

Tax

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Tax Analysis

Court of Final Appeal ruled lump sum receipt arising from redevelopment arrangement non-taxable

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The Court of Final Appeal (CFA) handed down its judgement in *Perfekta Enterprises Limited (Perfekta) v Commissioner of Inland Revenue (CIR)* [2019 HKCFA 25] on 12 July 2019.

The CFA overturned the lower court decision and held that the taxpayer, Perfekta, did not change its intention of holding a piece of land as a capital asset, to holding the land as trading stock. Rather, Perfekta intended to dispose of the land by way of transfer to a subsidiary which would then redevelop the land in a joint venture with a developer, in the nature of trade. Therefore, the lump sum received by Perfekta under a redevelopment arrangement of the land was capital in nature and not subject to profits tax.

This is an important precedent for redevelopment arrangements where the owner of a capital asset (i.e. land) transferred the land to another group company for carrying out the redevelopment in the nature of trade, securing the portion of gain (i.e. increase in land value) before redevelopment as capital nature and not subject to tax. The CFA reinforced the principle that disposal of land at an enhanced value would not necessarily indicate an intention to trade. Another key point clarified by the CFA is that the separate corporate personality should not be disregarded when evaluating the intention of the taxpayer.

Background

Perfekta was engaged in the toy manufacturing business and had owned a piece of land in Kwun Tong since the 1960s / 1970s. The building situated on the land was used as manufacturing base until 1987.

From 1991 to 1993, Perfekta made various applications to the government to enable the redevelopment of the land.

In 1994, Perfekta's board of directors discussed a proposal from a developer, Cheung Kong (Holdings) Limited (Cheung Kong), regarding the redevelopment of the land and decided that any joint development venture with Cheung Kong should be carried out by a subsidiary.

On 30 July 1994, Perfekta, Cheung Kong and a subsidiary of Cheung Kong, Great Poka Limited (Great Poka) entered into a Redevelopment Agreement. Under the Redevelopment Agreement, Perfekta would receive from Great Poka an Initial Payment of HKD165 million. In return, Perfekta would transfer the ownership of the land to its wholly owned subsidiary, Newco (thereafter incorporated as Prodes Company Limited, (Prodes)), and procure Prodes to enter into a new joint venture agreement (New Agreement) with Great Poka for the redevelopment project.

Perfekta later assigned the land to Prodes which executed the New Agreement, and received the Initial Payment in accordance with the Redevelopment Agreement.

The dispute

The Inland Revenue Department (IRD) considered that the Initial Payment was revenue in nature and raised a tax assessment to Perfekta.

Perfekta appealed to the Board of Review (BoR), the majority of which characterized the Initial Payment as a "reinvestment balance" (i.e. a balancing payment made to equalize the joint venturers' contributions to the redevelopment project) and hence not taxable.

The case was appealed to the Court of First Instance (CFI) and the Court of Appeal (CA), both of which overturned the BoR's decision. Both courts were of the view that Perfekta changed its intention from holding the land as capital asset to trading stock and the Initial Payment was revenue in nature and taxable. The CA considered that the use of Prodes to carry out the redevelopment was only a method of implementing Perfekta's intention to trade. For details of the CA decision, please refer to our [Tax Analysis \(Issue H84/2018\)](#) published on 27 July 2018.

The case was then further appealed to the highest court in Hong Kong, the CFA.

Decision of the CFA

The CFA held that Perfekta 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.

Enhancing value not necessarily intention to trade

The CFA considered that the steps and activities taken by Perfekta from 1991 onwards to enhance the value of the land (including obtaining planning permission, government consent and approval of the building plans) were for ascertaining the best price it could in the course of disposing of a capital asset. It did not necessarily evidence Perfekta's intention to enter into a trade.

The CFA reinforced the principle that disposal of land at an enhanced value would not necessarily indicate an intention to trade. In the present case and in *Church Body of Hong Kong Sheng Kung Hui v CIR*, the series of activities carried out before signing the joint venture agreement, including obtaining planning permission, seeking the government's approval to change the use of the land, appointing professional service providers in relation to the redevelopment, etc. were considered as enhancing the value of the land for realization and not as the triggering events for the change of intention to trading. Although these cases may serve as precedents, a taxpayer intending to change the use of its capital assets should be careful in planning its activities. If the activities go beyond merely enhancing the value of the assets, the taxpayer may be regarded as having changed its intention from holding them as capital assets to holding them as trading stock.

