could not be cashed in and were not freely transferable.

The Commissioner argued that the value of the holidays constituted income according to ordinary concepts, and that the holidays were given to the taxpayers directly or indirectly for services rendered by them.

Decision

Held: Judgement for the taxpayers.

(1) The concept of "income" is not defined in the Australian *Income Tax Assessment Act 1936–1973* and should be interpreted according to its ordinary meaning.

(2) The Full Federal Court considered the meaning of income as used in other sections of the *Income Tax Assessment Act* and noted that taxable income must be, or be expressed as, a pecuniary amount.

(3) If the taxpayer receives a benefit which cannot be cashed in, the taxpayer has not received any income as that term is ordinarily understood.

(4) In the present case, the taxpayers could not convert the holiday benefits to pecuniary account. It was immaterial that the taxpayers would have had to expend money themselves had they wished to provide the holidays for themselves. If the receipt of an item saves a taxpayer from incurring expenditure, the saving is not income. Income is what comes in, it is not what is saved from going out.

(5) The Full Federal Court did not address the issue of whether the holiday benefits were payments for services rendered, as they viewed the relationship between the retailers and manufacturers as that between buyers and sellers.

COMMON LAW INCOME PRINCIPLES: BENEFICIAL RECEIPT

3-1500 The Countess of Bective v FC of T

HIGH COURT OF AUSTRALIA (1932) 47 CLR 417

Author's Notes

The income of a taxpayer does not include income received for the benefit, or on behalf, of another. In trust arrangements, income is commonly received by one party for the benefit of another. The following case of *The Countess of Bective v FC of T* (1932) 47 CLR 417 is an illustration of this point.

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Facts and Arguments

The taxpayer suffered from a renal disease and claimed medical expenses in relation to the treatment amounting to $2,126.

The taxpayer argued that the expenses were deductible as they were incurred on the instructions of the hospital and that to allow the deduction was to be sympathetic to his plight.

The Commissioner argued that such expenses were private or domestic in nature and hence not deductible under the *Inland Revenue Ordinance*.

Decision

Held: Judgement for the Commissioner.

(1) The Ordinance is clear — no deductions are permitted for private or domestic expenses. The medical expenses incurred by the taxpayer were private or domestic expenses.

(2) The Board of Review has no discretion whatsoever to allow the deduction requested by the taxpayer.

ALLOWABLE DEDUCTIONS: GENERAL DEDUCTIBILITY OF ALLOWABLE EXPENSES — WHOLLY AND EXCLUSIVELY INCURRED

3-2250 Case I18

BOARD OF REVIEW (1999) HKRC ¶80-587

Author's notes

An outgoing or expense must be wholly, exclusively and necessarily incurred in the production of assessable income in order to qualify for a deduction.

Preliminary

This was an appeal by the taxpayer against the Commissioner disallowing deductions for private motor vehicle depreciation.

History

The taxpayer claimed deductions for depreciation suffered on the use of his private motor vehicle for "home-office" travel against assessable allowances received by the taxpayer for travel.

Facts and Arguments

The taxpayer was a health inspector required to travel between various places in the New Territories. He was given an allowance for travel to such places and also an allowance for travel from home to work and vice versa. He was taxed on

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the latter allowance but not the former. He also claimed private motor vehicle depreciation against the assessable allowance.

He argued that the depreciation was deductible as it was incurred for purposes of travelling to work and for travel while on duty.

Section 12(1)(a) of the *Inland Revenue Ordinance* states that a deduction shall be allowed for all outgoings and expenses, other than expenses of a domestic or private nature and capital expenditure, wholly, exclusively and necessarily incurred in the production of the assessable income. Section 12(1)(b) states that a deduction shall be allowed for allowances in respect of capital expenditure on machinery or plant the use of which is essential to the production of the assessable income.

The Commissioner argued that the taxpayer did not show that the use of the motor vehicle was essential to the production of the whole of his income.

Decision

Held: Judgement for the Commissioner.

(1) Assessable income means the aggregate of income from all sources.

(2) The use of the car was not essential to the production of the assessable income as an aggregate of all the income sources.

(3) It was the duty of the taxpayer to make himself available for work at the place of employment, but it was not essential that he drove to work.

ALLOWABLE DEDUCTIONS: GENERAL DEDUCTIBILITY OF ALLOWABLE EXPENSES — "NECESSARILY" INCURRED

3-2300 Brown v Bullock (Inspector of Taxes)

COURT OF APPEAL (1961) 1 WLR 1095

Author's notes

The requirement that an expense must be "necessarily incurred" to be deductible restricts the scope of deductibility, as it must be shown from the duties of one's employment that the expense was required to be incurred. It is not sufficient, as the following case of *Brown v Bullock (Inspector of Taxes)* (1961) 1 WLR 1095 demonstrates, that the expense is incurred with the encouragement of one's employer.

Preliminary

This was an appeal by the taxpayer against a decision of the High Court that certain private club subscriptions were not allowable deductions against the taxpayer's assessable employment income.

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A "corporation" is any company incorporated or registered in Hong Kong or elsewhere. A "body of persons" is any body politic, corporate or collegiate or any company, fraternity, fellowship or society of persons whether corporate or incorporate (sec 2(1)).

4-0150 DEFINITION OF TRADE

Trade is defined as including:

(i) every trade and manufacture; and

(ii) every adventure and concern in the nature of trade (sec 2(1)).

The basic characteristics of trade have been established through case law. There are six badges of trade:

(i) the subject matter of the transactions — certain items are normally the subject of trading ventures and one looks the nature of the items to determine the existence of trade. For example a taxpayer who bought one million rolls of toilet paper and sold them at a profit was found to be engaging in an adventure in the nature of trade (*Rutledge v IRC* (1929) 14 TC 490);

(ii) the length of ownership — when a taxpayer acquires an asset and sells it immediately or very shortly after there is a *prima facie* inference that the asset was acquired with an intention to sell (*Case E60* (1995) 1 HKRC ¶80-357);

(iii) frequency and regularity of transactions — this may suggest trading. A taxpayer who bought a mill and resold it at a profit and then repeated the pattern with other similar transactions was found to be trading (*Pickford v Quirke (Inspector of Taxes)* (1927) 13 TC 251). A one-off transaction in land was found not to be an adventure in the nature of trade in times of inflation and high tax rates and land did not have to yield income before they can be considered as being held for investment purposes (*Marson v Morton* (1986) 1 WLR 1343);

(iv) supplementary work enhancing marketability — an organised effort by a taxpayer to enhance the marketability of an asset (for example by making improvements) or by actively seeking buyers through advertising may point to a trading venture (*IRC v Livingston* (1927) 11 TC 538; *Taylor v Good (Inspector of Taxes)* (1974) 49 TC 277);

(v) circumstances of the disposal or realisation — the reasons for the sale may help indicate if the taxpayer was engaged in a trading venture (*West v Philips (Inspector of Taxes)* (1958) 38 TC 203); and

(vi) the taxpayer's motive — a taxpayer who acquires property with the intention to resell is *prima facie* undertaking a trading venture (*D14/87* IRBRD Vol 2, 369). The existence of trade however does not depend on the existence of a profit motive (*Re Duty on the Estate of the Incorporated Council of Law Reporting for England and Wales* 3 TC 105).

