Hong Kong Tax Alert

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Court of Final Appeal rules initial payment received under a joint property redevelopment agreement for sale to be non-taxable

Whilst in a previous court case initial payments received by an original property owner-cum-investor from a property developer under a joint venture agreement in respect of the redevelopment of said property for sale purposes were held to be taxable trading receipts, the Court of Final Appeal (CFA) has found otherwise in this more recent case[1].

This CFA decision indicates that the manner and terms of structuring a transaction, and how a tax dispute concerning property investment versus trading involving a change of intention is argued, could be a highly complicated matter. Taxpayers should seek professional tax advice, where necessary.

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1. Perfekta Enterprises Limited v Commissioner of Inland Revenue (FACV 11/2018)

Facts of the case

In 1977, the Taxpayer completed the acquisition of an entire structure which was an old factory building. Subsequent to that date, and until December 1994, the Taxpayer had used the building for its toy manufacturing business.

From 1991 to 1994, the Taxpayer took various steps including several applications to the Town Planning Board and the District Lands Office for permission to redevelop the old factory building into a new composite industrial/office building. In February 1994, the said redevelopment was approved, subject to the payment of a land premium HK$61 million to the Government for the modification of the lease conditions of the old factory building site (the Land). On 23 April, 1994, the Land was valued at HK$418 million exclusive of the land premium.

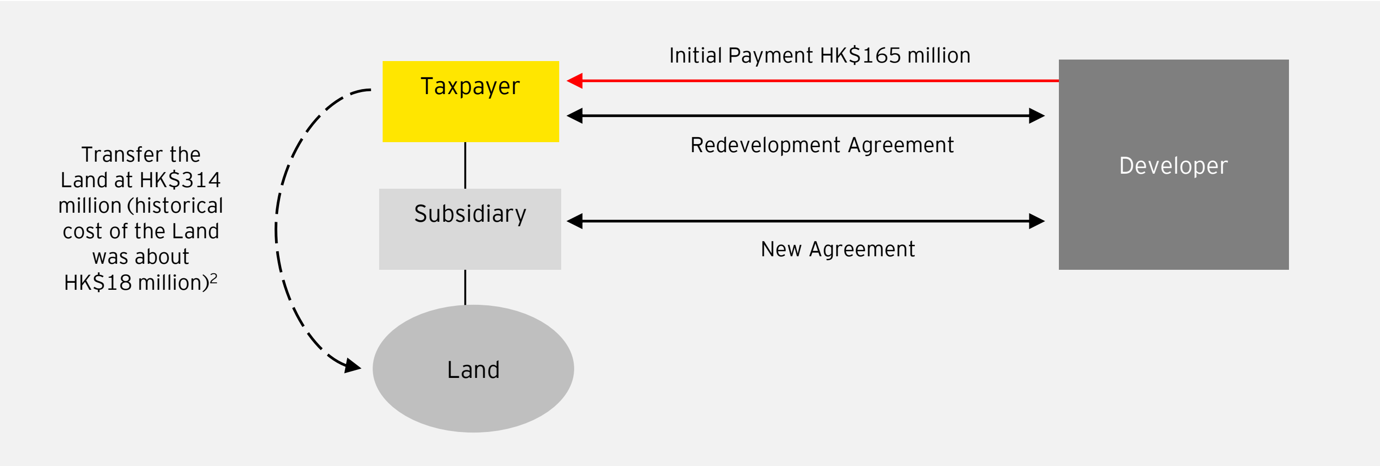
On 30 July 1994, the Taxpayer and a developer (the Developer) entered into a redevelopment agreement for the said redevelopment for sale or trading purposes (the Redevelopment Agreement). Pursuant to the Redevelopment Agreement, the Developer paid the Taxpayer an initial payment of HK$165 million (the Initial Payment) as consideration for the Taxpayer granting the Developer the right to redevelop the Land subject to the terms of the Redevelopment Agreement.

Under the Redevelopment Agreement, the Taxpayer undertook that it would (i) transfer the registered and beneficial ownership of the Land to a subsidiary (the Subsidiary) prior to the redevelopment within four months of obtaining a re-grant of the Land from the Government; and (ii) procure the Subsidiary to enter into a new agreement (the New Agreement) to redevelop the Land with the Developer, sharing profits on a 50:50 basis (a draft copy of the New Agreement being annexed to the Redevelopment Agreement).

