

HONG KONG COURT OF APPEAL CONSIDERS WHETHER RECEIPT ARISING FROM THE DISPOSITION OF LAND IS CHARGEABLE TO PROFITS TAX

The Hong Kong Court of Appeal has handed down an important decision on whether monies received by a taxpayer pursuant to a redevelopment agreement should be considered "capital" or "revenue" in nature. The decision – on which the judges were divided - comes shortly after another Court of First Instance ruling in which a taxpayer was granted permission to appeal against whether sums paid to secure mobile wireless spectrum should be considered as capital or revenue.

BACKGROUND

According to section 14(1) Inland Revenue Ordinance (Cap.112) (the Ordinance), profits tax is chargeable only on profits arising in, or derived from, the carrying on by a taxpayer of a "trade, profession or business" in Hong Kong. Profits arising from the sale of capital assets are excluded from such charges. It follows that landowners may sell land at price above the acquisition cost but not be subject to tax on the profits, unless in doing so they are embarking upon a trade or business.

In *Commissioner of Inland Revenue v Perfekta Enterprises Limited* [2018] HKCA 301, the Court of Appeal considered whether the respondent taxpayer was engaged in a trade or business when it disposed of a piece of land originally acquired as a capital asset and consequently, whether profits arising should be chargeable to profits tax.

The taxpayer was the owner of a piece of land in Kwun Tong, Kowloon, having used it in the 1960s and 1970s as a toy factory. The Commissioner of Inland Revenue (Commissioner) accepted that the land was acquired by the taxpayer as a capital asset. When production later moved to the Mainland, the land was transferred to the taxpayer's subsidiary and the subsidiary then entered into a joint venture with the land developer to redevelop the land as an office and industrial complex.

Under a redevelopment agreement signed on 30 July 1994 between the developer and the taxpayer, the developer agreed to pay the taxpayer an "initial payment" of HK\$165,104,100. The Commissioner took the view that this initial payment was revenue in nature as it was a trading profit and therefore chargeable to profits tax.

Key issues

- The Hong Kong Court of Appeal has considered the principle as to whether a taxpayer receipt arising from a disposition of land should be deemed revenue or capital in nature.
- According to section 14 Inland Revenue Ordinance (Cap.112), profits tax is chargeable only on profits arising in or derived from the carrying on by a taxpayer of a "trade, profession or business" in Hong Kong.
- The majority in the Court of Appeal decided that the taxpayer had shown the requisite intention to trade by entering into a redevelopment agreement and should be liable to profits tax.

The taxpayer objected and appealed to the Board of Review (the Board) on the ground that the initial payment was a capital receipt and therefore not chargeable to tax. Because there was no dispute that the land was originally acquired as a capital asset, the Board had to determine whether there was a change of intention of the taxpayer from capital holding of the land, to trading.

The Board, by a majority, allowed the appeal on the basis that whilst there was a change of intention of the taxpayer on the date it entered into the redevelopment agreement, it was not for the purpose of trade. The majority of the Board found that the intention of the taxpayer was to dispose of the land, realise part of its value in the form of cash while reinvesting the balance in the joint venture with a view to earning more profit.

The Commissioner and the taxpayer appealed to the Court of First Instance, which allowed the Commissioner's appeal and set aside the Board's decision. The Court of First Instance ruled that the minority of the Board (the Chairman) was correct in finding that there was a change of intention to trade on the part of the taxpayer, and he was correct to take into account the subsidiary's activities and intention when ascertaining the taxpayer's intention.

The taxpayer in turn appealed to the Court of Appeal.

THE MAJORITY

The majority in the Court of Appeal, Mr Justice Cheung and Mr Justice McWalters, noted that the question of whether an activity amounts to the carrying on of a trade or business was a question of fact and degree to be determined objectively by the relevant fact-finding tribunal (in this case, the Board) having regard to all the circumstances.

An asset originally acquired as a capital asset would remain an investment unless and until the owner changed their intention to that of trading. Pursuant to section 68(4) of the Ordinance, once the Commissioner demonstrated there was trading activity following on from the redevelopment agreement, the burden of proof fell on the taxpayer to show that the assessment was excessive and incorrect.