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4-0200 INTENTION OF TAXPAYER TO TRADE

The intention of the taxpayer to trade is determined from the taxpayer's state of mind. Where a taxpayer is a company, the intentions or purposes of those who control it are the intentions or purposes of the taxpayer. Where a transaction is carried out by the taxpayer company which is part of a group of companies, the relevant intention or purpose is that of the group and not of the particular company viewed in isolation (*Waylee Investment Ltd v CIR* (1991) 1 HKRC ¶90-048).

The intention to trade at the time the asset disposed of was acquired is relevant to the issue of whether a taxpayer is involved in a trading venture (*Simmons v IRC* (1980) 2 All ER 798).

Change of intention

A taxpayer may change his intention from investment to trading (or vice versa). There must be clear and unequivocal evidence to a change of intention (*D16/88*).

4-0250 STATUTORY DEFINITION OF BUSINESS

Section 2(1) defines "business" as including:

- an agricultural undertaking;
- poultry and pig rearing;
- the letting or sub-letting of premises by any corporation; and
- the sub-letting by any other person of premises held under a lease or tenancy other than from the Government.

The term "business" has a very wide meaning and is significantly wider than "trade" or "profession" (*Kwan-Nang Kwong & Anor v CIR* (1989) 1 HKRC ¶90-017; *Lam Woo Shang v CIR* (1961) 1 HKTC 123).

4-0300 PRESUMPTION OF BUSINESS ACTIVITY

There is a case law presumption that a company is carrying on a business with respect to transactions it enters into (*American Leaf Blending Co Sdn Bhd v DG of IR (Malaysia)* 1978) STC 561; *CIR v Bartica Investment Ltd* (1996) HKRC ¶90-080). The presumption of business activity may apply even to one-off transactions (*CIR v Marine Steam Turbine Co Ltd* (1920) 1 KB 193.

4-0350 CHARACTERISTICS OF PROFESSION

The term "profession" is not defined in the Ordinance but is established by case law to mean work requiring purely intellectual skill, or manual labour dependent upon purely intellectual skill (*IRC v Maxse* (1919) 1 KB 647).

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Compensation for the temporary disablement of a taxpayer's revenue assets are also assessable. In *London and Thames Haven Oil Wharves Ltd v Attwooll (Inspector of Taxes)* (1967) 2 All ER 124, the compensation paid to a taxpayer when a ship negligently collided with its jetty and made it unusable for over a year was assessable as lost trading profits.

Compensation for cancellation of fundamental contracts

Compensation paid for the cancellation of a fundamental contract which affects the fundamental structure of a business is capital in nature and not assessable to tax (*Van den Berghs Ltd v Clark (Inspector of Taxes)* (1935) 19 TC 390).

Compensation for loss of a fixed asset is not assessable (*Glenboig Union Fireclay Co Ltd v IRC* (1922) 12 TC 427).

Compensation for termination of agency and management contracts

When the cancellation of an agency contract has the effect of terminating the taxpayer's business entirely, the compensation receive is capital in nature (*Californian Oil Products Ltd (in liquidation) v FC of T* (1934) 52 CLR 28. If the business can absorb the loss and carry on operations, the compensation may take the form of compensation for lost future profits assessable as revenue receipts (*Kelsall Parsons & Co v IRC* (1938) 21 TC 608).

4-1250 PAYMENT FOR RESTRICTIVE COVENANTS

A payment to a taxpayer not to carry on a trade, business or profession may be capital in nature in his hands. A taxpayer who received payment from a film company for agreeing not to act for other film companies for 18 months was not taxed on the amount received (*Higgs (Inspector of Taxes) v Olivier* (1952) 33 TC 136. However a payment made for a restrictive covenant may be assessable if the payment would be a trade receipt (*Thompson (Inspector of Taxes) v Magnesium Elektron* Ltd (1944) 26 TC 1).

4-1300 PAYMENT FOR PATENTS AND KNOWHOW

Gains from the sale of patents are capital receipts as the patents are capital assets. A lump sum payment for the promise that the taxpayer would not manufacture Terylene in certain countries was held to involve the sterilisation of a fixed asset which was the patent (*Murray (Inspector of Taxes) v Imperial Chemical Industries Ltd* (1967) 44 TC 175). If however the payment is made in instalments and is calculated by reference to usage, then the payment may be revenue in nature (*Constantinesco v R* (1926) 11 TC 730).

Payment for the loss of know-how may also be a capital receipt where the know-how is a capital asset of the business (*Evans Medical Supplies Ltd v Moriarty (Inspector of Taxes)* (1957) 3 All ER 718). The payment would be assessable to tax however if the provision of know-how is an extension of the taxpayer's business (*Rolls Royce Ltd v Jeffrey (Inspector of Taxes)* (1962) 1 All ER 801).

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4-1350 ALLOWABLE DEDUCTIONS

A taxpayer's chargeable profits is arrived at by deducting allowable deductions, depreciation allowances, balancing charges and losses against the taxpayer's taxable receipts.

A general deduction is allowed for all outgoings and expenses incurred in the production of assessable profits in the relevant year of assessment (sec 16(1)). Section 16(1) provides a non-exhaustive list of allowable deductions and sec 17 provides an exhaustive list of prohibited expenses. Only those items which qualify under sec 16 and are not prohibited under sec 17 qualify for deductions under the Ordinance (*Wharf Properties Ltd v CIR* (1997) 1 HKRC ¶90-085 (Privy Council); *Lo & Lo v CIR* (1984) 2 HKTC 34).

4-1400 "OUTGOINGS" AND "EXPENSES"

"Outgoings" are sums actually paid out. "Expenses" also includes a liability to pay. A deduction under sec 16 is permitted even if the amounts have not been paid, provided the expenses have been incurred in that a legal liability to pay has crystallised (*CIR v Lo & Lo* (1984) 2 HKTC 34).

4-1450 NOTIONAL EXPENDITURE OF A COMPANY

Notional expenditure charged by the head office of an overseas company to its Hong Kong branch is not deductible because it cannot be "incurred". In *Banque National De Paris Hong Kong Branch v CIR* (1985) 2 HKTC 139, the Hong Kong branch of the bank paid interest on retained profits to its head office. The interest payments were held to be not deductible as the branch and head office were one and the same entity. For tax purposes the interest payments could not be said to be "incurred" as the company could not have a legal obligation to pay itself.