The Redevelopment Agreement further provided that if the Subsidiary did not enter into the New Agreement, the transfer of the Land by the Taxpayer to the Subsidiary would become void and the Taxpayer would be obliged, in place of the Subsidiary, to enter into the New Agreement with the Developer.

On 14 November 1994, the Taxpayer transferred the Land at a consideration of HK$314 million to the Subsidiary, which then entered into the New Agreement with the Developer on 24 November 1994.

The facts of the case are depicted in the below diagram.



CIR assessed the Initial Payment of HK$165 million as a trading receipt

Agreeing that the Land was originally held by the Taxpayer as a capital asset, the Commissioner of Inland Revenue (CIR) accepted that the profit derived by the Taxpayer in respect of its transfer of the Land to the Subsidiary at HK$314 million was a non-taxable capital receipt.

However, contending that the Taxpayer changed its intention to one of trading upon its entering into the Redevelopment Agreement, the CIR assessed the Initial Payment of HK$165 million received by the Taxpayer under the Redevelopment Agreement as being a taxable trading receipt. The assessment was therefore based on the gross receipt of the Initial Payment of HK$165 million, without any deduction for the Land which was valued at HK$418 million around the time the alleged change of intention took place.

The Taxpayer appealed against the tax assessment in respect of the Initial Payment of HK$165 million to the tax tribunal of the Board of Review (BOR) arguing that the amount was also its non-taxable capital receipt.

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2. The Taxpayer transferred the Land to the Subsidiary at HK$314 million (i.e., the market value of the Land of HK$418 million - HK$165 million Initial Payment received + land premium HK$61 million). However, given that the land premium and other construction costs were to be borne by the Developer, it appears that, from a transfer pricing perspective, the Taxpayer should have transferred the Land to the Subsidiary at HK$253 million (i.e., HK$418 million - HK$165 million) instead of HK$314 million. As a result, at the very beginning of the joint venture project, the Taxpayer should have made no gain or loss based on the valuation of the Land at HK$418 million (i.e., HK$165 million + HK$253 million).

   Eventually, upon the completion of the sale of the said redevelopment in 2007, the Subsidiary only received a share of the net profit of the said redevelopment under the New Agreement amounting about HK$386,000. As a result, the Subsidiary suffered an almost total loss of the purchase price of HK$314 million which it paid to the Taxpayer on 14 November 1994 for the Land.

   The above additional facts would help explain why the Taxpayer sought to introduce an additional ground of appeal at the last minute at the Board of Review hearing of the case as noted in footnote 4 below.

Decision of the Board of Review

Three-member panel of BOR decided in favor of Taxpayer by a 2:1 vote

By a majority, the BOR allowed the Taxpayer's appeal, but on an unusual basis which was contended for by neither party before the BOR. The majority found that whilst there was a change of intention on the part of the Taxpayer to one of trading upon its entering into the Redevelopment Agreement, the Initial Payment was nonetheless not received as part of that trading activity. This was essentially based on its finding that the Initial Payment was received by the Taxpayer as part of the proceeds from a notional sale or appropriation of the Land from being originally a capital asset to a trading stock of the Taxpayer upon its change of intention. The majority considered that the Taxpayer embarked on a trade of property development for sale only in respect of that part of the value of the Land that the Taxpayer invested or injected into the Subsidiary (the Reinvestment Theory)[3]. As such, the Initial Payment was a non-taxable capital receipt of the Taxpayer.

Rejecting the Reinvestment Theory, the minority of the BOR held that the Taxpayer changed its intention to one of trading when it entered into the Redevelopment Agreement on 30 July 1994, which preceded the date the Subsidiary came into existence or first came into the picture. As such, the Initial Payment, derived from the Redevelopment Agreement which signified the commencement of a trade of property development for sale, was a taxable trading receipt of the Taxpayer[4].

The CIR appealed against the majority decision of the BOR to the Court of First Instance (CFI).

