HONG KONG COURT OF FINAL APPEAL DEFINITIVELY RULES IN FAVOUR OF TAXPAYER THAT ITS RECEIPT ARISING FROM DISPOSITION OF LAND IS NOT CHARGEABLE TO PROFITS TAX

The Hong Kong Court of Final Appeal has handed down an important unanimous decision in favour of the taxpayer, ruling that monies received by the taxpayer pursuant to a redevelopment agreement should be considered "capital" and not "revenue", hence the taxpayer is not liable to profits tax.

Key issues

- The Hong Kong Court of Final Appeal has considered the issue of whether a taxpayer has changed its intention concerning its ownership of a piece of land so that, when disposing of it in the context of a redevelopment in a joint venture, it was carrying on a trade or business and liable to profits tax.
- The decision reiterates the principle that the taxpayer and its subsidiary are separate legal entities. Therefore, the redevelopment undertaken by the taxpayer's subsidiary was not to be treated as operations of the taxpayer itself, and similarly the subsidiary's intention to trade could not be treated as the taxpayer's intention to trade.
- The Court of Final Appeal decided unanimously that the true and only reasonable conclusion on the evidence and facts is that the taxpayer did not change its intention in relation to the land and did not engage in a trade in disposing of it.

BACKGROUND

The detailed background of this matter is set out in our briefing discussing the earlier Court of Appeal decision ("Hong Kong Court of Appeal considers whether receipt arising from the disposition of land is chargeable to profits tax").

To recap, under the Inland Revenue Ordinance (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.

In *Perfekta Enterprises Limited v Commissioner of Inland Revenue* [2019] HKCFA 25, the Court of Final Appeal (CFA) considered whether the appellant taxpayer was engaged in a trade or business, therefore liable for profits tax, when it signed a redevelopment agreement with a developer on 30 July 1994 and thereby received an *"initial payment"* of HK$165,104,100 (as consideration for the right to redevelop the land).

The taxpayer was initially the owner of a piece of land in Kwun Tong, Kowloon, and used it for manufacturing purposes back in the 1960s and 1970s. The manufacturing later moved to the Mainland. To enhance the value of the land, the taxpayer obtained planning permission to develop a composite industrial and office building, government consent for variation of the lease and approval of building plans. The taxpayer then entered into the redevelopment agreement with the developer so that the developer and the taxpayer's subsidiary (then not formed) could enter into a joint venture for the redevelopment of the land.

The land was later transferred to the taxpayer's subsidiary. The subsidiary also entered into another agreement with the developer for the carrying out of the redevelopment joint venture, whereby the profits of the joint venture were to be shared equally between the subsidiary and the developer.

Since it was common ground that the land had been held by the taxpayer as a long-term capital asset prior to its disposal, in order for the *"initial payment"* to

be taxable, it would be necessary to find that there was a change of intention on the part of the taxpayer such that its intention was to dispose of the land as part of a trade or business.

This question is a question of fact.

THE DECISION OF THE COURT OF FINAL APPEAL

The decision of the CFA was a unanimous one.

The taxpayer's contention was that any intention to trade was that of its subsidiary, which is a separate legal entity. On the other hand, the Commissioner of Inland Revenue (the Commissioner) contended that the taxpayer changed its intention from capital holding to trading *via* its subsidiary.

The CFA disagreed with the conclusion reached by the courts below that the taxpayer changed its intention and was not disposing of the land as a capital asset, but trading. The CFA considered the fact that a subsidiary of the taxpayer was to be used for the redevelopment of the land to be important. To provide context, there are limited circumstances in which a court may disregard the principle that a parent and its subsidiary are two separate legal entities, for example, in situations involving artificial or fictitious transactions as provided for in the Ordinance. There was no suggestion that such circumstances applied in the present case nor was the Commissioner seeking to invoke them.

The CFA considered that the courts below wrongly overlooked the fact that the subsidiary was a separate legal entity embarking on its own account on a trading joint venture to redevelop the land. The redevelopment agreement already set out the taxpayer's intention that any redevelopment of the land was to be undertaken by the subsidiary and not by itself. The subsidiary was thereafter incorporated to fulfil its role in the redevelopment and became the owner of the land, entering into a subsequent agreement with the developer (to which the taxpayer was not a party). In the circumstances, the Commissioner's submissions that irrespective of whether the subsidiary had any intention to trade, the taxpayer itself had the requisite intention to trade, could not be accepted.

In this regard, the steps taken by the taxpayer to enhance the value of the land by obtaining planning permission, variation of the government lease and approval of building plans were held by the CFA to be steps entirely consistent with disposal of the land as a capital asset for the best price obtainable and did not necessarily evidence an intention to enter into a joint venture to trade.

The CFA also rejected the Commissioner's alternative argument that the taxpayer was engaged in a trade or business of *procurement*, whereby it procured a subsidiary to enter into the redevelopment joint venture, and noted that this was an argument not advanced in the courts below. Relevantly, the taxpayer was a toy manufacturer holding on a long-term basis a capital asset in the form of the land, and the substance of the transaction was that it disposed of that capital asset. It was no part of the taxpayer's business to act as a procurer of joint venture participants for property developers.

In the circumstances, the CFA decided that the true and only reasonable conclusion on the undisputed evidence and primary facts is that the taxpayer did not change its intention in relation to the land, and did not enter into a venture in the nature of a trade in disposing of it.

The final point to note on a technical matter is that the courts below had vitiated the majority decision of the Board of Review (the Board) and substituted the

minority decision for that of the Board (the minority decision being there had been a change of intention). Since the CFA found no change of intention, it was unnecessary for it to decide whether there could be such substitution, which affects whether the matter would need to have been remitted to the Board and the basis of appeal. This question remains unresolved by the CFA and remains to be clarified in the future.

CONCLUSION

This is an important decision as the CFA has provided its definitive analysis and guidance on various issues surrounding whether a taxpayer is liable to profits tax where it disposes of land in the context of redevelopment. In particular, it is welcoming to see that the CFA fully recognised that it is only in very limited circumstances that the separate legal entity principle can be disregarded.

The issue of whether there is a change of intention is a question of fact and hence depends on the specific facts and circumstances of each individual case. As the CFA has rightly pointed out, in determining whether there is an intention to trade, it is always important to remember that the question to be asked is: "*What trading or business venture has the taxpayer embarked upon?"*

The CFA, in resolving this question, undertook the exercise of evaluating various documentation, events (both before and after the execution of the redevelopment agreement) and factors. In terms of documentation, the CFA took into account the wording of the minutes evidencing the taxpayer's decision to dispose of the land and the terms of the redevelopment agreement. Regarding events, the CFA considered the whole structure of contractual arrangements and the fact that subsequent events in fact occurred in line with such structure supported the finding that there had been no change of intention. The CFA also confirmed that steps taken by a taxpayer to enhance the value of the land such as obtaining relevant planning permission and variation of the government lease may be steps entirely consistent with disposal of the land as a capital asset for the best price obtainable and did not necessarily evidence an intention to trade.

This decision therefore shows the importance of carefully structuring a transaction and wording the contractual documentation, as well as maintaining other documentary evidence (which may show a party's intention).

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