Similarly, a deduction was denied for interest expenses arising out of artificial loan and interest transactions between related companies in *Case A99* (1991) 1 HKRC ¶80-099.

4-1500 "IN THE PRODUCTION OF CHARGEABLE PROFITS" — CESSATION OF BUSINESS

In order to be deductible, an outgoing or expense must be incurred in the production of chargeable profits. Payments made in connection with the final cessation of business are not deductible since the payments are made in the course of closing down a business; not to earn chargeable profits (*IRC v Anglo Brewing Co Ltd* (1925) 12 TC 803). Compensation payments to avoid a lawsuit after the discontinuance of a business are made not for the purpose of earning chargeable profits but for the purpose of ending the business (*Overseas Textiles Ltd v CIR* (1990) 1 HKRC ¶90-042). One exception involves severance payments made to staff upon the cessation of business (*CIR v Cosmotron Manufacturing Co Ltd* (1997) HKRC ¶90-091 (Privy Council)). The Privy

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EXEMPTION OF CAPITAL RECEIPTS — PROFITS FROM DISPOSAL OF ASSET CAPITAL OR REVENUE? — INTENTION OF COMPANY

4-3050 Waylee Investment Ltd v CIR

PRIVY COUNCIL (1989) 1 HKRC ¶90-021

Author's Notes

The intention of a taxpayer to trade is determined from the taxpayer's state of mind. Where the taxpayer is a company, the intentions or purposes of those who control it are the intentions or purposes of the taxpayer. Where a transaction is carried out by a taxpayer company which is part of a group of companies, the relevant intention or purpose is that of the group and not of the particular company viewed in isolation.

Preliminary

This was an appeal by the Commissioner against a decision of the Court of Appeal reported at (1989) 1 HKRC ¶90-021. The Court of Appeal held, looking at the intentions of the group of companies to which the taxpayer belonged, that the gain from the sale of shares was a taxable gain arising from an adventure or concern in the nature of trade.

History

The Commissioner assessed to profits tax the gains made by the taxpayer from the sale of shares. The taxpayer appealed to the Board of Review who discharged the assessment. The Commissioner then appealed to the High Court who dismissed the appeal. On further appeal by the Commissioner to the Court of Appeal, the Court of Appeal allowed the appeal, on the grounds that the intention of the banking group in question, and not solely that of the taxpayer, was relevant. The Board of Review and High Court had thus erred in law in their findings that the gains made on the sale of the shares in Hutchinson were capital in nature. The taxpayer appealed to the Privy Council against the Court of Appeal's decision.

Facts and Arguments

The taxpayer was a wholly owned subsidiary of the Hong Kong and Shanghai Banking Corporation ("the Bank"). The Bank came to the aid of one of its major customers, Hutchinson, when it experienced financial difficulties in 1972–1975. In August 1975, Hutchinson was in need of liquid capital to avert imminent collapse. Such a collapse would have been detrimental to the Bank as its substantial loans to Hutchinson were not adequately secured. There was also a larger concern as to the confidence in the Hong Kong economy as a whole were Hutchinson allowed to collapse. As part of a rescue package, the Bank decided to provide $150 million in exchange for a 30% equity stake in Hutchinson, comprising 150 million HK$1 ordinary shares in Hutchinson. In

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line with the long-term investment holding policy of the Bank, the equity stake was acquired through the taxpayer, a wholly owned subsidiary of the Bank. The Bank loaned the taxpayer $150 million on interest free terms and with no fixed repayment dates to fund the equity investment.

In acquiring the 30% equity stake via the taxpayer, the Bank was able to obtain effective management control over Hutchinson and the power to nominate the chief executive and two directors to the board of Hutchinson.

In the interim there was a merger in Hutchinson, the outcome of which was an exchange of the 150 million HK $1 shares held by the taxpayer for 90 million ordinary shares and 90 million preferences shares in Hutchinson Whampoa Ltd.

In 1974 when the crisis was over the taxpayer sold the 90 million ordinary shares it held in Hutchinson Whampoa Ltd. The gains made on the disposal amounted to $87,981,743 after a loss set-off. The Commissioner assessed this gain to profits tax under sec 14(1) of the *Inland Revenue Ordinance* as being trading profits — "trade" being defined in sec 2(1) of the Ordinance to include "every adventure and concern in the nature of trade".

The Court of Appeal in finding for the Commissioner, took the view that the taxpayer's intentions and the Bank's intentions were one and the same. *Kempster* JA said at p 100,244:

"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."

Decision

Held: Judgement for the taxpayer.

(1) The approach adopted by the Court of Appeal, ie of looking at the group's intentions and not solely at the taxpayer's intentions, was accepted as correct. The Bank's purpose and the taxpayer's purpose are indistinguishable.

(2) The issue is thus whether it was open to the Board of Review to find that the Hutchinson shares were acquired by the Bank as a long term investment and the profit on sale of the shares a capital asset.

(3) The importance of the rescue operation to the Bank's business is a substantially neutral factor.

(4) The Bank did not ever intend the shares in Hutchinson to be part of the Bank's circulating capital as to treat it as such was inimical to the whole design of the rescue purpose to project confidence in Hutchinson.

(5) Public statements form the Bank that the shares in Hutchinson would be sold "as soon as conditions permit" were referring to the Bank's policy not to be involve in long term management of a trading company and the Bank's intention to effect the sale without distorting or disturbing the market. The Court of Appeal had placed too large a significance on these words to mean an intention to hold the shares as trading stock.

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History

The Commissioner assessed the taxpayer to excess profits tax in respect of profits made from carrying on the business as publisher and proprietor of the National Review. The taxpayer appealed and the case was heard before the Income Tax Commissioners who held in the taxpayer's favour. The Commissioner appealed to the High Court which reversed the decision of the Income Tax Commissioners. The taxpayer appealed to the Court of Appeal.

Facts and Arguments

The taxpayer, Leopold James Maxse, purchased the National Review, a monthly magazine publication, in 1893. Since then, he had been the sole proprietor, editor and publisher of the magazine. Before the outbreak of the war, the contributions had come from a number of other writers but after the war the contributions came mainly from himself. The popularity of his contributions led to the sales and income from the magazine advertisers.

The Commissioner assessed the taxpayer to excess profits tax. Section 38 of the *Finance (No 2) Act 1915* stated that "The trades and businesses to which this Part of this Act applies are all trades and businesses (whether continuously carried on or not) of any description carried on in the United Kingdom, or owned or carried on in any place by persons ordinarily resident in the United Kingdom, excepting, … (c) any profession the profits of which are dependent mainly on the personal qualifications of the person by whom the profession is carried on and in which no capital expenditure is required, or only capital expenditure of a comparatively small amount …"

The taxpayer argued that he came within the exception as his personal qualifications were an absolute essential factor in the realisation of the magazine's profits. The fact that he was paid for his professional work by the profits of the magazine did not make him any the less a professional man, or his work any less the carrying on of a profession.