3. Reinvestment Theory: The majority of the BOR held that "[n]othwithstanding that there has been a change of intention on 30 July 1994 … the Appellant had not injected the entire value of the [Land] (HK$418 million) into the joint venture project at its start-up. If that was what it had invested and put at risk, then the Appellant should have been entitled to a share of profit far greater than 50 percent. But the parties had decided to embark on a joint venture where the profits were to be shared equally. They had negotiated and worked out what was needed to be paid by way of balancing payment, so that the parties' contributions to the joint venture project would be equal in value."

   The Initial Payment therefore was not … in the nature of a trading or revenue receipt. It was a balancing payment made to equalize the parties' contribution before trading commenced. It represented the carving out of part of a capital asset which was larger than that required to contribute to a joint venture project where profit was to be shared equally."

4. In addition to the above argument that the Initial Payment was a non-taxable capital receipt, on the last day of the hearing at the BOR the Taxpayer applied for permission to pursue a new ground of appeal, namely that if there was a change of intention so that the Land became trading stock, the calculation of the trading profit in respect of the Initial Payment must take into account all expenses and outgoings incurred by the Taxpayer, including the value of the Land at the date of the change of intention. The three-member panel of the BOR however unanimously refused to allow the Taxpayer this last minute additional ground of appeal. The Taxpayer appealed against this refusal of the BOR to the Court of First Instance (CFI).

Decision of the Court of First Instance

The CFI overturned the majority decision of the BOR, holding that there was no evidential and legal basis for the Reinvestment Theory. Specifically, the CFI noted that none of the terms of the Redevelopment Agreement, nor the witness evidence of the Taxpayer at the BOR hearing, expressly indicated that the Taxpayer "re-invested" by injecting only part of the value of the Land into the redevelopment and only leaving the said redevelopment to be carried out by the Subsidiary.

The CFI then upheld the minority decision of the BOR that the Initial Payment, derived from the Redevelopment Agreement for sale, was a taxable trading receipt of the Taxpayer.

The Taxpayer appealed against the CFI's decision to the Court of Appeal (CoA).

Decision of the Court of Appeal

Deciding in favor of the CIR, the majority of the CoA upheld the CFI decision, holding that the CFI judge did not commit any error of law in his decision to uphold the minority decision of the BOR.

The dissenting judgement of the CoA was given by Justice Godfrey Lam, who held that the Taxpayer did not change its intention upon its entering into the Redevelopment Agreement. Rather, the terms of the Redevelopment Agreement manifested that the joint redevelopment with the Developer for trading purposes was to be undertaken by the Subsidiary. As such, Justice Godfrey Lam held that the Initial Payment represented a mere realization of a capital asset of the Taxpayer, which was therefore not taxable.

The Taxpayer then appealed against the majority decision of CoA on the change of intention to the CFA.

On further appeal, the CFI upheld the decision of the BOR to refuse the Taxpayer's additional ground of appeal. The Court of Appeal (CoA) however considered that whether any part of the value of the Land of HK$418 million could be deducted from the Initial Payment should be properly examined and remitted the case on the issue to the BOR for its determination.

Both the Taxpayer and the CIR appealed against different aspects of the CoA decision to the CFA. Ultimately, it was unnecessary for the CFA to address the issue of whether any part of the value of the Land of HK$418 million could be deducted from the Initial Payment in ascertaining the profit derived therefrom. This was because the CFA unanimously held that there had been no change of intention on the part of the Taxpayer to embark on a trade of development for sale upon its entering into the Redevelopment Agreement, thus overturning the majority decision of the CoA that the Initial Payment was a taxable trading receipt.

Decision of the Court of Final Appeal

The CFA noted that on the authority of an earlier CFA decision in *Church Body of the Hong Kong Sheng Kung Hui and another v Commissioner of Inland Revenue* [2014] 5 HKLRD 384, the enhancement work undertaken by the Taxpayer from 1991 to 1994, undertaken with a view to maximizing the development potential and value of the Land, did not go beyond what other non-trader owners might have done in similar circumstances. As such, the relevant enhancement work, including obtaining planning permission and modifying the lease conditions of the Land, did not necessarily evidence that the Taxpayer intended to enter into a joint venture in the nature of a trade.