Separate legal identity cannot be disregarded

According to the CA's decision, Perfekta changed its intention when it signed the Redevelopment Agreement and its subsidiary, Prodes, was only a method of implementing Perfekta's intention to trade. The CFA commented that the lower court wrongly overlooked the fact that Prodes was a separate legal entity embarking on a trading venture to redevelop the land. It was Perfekta's intention that any redevelopment of the land be undertaken by its subsidiary.

The CFA judgement emphasized that Perfekta and Prodes were two separate legal entities and such fact could not be disregarded by reference to the principles of *Salomon v. A. Salomon & Co. Ltd [(1897) A.C.22]* and *ING Baring Securities (Hong Kong) Ltd v CIR*.

"Separate legal identity" is a fundamental concept in Hong Kong law. It is uncommon for Hong Kong courts to disregard the separate legal personalities of companies. Although the CA decision of this case created controversy in respect of this fundamental concept, we are pleased that the CFA judgement made it clear that separate legal identity cannot be disregarded.

Documentation supporting the intention

The CFA found that the board of director minutes indicated that Perfekta did not change its intention from capital to trading but rather that it was going to dispose of the land by way of transfer to a subsidiary which would then redevelop it together with Cheung Kong in the venture of trade. The terms of the Redevelopment Agreement reflected the same. In addition, the fact that Perfekta was not a party to the New Agreement also demonstrated that Perfekta was not intended to be a participant in the redevelopment.

It is worth noting that the CFA heavily relied on the board minutes and agreements as evidence of the taxpayer's intention in reaching its judgement. Since intention is not easy to prove taxpayers should carefully prepare and retain documentation that could serve as important evidence for any future tax dispute.

Amount of receipt supporting the non-trade intention

In the arrangement, Perfekta would receive a total sum (including Initial Payment) equal to the value of the land (taking into account the land premium) at the time the board discussed Cheung Kong's proposal. The CFA observed that Perfekta received no more than what it would have received if it had sold the land in the open market, which evidenced that Perfekta had no intention to trade. The CFA's observation illustrated that the consideration for the right amount could also serve as evidence for intention.

Subsidiary incorporated after signing the agreement did not matter

According to the CA's decision, there was a change of intention at the time of entering into the Redevelopment Agreement because Prodes had not been established and hence the intention to trade was that of Perfekta. However, the CFA rejected the CA's line of argument on the ground that Perfekta's intention should be gleaned from both the terms of the agreement and the events subsequent to the execution of the agreement. Prodes' incorporation after the execution of the Redevelopment Agreement was an event to execute the agreement.

The different views of different judges on the cause and sequence of the events raises the question of whether taxpayers planning for intra-group transfers of capital assets for subsequent trading purposes would be better off using existing entities rather than incorporating a new entity in order to avoid a similar challenge.

Alternative argument rejected: business of procurement

During the course of the CFA hearing, the representative of the IRD sought to advance a wholly new alternative argument: Perfekta was engaged in a trade in the nature of procuring its subsidiary to enter into the joint venture agreement. Hence, the Initial Payment was derived from Perfekta's ability to grant contractual rights and to undertake obligations.

The CFA reiterated that in determining an intention to trade, it is important to identify the activity i.e. "what trading or business venture has the taxpayer embarked upon?" The CFA commented that this new alternative argument lacked reality. It was common ground that Perfekta was a toy manufacturer and no part of its business was to act as a procurer of joint venture participants for property developers.

Our comments

This court case is an important precedent for lump sums received from the disposal of land for redevelopment. It could be used as a roadmap for taxpayers when they plan to make use of their capital assets for redevelopment projects. Several key messages from this case are worth noting:

- Activities enhancing the value of an asset for disposal at the best price would not necessarily indicate an intention to trade.

- It is important to identify the activity that amounts to trading in determining an intention to trade.
- Separate legal identity cannot be disregarded even if it is an intra-group arrangement.
- Documentary evidence is crucial in backing up taxpayer's claim of its intention.

Taxpayers should also be aware that any internal restructuring arrangement should be supported by commercial reasons. In the CFA decision, the judge reminded us that it was possible for the IRD to rely on the general anti-avoidance provisions and challenge the transactions as artificial or fictitious, or designed to avoid tax liability, although those provisions did not apply in this case.

Whether there is a change of intention and whether a receipt is of capital or revenue nature are often contentious issues and questions of fact. The present *Perfekta case*, together with *Church Body of Hong Kong Sheng Kung Hui v CIR*, serve as the most recent precedents for these issues. Given the questions of fact and precedents established in these cases, it will be critical for taxpayers to consult professional tax advisors before proceeding with plans of a similar nature.

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