The Commissioner argued that the taxpayer might be a professional man but he was carrying on a business. Part of his profits came from advertisements, and he paid employees to work for him and help him carry on his business. Particular skills may be employed in many businesses not confined to mere buying and selling but they do not cease to be businesses.

Decision

Held: Judgement for the taxpayer.

(1) Mr Maxse was carrying on the profession of a journalist by writing numerous articles for the magazine and also by editing this magazine. An author would not cease to be such if he published or procured to be published his own works at his own expense and derived only remuneration from the sale of his articles. The truth was that Mr Maxse was both a journalist and editor and was also carrying on the business of a publisher. But this did not prevent him from being a journalist.

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(2) The profits of exercising a profession are excepted under the Act and the proper course to be followed is to separate the two. The business of publishing the magazine should be debited with a fair and reasonable sum for his contributions and remuneration as editor.

(3) A "profession" is an occupation requiring either purely intellectual skill or manual skill controlled by the intellectual skill of the operator.

SOURCE OF PROFITS: "PROFITS ARISING IN OR DERIVED FROM HONG KONG"; THE TEST FOR SOURCE OF PROFIT; APPORTIONING OF PROFITS — TRADITIONAL APPROACH; POSSIBILITY OF APPORTIONMENT INTRODUCED; TRADING STOCK & WORK-IN-PROGRESS: IDENTIFYING TRADING STOCK

4-3600 CIR v Hang Seng Bank Ltd

(1990) 1 HKRC ¶90-044

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Author's Notes

The determination of profits "arising in or derived from Hong Kong" is a key issue and challenge in practice. The cases discussed in this section illustrate the practical difficulties of applying the law to varying facts and circumstances.

CIR v Hang Seng Bank Ltd (1990) 1 HKRC ¶90-044 is a landmark Privy Council decision in which a new approach for determining the source of profits was formulated. Prior to this decision, the broader operations test was generally accepted and applied by the courts.

The broad guiding principle approach adopted in Hang Seng Bank represented a significant movement away from the broader operations test which was applied in *Sinolink Overseas Co Ltd v CIR* (1985) 2 HKTC 127. The essential difference between the two tests is that the broader operations test placed emphasis on "all of the operations" of the taxpayer which contributed to the generation of net profits whereas under the broad guiding principle, emphasis is on "the individual transactions" which produced the profits .

The Inland Revenue Department has issued a statement on the basic principles for determining the source of income and this is contained in Departmental Interpretation and Practice Note No 21: Locality of Profits (first issued in 1992 and revised in 1996 and 1998)

The ascertainment of the source of profits will continue to be a complex and contentious area of Hong Kong tax law. Notwithstanding the broad guiding principle enunciated in the *Hang Seng Bank case*, the courts continue to look at the whole operations of the taxpayer' business to resolve the source issue.

The taxpayer argued that the source of the profits was outside Hong Kong. The Commissioner disagreed.

Decision

Held: Judgment for the taxpayer.

(1) From an analysis of the cases before the Board of Review, there was no direct precedent in Hong Kong. Overseas cases were correctly referred to. The Board of Review correctly applied the test in *Smidth v Greenwood* to the question of the source of the profits and gave the correct meaning of operations.

(2) "Where did the operations take place from which the profits in substance arose" was the correct principle to consider in determining where the profits from the salvage services arose.

(3) The place where the contract is entered into is important but will not be a determinative factor if there are other more compelling factors, and this will depend on the facts of each case.

(4) The towing of the vessel through three miles of territorial waters did not make the profits arise or accrue in Hong Kong.

(5) A practical man would not think that the salvage profits were derived from or accrued in Hong Kong simply because the company had its office or establishment in Hong Kong.

(6) The correct test was where the business was carried on from which the profits arose or derived. The practical hard matter of the fact was that almost all the services had been performed outside Hong Kong and, therefore, the Board of Review had reached the correct conclusion.

(7) The appeal was allowed.

SOURCE OF PROFITS: INTEREST INCOME OF FINANCIAL INSTITUTION; DEEMED HK-SOURCED TRADING RECEIPTS — INTEREST INCOME OF FINANCIAL INSTITUTION

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4-3850 CIR v Orion Carribbean Ltd

(1997) HKRC ¶90-089

Preliminary

This was an appeal by the Commissioner against a decision of the Court of Appeal reported at (1996) HKRC ¶90-077 in which the Court of Appeal held that the profits of the taxpayer were not profits arising in or derived from Hong Kong. The judgement of the Privy Council was delivered on 23 June 1997.

History

The Commissioner assessed the taxpayer on profits derived from its borrowing and lending activities. The Board of Review held that the profits of the taxpayer were not profits arising in or derived from Hong Kong even though there was a finding that the profits arose from a business carried on in Hong Kong. The Court of Appeal upheld the Board of Review's decision, as the Board's decision regarding the source of interest income on a loan was in line with the *Hang Seng Bank case*. In particular, the decision fell within the example quoted in the *Hang Seng Bank case* to the effect that where profit is earned by lending money, the profit will have arisen in or derived from the place where the money is lent.

Facts and Arguments

The taxpayer was a company incorporated in the Cayman Islands in 1979 and a wholly owned subsidiary of Orion Royal Pacific Ltd ("ORPL"), a company incorporated in Hong Kong. ORPL was wholly owned by Orion Royal Bank Ltd ("ORBL"). Until June 1981, ORPL was owned by a consortium which included the Royal Bank of Canada ("RBC"). After June 1981 RBC wholly owned ORBL and indirectly, ORPL and the taxpayer. There was evidence of ORPL being one of the main institutions or banks active in syndicated loans in Hong Kong in the late 1970's and early 1980's. It would on its own or in cooperation with other banks underwrite term loans and syndicate them among other banks in Asia and Europe.

The taxpayer was formed in 1979 with only three directors and no staff. The taxpayer served as a tax avoidance vehicle to borrow moneys in foreign currencies from ORPL and on-lend the money in foreign currencies to borrowers outside Hong Kong. These borrowers were recommended by ORPL and approved by the taxpayer. The structure protected the interest differential from tax under sec 14 of the Hong Kong *Inland Revenue Ordinance*.

The Board of Review found that the taxpayer was carrying on the business of borrowing and on-lending money but ORPL was the taxpayer's agent at all times in providing management, administrative and accounting services with respect to the loan transactions.