Rather, the CFA considered that the terms of the Redevelopment Agreement and relevant board minutes of the Taxpayer clearly illustrated that an entity "separate" to the appellant was to be used for the joint venture in the nature of a trade, i.e., it was the Taxpayer's intention to sell the Land to the Subsidiary, and for the Subsidiary to enter into a trading joint venture with the Developer. The CFA stressed as being important the fact that a subsidiary of the Taxpayer was to be used for the purposes of redeveloping the Land. This is because the Taxpayer and the Subsidiary were two separate legal entities and "the court is not free to disregard the principle of *Salomon v. A. Salomon & Co. Ltd*. [1897] A.C. 22 [on the separate legal personality of a corporation], save in limited circumstances [such as in a tax-avoidance case]".

That the Subsidiary was only incorporated after the execution of the Redevelopment Agreement was considered by the CFA as not affecting its conclusion on the intention of the Taxpayer. This was because the intention of the Taxpayer was to be gleaned not only from the terms of the Redevelopment Agreement, but also from the events subsequent to its execution.

The CFA added that the intention of the Taxpayer, i.e., of not participating in a trading joint venture, as demonstrated by the terms of the Redevelopment Agreement and the relevant board minutes, was in fact carried into effect. Such actions included the fact that:

I. the Subsidiary was later formed to enter into the New Agreement with the Developer;

II. the Taxpayer duly assigned the Land to the Subsidiary on 14 November 1994;

III. significantly, the Taxpayer was not a party to the New Agreement;

IV. the relevant provisions of the Redevelopment Agreement by which the Taxpayer might have become a party to the New Agreement were never triggered such that the intention must have remained that the Subsidiary would carry out the redevelopment rather than the Taxpayer; and

V. the profits of the joint venture envisaged by the New Agreement were to be shared equally only between the Subsidiary and the Developer.

Based on the above evidence and facts, the CFA ruled that the BOR and the lower courts erred in law in holding that the Subsidiary was the "alter ego" or a mere nominee of the Taxpayer, or was "only a method or mechanics of implementing the [Taxpayer's] intention to trade".

The CFA also dismissed Counsel for the CIR's alternative argument that the Initial Payment was a taxable receipt in the nature of a fee for the Taxpayer procuring the Subsidiary to enter into the New Agreement with the Developer.

Noting that the Taxpayer was a toy manufacturer, the CFA held that it was no part of the Taxpayer's business to act as a procurer of joint venture participants for property developers. The rights the Taxpayer granted and the obligations it undertook were only designed to enable the Taxpayer to dispose of the Land to the Subsidiary and then allow the Taxpayer to drop out of the joint venture project to redevelop the Land. None of those rights or obligations however, supported a conclusion that the Taxpayer itself was intending to embark on a venture in the nature of a trade in respect of the Land.

On the basis of the above, the CFA concluded that the true and only reasonable conclusion on the undisputed evidence and primary facts of the case was 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 the Land. Thus, the CFA allowed the Taxpayer's appeal and annulled the assessment.

Commentary

This case reaffirms the long-established "enhancement for realization" principle that where a property is originally acquired by an investor or non-trader owner as a capital asset, said owner will not generally be regarded as embarking on a trade if they engage in activities to enhance the value of the asset in order to obtain the best or maximum price upon the sale of the same.

Another perspective of the case is that this long-running tax dispute might have been avoided altogether if the said redevelopment had been structured by way of the Taxpayer transferring the Land to the Subsidiary at HK$418 million and having the Subsidiary, instead of the Taxpayer, receive the initial Payment from the Developer.

It should however also be noted that in the case *of Hong Kong Oxygen & Acetylene Co Ltd v Commissioner of Inland Revenue* [2001] 1 HKLRD 489, similar initial payments received under a joint property development agreement, also involving a separate subsidiary, under slightly different terms and considerations, were held to be trading receipts.

This CFA decision and the *Hong Kong Oxygen & Acetylene Co Ltd* case indicates that the manner and terms of structuring a transaction, and the approach taken in arguing a tax dispute concerning property investment versus trading involving a change of intention, can be highly complicated matters. Taxpayers should seek professional tax advice where necessary.

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