The taxpayer also argued there was no change of intention to trade on its part because its intention all along was for a separate entity to undertake the joint venture. The majority in the Court of Appeal disagreed and found that the use of the subsidiary was only a means of implementing the taxpayer's intention to trade. They agreed with the minority of the Board that the developer did not join hands with the taxpayer to merely enhance the land for the benefit of the taxpayer. By the time the taxpayer entered into the redevelopment agreement, the taxpayer's activities had gone beyond mere enhancement for the purpose of realising the land.

An issue was raised before the Court of Appeal on the legal effect of the Board's decision after the majority's view on change of intention was rejected and the minority's view was upheld. The majority on the Court of Appeal ruled that there was no room for this argument, given the taxpayer had not asked (either before the Court of First Instance or the Court of Appeal) for the case to be remitted to the Board to determine afresh the issue of change of intention on the basis that the decision that was upheld was a minority decision.

The majority also rejected the taxpayer's contention that it had sold off the right to redevelop the land, separately from the land itself, such that the initial payment should be characterised as a capital receipt. The majority did however

consider that the issue of valuation put forward by the taxpayer should be properly examined, and remitted this back to the Board for determination.

THE MINORITY

Mr Justice Lam, in the minority, reached a different conclusion. While the majority of the Court of Appeal focused on the reasoning of the minority of the Board, Mr Justice Lam concentrated his analysis on the reasoning of the majority of the Board. He considered that it was the decision of the majority of the Board which properly represented the decision of the Board, and also the findings of the majority of the Board which properly represented the findings of the Board.

He agreed that the execution of a joint venture agreement by a taxpayer did not necessarily mean the taxpayer had formed an intention to trade, and said that finding such an intention would depend on the "*nature and implications*" of the agreement.

However, Lam J considered that the decision of the majority of the Board "*plainly ignored the separate legal personalities of the taxpayer and its subsidiary*", and the majority seemed to have treated the taxpayer and its subsidiary as one.

He was persuaded by the taxpayer's argument that the true and only reasonable conclusion on the undisputed evidence and primary facts was that the taxpayer had not changed its intention to one of trading. Even if the redevelopment agreement was seen as a "profit-making" exercise for the benefit of the taxpayer, that would still be insufficient to indicate an intention to trade.

PERMISSION TO APPEAL TO THE COURT OF FINAL APPEAL

Despite the division in giving the ruling itself, all three judges of the Court of Appeal unanimously refused the respective applications by the Commissioner and the taxpayer for permission to appeal against the ruling, in their decision on 21 August 2018 [2018] HKCA 544.

ANALYSIS

The division amongst the Court of Appeal judges demonstrates the complexity involved in determining whether receipts of taxpayers are revenue or capital in nature. The decision also demonstrates that the manner of structuring a transaction and the terms contained in the transactional documents may have a significant impact on the taxability of the receipt. There were issues in respect of which there was a divergence in analysis between the majority and the minority in the Court of Appeal, for example whether the Court can substitute the finding in the minority decision for that of the Board, and whether trading activities undertaken by a separate legal entity (a subsidiary) may be taken into consideration when determining whether income is of a capital or a revenue nature.

This decision comes shortly after another Court of First Instance decision in which a taxpayer was granted permission to appeal on the issue as to whether sums paid to secure valuable mobile wireless spectrum should be considered revenue or capital in nature (*China Mobile Hong Kong Co Ltd v Commissioner of Inland Revenue* [2018] HKCFI 373). The appeal will be heard in September 2019.

Unless either (or both) parties in *Perfekta* succeed in obtaining permission to appeal from the Court of Final Appeal itself, it is anticipated that the courts will

likely continue experiencing difficulties in interpreting provisions of the Ordinance until there is a more definitive analysis before the Court of Final Appeal at some point in the future.

In any event, these cases and their appeals will no doubt provide valuable jurisprudence as to the considerations involved when determining the nature of payments received in the corporate context.

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