The taxpayer submitted that the Board of Review's decision should be upheld as a matter of law as the source of interest income on a loan is where the money is advanced. As the moneys were advanced outside of Hong Kong, the source of the interest income was thus outside Hong Kong. The example quoted by Lord Bridge of Harwich in the *Hang Seng Bank* case was relied upon for support.

Decision

Held: Judgement for the Commissioner.

(1) No simple, single, legal test can be employed in ascertaining the source of income. The ascertainment of the source of income is a "practical hard matter of fact".

Facts and Arguments

The taxpayers comprise three individuals: X, Y and Z. X was a young man who wanted to purchase his own residential property but lacked the funds to do so. He saw property A being advertised for sale and approached his former work colleagues Y and Z for help in funding the purchase. Y and Z wanted to co-invest as opposed to providing an outright loan. The understanding of the parties was that, once X had the funds to purchase Y and Z's share of the property, he would do so at the prevailing market prices. Hence, the three individuals purchased the property as co-tenants. After the purchase, the property market swung upwards and the taxpayers sold the property within four months, and realised a gain, the subject of the appeal.

After the sale of property A, X purchased another property B as his residence but sold this shortly when he had enough funds to purchase property C, which was an improved residential property compared to property B.

The Commissioner argued that the gain from the disposal of property A was liable to profits tax as the taxpayers had acquired property A for the purpose of resale.

The taxpayers disagreed, arguing that the property A had been acquired with the intention that X would use it as his residence.

Decision

Held: Judgment for the taxpayers.

(1) To determine whether a property is a capital asset or a trading asset, the purchaser's intention at the time of acquisition is crucial.

(2) As per Lord *Wilberforce* in *Simmons v IRC* (1980) 53 TC 461, at p 491:

"Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment?"

(3) An intention to hold a property as a capital investment must be definite and capable of fulfillment.

(4) X's evidence that he purchased property A with the intention of residing in it but had to sell the property in totally unforeseen circumstances was accepted.

(5) X's evidence as to the intended source of financing for completing the purchase of property A and of bridging finance and refinancing was accepted. Hence, he had the means to bring to fruition his intention of holding the property for use as his residence.

(6) The Commissioner's arguments as to the short term of the holding, the absence of a written agreement to document the taxpayer's intentions, the methods of financing, etc, were cogent. However, based on the accepted evidence of X, the appeal was dismissed.

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CHARACTERISTICS OF TRADE: OTHER THAN THE BADGES OF TRADE — CHANGE OF INTENTION; EXEMPTION OF CAPITAL RECEIPTS — PROFITS FROM DISPOSAL OF ASSET — CAPITAL OR REVENUE? — CHANGE OF INTENTION; CHANGE OF INTENTION FROM TRADE TO INVESTMENT

4-4900 D16/88

BOARD OF REVIEW (1988) IRBRD VOL 3, 225

Author's notes

A change of intention must be clear and unequivocal and supported by objective evidence. Subjective evidence such as a statement that there has been a change of intention may be self-serving and a board of directors' resolution stating a change of intention is not conclusive by itself of that change.

Preliminary

This was an appeal by the taxpayer against a determination by the Commissioner that gains made from the disposal of properties by the taxpayer were assessable trading profits.

History

The Commissioner assessed the taxpayer on gains made from the disposal of a number of properties. The taxpayer objected alleging that the properties were originally trading assets but that the taxpayer had changed their intentions as evidenced by a board of directors' resolution to that of long term investment.

The taxpayer appealed to the Board of Review after the Commissioner refused to amend the assessment.

Facts and Arguments

The taxpayer is a subsidiary of a public company and carried on the business of dealing in properties. The taxpayer admitted that it had acquired all the properties in question as trading stock. However it produced evidence that it had considered changing it intention with respect to some of the properties but desisted for tax reasons in 1975. In 1980 and 1981 the taxpayer sold several properties and made gains from their disposal. In support of their claim that the gains made were capital in nature they produced a board of directors' resolution passed in September 1977 to the effect that the First, Second, Third, Fifth and Sixth properties would be kept for long term investment from then on.

For the years of assessment 1980/81, 1981/82 and 1982/83 the taxpayer claimed industrial building allowance on the parts of the building not sold.

The properties sold were parts of the Third, Fourth, fifth and Sixth buildings.

Facts and Arguments

The taxpayer was a well-known actor who had just finished acting in a film known as "Henry V". The production company were concerned that "Henry V" was a novelty and it was not known if the public would like the film. They were also concerned that if the actor produced a more popular film, the public would choose to see the more popular film instead because of his popularity and fame. The restrictive covenant agreement was entered into to prevent this from happening.

The Commissioner argued that the payment was assessable income as the agreement to engage the actor for the film and the restrictive covenant were inter-dependent.

Decision

Held: Judgment for the taxpayer.

(1) The restrictive covenant agreement was very unusual. It was not usual for the actor to enter into such agreements in the course of his vocation as an actor.

(2) That no actor had ever entered into such agreements before showed how unusual such agreements were.

(3) The restrictive covenant payment was thus not paid to him in the ordinary course of the exercise of his profession.

(4) The amount paid to him was a capital receipt.

EXEMPTION OF CAPITAL RECEIPTS — GAINS FROM THE SALE OF PATENTS AND KNOW-HOW — CAPITAL OR REVENUE? — PATENT

4-5250 Murray (Inspector of Taxes) v Imperial Chemical Industries Ltd

COURT OF APPEAL (1967) 2 ALL ER

Author's notes

Receipts for a "keep-out" covenant which are, in effect, for an outright disposal of patent rights are capital in nature, regardless of the payments being made periodically or in one lump sum. This was the decision in the following case of *Murray (Inspector of Taxes) v Imperial Chemical Industries Ltd* (1967) 2 All ER.

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Preliminary

This was an appeal by the Commissioner against a decision of the High Court which upheld the determination of the Commissioners for the *Special Purposes of the Income Tax Acts*. The Special Commissioners had determined that certain sums received under covenants in consideration for the sale of manufacturing and selling rights of Terylene were not trading receipts for income tax purposes.

History

The taxpayer company objected to assessments under Case 1 of Sch D to the *Income Tax Act 1952*. The taxpayer claimed that the payments received for the covenants were capital in nature and, in addition, sought an adjustment to their tax liability for a loss. The Commissioner refused to amend the assessments and the taxpayer appealed to the Special Commissioners. The Special Commissioners found in favour of the taxpayer, determining that certain sums received under covenants in consideration for the sale of manufacturing and selling rights of Terylene were not trading receipts for income tax purposes.

The Commissioner appealed against this determination to the High Court. The High Court upheld the Special Commissioners determination. The Commissioner then appealed to the Court of Appeal.

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Facts and Arguments

The taxpayer was granted an exclusive licence to exploit the master patents for a new fibrous material called Terylene. Although the taxpayer manufactured it on a large scale at Wilton, it could not manufacture enough on its own to meet world demand. Therefore, it granted exclusive licences to foreign companies. A typical sub-licence would grant the foreign company an exclusive licence to use the major patents in return for a royalty, and an exclusive licence to use the ancillary patents in return for a royalty and an agreement to provide know-how. The taxpayer also agreed to keep out of the territory of the sub-licensee. In return, the taxpayer company received a fixed sum payable in six equal annual instalments.

The taxpayer argued that the receipts for the covenants were capital in nature.

The Commissioner argued that the payments were revenue in nature.

Decision

Held: Judgment for the taxpayer.

(1) The "keep-out" covenant was ancillary to the grant of the licence. The licensor expressly agreed with the licensee that it would not enter the domain which it had granted to the licensee.

(2) The taxpayer was not a dealer in patent rights or patent licences. When it granted the exclusive licence, it disposed of a capital asset.

restricted as this. I certainly cannot think that they are limited to the relief of wants, occasioned by the lack of pecuniary means ... It is the helplessness of those who are the objects of its care which evokes the assistance of the benevolent. I think then that the popular conception of a charitable purpose covers the relief of any form of necessity, destitution, or helplessness which excites the compassion or sympathy of men, and so appeals to their benevolence for relief." On p 89, he went on to say "If, then, one were driven to interpret the words under construction according to their proper signification, I think the proper course would be to prefer the broadest sense in which they are employed." As no decisions of the Court of Scotland have put a narrower interpretation on the words in question, the proper course is to interpret the words in the *Income Tax Act* in the sense in which they have been used alike in the law of both countries.

NON-DEDUCTIBLE EXPENSES AND LOSSES: NON-CURRENT EXPENDITURE TEST; ENDURING BENEFIT TEST

4-5700 Sun Newspapers Ltd & Associated Newspapers Ltd v FC of T

FULL COURT OF AUSTRALIA (1938) 61 CLR 337

Author's notes

There are several tests developed and applied in case law to determine the nature of an expenditure or outgoing. In the following case of *Sun Newspapers Ltd & Associated Newspapers Ltd v FC of T* (1938) 61 CLR 337, the Full Court of Australia applied the non-recurring expenditure test.

Preliminary

This was an appeal by the taxpayer against a decision of the High Court that certain expenditure incurred to secure a temporary absence from competition was not deductible under sec 23(1)(a) or sec 25(e) of the *Income Tax Assessment Act 1922-1934.*

History

The taxpayer claimed a deduction for certain payments made to the optionees of *The World*, a competitor newspaper. The Commissioner disallowed the deduction on the basis that the money paid was not wholly and exclusively incurred in the production of assessable income under sec 25(e) and was an outgoing of capital which enhanced the value of the business as a whole.

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The taxpayer appealed to the High Court on this question. *Rich* J held that the expenditure was not deductible. *Rich* J agreed with the Commissioner that the expenditure was not incurred wholly and exclusively in the production of assessable income under sec 25(e) and was an outgoing of capital not deductible under sec 23(1)(a). It was a non-recurring expenditure used to buy out competition and secure a monopoly.

The taxpayer appealed to the Full Court.

Facts and Arguments

The taxpayer was incorporated in March 1929 and operated the Sydney evening newspapers, *The Sun* and *The Sunday Sun*, and several others. Its competitors operated the *Evening News* and *Sunday News*. The competitors and the taxpayer agreed to amalgamate their interests and the Associated Newspapers Ltd was the intended trustee of the amalgamated interests. Associated Newspapers Ltd was the other taxpayer in this appeal. The taxpayer's evening newspapers were sold for a penny-and-a-half.

The expenditure in question arose from an agreement which the taxpayers made with a rival newspaper who were proposing to operate a new evening newspaper in competition at a penny a newspaper. The taxpayers were concerned as to this threat of competition and agreed to pay the rival newspaper owners a sum of money for agreeing not to operate the newspapers for three years.

The taxpayers claimed a deduction for the sum paid.

The taxpayer alleged that a deduction was available under sec 25(e) or sec 23(1)(a).

Section 25(e) states that an expense must be wholly and exclusively laid out or expended in the production of assessable income in order to be deductible. Section 23(1)(a) states that — "In calculating the taxable income of a taxpayer the total assessable income derived by the taxpayer ... shall be taken as a basis, and from it there shall be deducted — all losses and outgoings (including commission, discount, traveling expenses, interest and expenses, and not being in the nature of losses and outgoings of capital) actually incurred in gaining or producing the assessable income."

Decision

Held: Judgment for the Commissioner.

(1) Both taxpayers claimed a deduction for the payments made but the payment, if allowable at all, should be allowable only to Sun Newspapers as they made the payments under the agreements.

(2) The question at hand was whether the payments were outgoings of capital.

(3) The expenditure in question was a large non-recurring unusual expenditure made for the purpose of obtaining an advantage of enduring benefit for the taxpayer's business. The benefit was the exclusion of competition.

Wimpy International Ltd v Warland (Inspector of Taxes) (1989) BTC 58 5-1250
Carr (Inspector of Taxes) v Sayer (1992) BTC 286 5-1300
Gray (Inspector of Taxes) v Seymours Garden Centre (Horticulture) (1995) BTC 320 5-1350
CIR v Scottish and Newcastle Breweries Ltd (1982) BTC 187 5-1400
J Lyons & Co Ltd v AG (1944) Ch 281 5-1450
Wharf Properties Ltd v CIR (1997) HKRC ¶90-085 5-1500

Depreciation and Other Capital Allowances

Depreciation and other capital allowances in respect of assets used by a taxpayer in his trade, business of profession are specifically allowable claims against his taxable receipts. Depreciation, which is the diminution in value of a capital asset held over time, is not deductible for profits tax purposes as it is capital in nature. Accordingly specific provision for the allowance of depreciation claims (called capital allowances) for tax purposes is made in Part VI of the *Inland Revenue Ordinance*.

Capital allowances are available for industrial buildings or structures, commercial buildings or structures and for plant and machinery used in the production of assessable income.

Capital allowances are available for the initial capital expenditure and for the annual depreciation caused by wear and tear.

5-0050 INDUSTRIAL BUILDINGS OR STRUCTURES

An "industrial building or structure" is any building or structure, or part thereof, which is used:

(i) for the purposes of a trade carried on in a mill, factory or similar premises;

(ii) for the purposes of a transport, tunnel, dock, water, gas or electricity undertaking or a public telephone or telegraph service;

(iii) for the purposes of a trade consisting of the manufacture or processing of goods or materials;

(iv) for the purposes of a trade which consists in the storage:

(a) of goods or materials which are to be used in the manufacture of other goods and materials;

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(b) of goods or materials which are to be subjected to any process in the course of a trade; or

(c) of goods or materials on their arrival into Hong Kong;

(v) for the purposes of a farming business; or

(vi) for the purposes of scientific research in relation to any trade, profession or business (sec 40(1)).

The phrase "industrial building or structure" also includes any building or structure, used in any trade, undertaking or business mentioned above, which is provided for the welfare of workers.

When only part of a building qualifies under the definition, and the non qualifying portion does not exceed 10% of the whole expenditure, the whole building is regarded as qualifying (Practice Note No 2 (Revised, para 13)).

5-0100 BUILDING OR STRUCTURE

The ordinary meaning of the words "building or structure" applies and this includes artificial works not commonly considered to be buildings such as wall, bridges, dams, roads, dry docks, bore holes, wells, sewers, water mains and tunnel linings.

5-0150 BUILDING OR STRUCTURE USED FOR MANUFACTURING OR PROCESSING

"Manufacturing" is the creation of a new thing, having a new industrial use (*MP Metals Pty Ltd v FC of T* (1967) 14 ATD 407. "Processing" has a much wider meaning. Goods may be subject to a process even if they are not adapted or changed. Pest extermination is regarded a processing (*D3/87* and *D4/87* IRBRD Vol 2, 329). The freezing of goods is a process (*Ellerker (Inspector of Taxes) v Union Cold Storage Co Ltd* (1939) 22 TC 195). The trade of a restaurant was held to have nothing to do with manufacturing or processing (*CIR v Aberdeen Restaurant Enterprises Ltd* (1989) 1 HKRC ¶90-009). In order to claim an industrial building allowance the process in question must be in the nature of the taxpayer's trade and not simply incidental to or forming part of the trade (*Tai On Machinery Works Ltd v CIR* (1969) 1 HKTC 411)

5-0200 INELIGIBLE BUILDINGS OR STRUCTURES

Dwelling houses (other than houses for manual workers), retail shops, showrooms, hotels and offices do not qualify as industrial buildings or structures (sec 40(1)).

Whether a building is an office is a question of fact and one must look at the building as a whole and its predominant purpose. In *IRC v Lambhill Ironworks Ltd* (1950) 31 TC 393, it was held that "an office is something which clearly has not got anything of an industrial character or is not directly ancillary to the industrial operations conducted in the rest of the works".

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5-0700 LEASING ARRANGEMENTS — ALLOWANCES RESTRICTED

Initial and annual allowances are restricted for machinery or plant in the case of taxpayers who have entered into certain lease arrangements:

- when the machinery or plant has been purchased from and leased back to the same person;
- when a lease arrangement has been entered into in relation to machinery or plant (except ships and aircraft) and the asset is used principally or wholly outside Hong Kong;
- when a lease arrangement has been entered into in relation to a ship or aircraft and the lessee is not an operator of a Hong Kong ship or aircraft; or
- when the asset was acquired through a leverage lease transaction, financed by a "non-recourse" debt.

5-0750 BALANCING ALLOWANCES AND CHARGES

Capital allowances permit the taxpayer to claim 100% deduction for the expenditure incurred over the economic life of the asset. Should an asset be disposed of for an amount less than the residue of capital expenditure remaining to be claimed, a balancing allowance is available to make up for the difference. A balancing charge is added to taxpayer's chargeable income should the asset be disposed of for an amount greater than the residue of capital expenditure remaining to be claimed.

BUILDING OR STRUCTURE USED FOR MANUFACTURING OR PROCESSING: MEANING OF "PROCESS"

5-0800 CIR v Tai On Machinery Works Ltd

HIGH COURT (1969) 1 HKTC 411

Author's Notes

The use of a building determines the entitlement of a taxpayer to claim that the building is an industrial building which qualifies for industrial building allowances. One of the qualifying uses — that of storing goods upon their arrival in Hong Kong — is discussed in *CIR v Tai On Machinery Works Ltd* (1969) 1 HKTC 411 and *D49/88* (Vol 3 IRBRD). Generally, it not the owner that is required to be carrying on a trade that consists in the storing of goods. It suffices that the building is used by the occupier for purposes of a trade that consists in the storing of goods upon their arrival in Hong Kong.

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Preliminary

This was an appeal by the taxpayer against a decision of the Board of Review dismissing the taxpayer's appeal that four floors of a building it owned and let to a tenant which used it for storage of goods qualified for industrial building allowances under sec 40(1) of the *Inland Revenue Ordinance* and for interest deductions under sec 16(1)(a) of the Ordinance.

History

The taxpayer was assessed to profits tax for the years 1964–65, 1965–66 and 1966–67. The taxpayer claimed industrial building allowances in respect of a building it constructed and which was completed on 10 December 1964. The taxpayer used the first four floors of the building for its own manufacturing purposes on 1 March 1965. The remaining four floors were let out to a shoe company between 16 June 1965 and 1 November 1965.

The taxpayer also claimed deductions for interest on overdrafts used to finance the construction.

The Commissioner disallowed both claims. The case was heard before the Board of Review that ruled for the Commissioner on the industrial building allowance claim and for the taxpayer on the interest deduction.

The Commissioner appealed to the High Court on the interest deduction issue and the taxpayer appealed on the industrial building allowance claim.

The issues before the High Court were:

(1) whether the Board of Review was correct in its view that the first four floors of the building used by the taxpayer for its manufacturing purposes was an industrial building but not the four upper floors which were let to the tenant and used for the storage of goods; and

(2) whether the Board of Review was correct in holding that the interest payments on the overdraft for the year ending 31 March 1965 were not expenditure of a capital nature and deductible under sec 16(1)(a) of the Ordinance.

Facts and Arguments

The taxpayer carried on the business of manufacturing fire extinguishing equipment and electric fans. The taxpayer erected an eight-storey building which was completed on 10 December 1964 and ready for occupation on 1 March 1965. The construction was financed by an overdraft. The taxpayer claimed deductions for interest on the overdraft, which was disallowed by the Commissioner. The taxpayer used the first four floors for its manufacturing purposes but let the upper four floors to a shoe company which used the premises to store its goods. The taxpayer claimed industrial building allowances on the building. The Commissioner only permitted the industrial building allowance claim on he first four floors used by the taxpayer for its manufacturing purposes.

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Decision

Held: Judgement for the Crown.

(1) Under sec 41 of the *Finance Act*, "plant" carries with it a connotation of equipment or apparatus, either fixed or unfixed. Its meaning is not wide enough to include buildings in general.

(2) Buildings do not cease to be buildings and become plant simply because they are purpose-built for a particular trading activity.

(3) One of the functions of a building is to provide shelter and security for the people using it and the goods inside it. A building used for this purpose is being used as a building and does not take on the character of plant simply because it is used for storage by a trader carrying on a storage business.

(4) Based on the above, permanent kennels are not plant but are purpose-built buildings.

(5) The particular apportionment method adopted by the Special Commissioners was wrong. They deducted from the actual cost an amount equal to the estimated cost of erecting different and cheaper buildings than those built. The correct approach was to treat particular parts of the actual buildings as plant and other parts not, and apportion the overall cost of construction accordingly.

(6) The decision of the Special Commissioners not to allow industrial building allowances on the permanent kenneling was correct.

ALLOWANCES FOR MACHINERY OR PLANT: DIFFERENCE BETWEEN "PLANT" AND THE BUILDING OR STRUCTURE IN WHICH IT IS HOUSED

5-1350 Gray (Inspector of Taxes) v Seymours Garden Centre (Horticulture)

COURT OF APPEAL (1995) BTC 320

Author's notes

A glass-house is a purpose built building which serves as the premises in which the business if carried on. The fact that it may also serve the function of nurturing and preserving plants was not enough for it to be treated as a plant in the following case of *Gray (Inspector of Taxes) v Seymours Garden Centre (Horticulture)* (1995) BTC 320.

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Preliminary

This was an appeal by the taxpayers against a decision of the High Court reversing the Special Commissioners decision that certain capital expenditure incurred by the taxpayers in constructing a planteria was "plant" qualifying for capital allowances.

History

The taxpayers claimed capital allowances on the costs of constructing a planteria in the assessment for 1984–85. The Crown disallowed the assessment. The taxpayers appealed and a case stated was heard before the Special Commissioners who found in the taxpayers' favour. The Crown appealed to the High Court which allowed the Crown's appeal. The High Court held that the planteria was not plant being simply the structure in which the final part of the taxpayers' trade as nurserymen — the display and sale of plants — is carried on.

Facts and Arguments

The taxpayers are a partnership carrying on the business of nurserymen, the display and sale of plants. They claimed capital allowances on certain capital expenditure incurred on the construction of a planteria at the garden centre. A planteria is a fixed structure designed to maintain plants of many different kinds moved from nurseries (which may or may not be owned by the person operating the planteria) in an environment in which they will remain in good condition until sale. It is so designed that an appropriate mini-climate can be provided in different parts of the planteria suitable for different varieties of plant and so as to be open to the public who can walk round the planteria and choose the plants on offer.

The taxpayers submitted that the planteria was plant qualifying for capital allowances under sec 41 of the *Finance Act*, being a tool in the growing of plants.

The Crown submitted that the planteria was part of the setting of the business carried on rather than the apparatus with which it is carried on. The function of the planteria was that of a shop to display plants for sale to the public in the context of the garden centre and had no function in the activity of growing plants on the cultivate land, which itself is not part of the garden centre retail complex. The plants were already grown and ready for sale by the time they were brought into the planteria. It was a structure which provided shelter for customers buying goods and for the goods themselves. The planteria's special features of design adapted to suit the nature of the goods (growing plants) were not additional functions which convert the premises into plant.

Decision

Held: Judgement for the Crown.

(1) The planteria passes the business test — that is, that it is used for carrying on the business. However an article which passes the business test is excluded if such use is as stock-in-trade or as the premises or place upon which the business is conducted.

(2) The proper remedy to correct the delay being unreasonable was for the taxpayer to take out a writ of mandamus to make the Commissioner issue his determinations in a more timely manner.

(3) The effect of the delay was not to make the determinations null and void as contended by the taxpayer. This was not intended by legislature. That the Commissioner continued to have jurisdiction in this case to issue the determinations did not necessarily cause any real prejudice to the taxpayer.

OBJECTIONS, APPEALS, OFFENCES AND PENALTIES

6-1550 Richfield International Land and Investment Co Ltd v CIR

COURT OF APPEAL (1988) 2 HKTC 444

Preliminary

This was an appeal by the Commissioner against a decision of the High Court which overturned a decision of the Board of Review and held that the gains made by the taxpayer from an asset disposal were capital in nature.

History

The Commissioner determined that certain gains made by the taxpayer from the sale of a property known as Gardena Court were assessable profits. The Board of Review held, based on the facts, that the taxpayer's original intention had been to hold its properties as investment in view of its public listing plans. However, it subsequently changed its intentions and held the properties as stock-in-trade. The taxpayer appealed to the High Court which held in favour of the taxpayer that the property was a capital asset and the gains realised capital in nature. The Commissioner appealed to the Court of Appeal.

Facts and Arguments

The taxpayer was incorporated in September 1972 as a private limited company. In October 1972, it acquired four properties. The taxpayer had no other direct interest in properties and did not acquire any more properties in Hong Kong. It did, however, acquire properties later through its subsidiaries and in California. At all material times, the properties were classified as fixed assets in the accounts from 1972 and its business was stated to be the business of long-term property investments.

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In November 1972, the taxpayer became a public company. In February 1973, the taxpayer sold one of the four properties and was assessed to profits tax on the gains made. The taxpayer did not object and the profits tax was paid. Between 1976 and 1978, the taxpayer sold all the units in another of its properties. Again, profits tax was assessed and paid on the profits on disposal.

In July 1979, the taxpayer sold Gardena Court and the gains on disposal were assessed to profits tax. The taxpayer argued that this property was held as a long-term investment and, since 1972, had been used to derive rental income only.

Decision

Held: Judgement for the Commissioner.

(1) Based upon the prospectus issued when the taxpayer went public, the early statements of the Chairman of the company, and the indirect acquisition and retention of property for long-term investment in California, the Board of Review accepted that the taxpayer's initial intention was to hold the property in Hong Kong for long-term investment.

(2) However, this intention did not last and this was supported by the sales early on in 1973 of two properties, Tai On and Lungcheong Villa. The Board of Review determined from the board's minutes on 18 April 1978 that the Chairman was quite willing to sell the properties.

(3) The Board of Review found that the original intention of the taxpayer in going public was to hold its then property portfolio for rental. However, by April 1978, the taxpayer's properties formed its stock-in-trade.

(4) The issues for the Court of Appeal were:

   (i) whether as a matter of law there was any evidence upon which the Board of Review could properly conclude that the taxpayer had altered its original intention to hold the properties as investments; and

   (ii) whether the Board of Review was correct in law in holding that the profits on sale of the Gardena Court properties were chargeable to profits tax.

(5) It is clear from case law that a decision of the Income Tax Commissioners can be reviewed only if the court is satisfied that they have made an error of law or that the only reasonable conclusion on the facts found by them is inconsistent with their determinations.

(6) It is also clearly established in case law that on appeal, the burden is on the taxpayer to displace the assessment.

(7) The High Court in this instance allowed the taxpayer's appeal, but the reasons for doing so are not clear.

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