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Hong Kong Tax Analysis

Court of Appeal rules "Initial Payment" arising from redevelopment arrangement taxable

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Hong Kong's Court of Appeal ruled on 1 June 2018 in the case, *Commissioner of Inland Revenue v. Perfekta Enterprises Limited [2018 HKCA 201]*, that an "initial payment" received by the taxpayer under a property redevelopment agreement was subject to profits tax under the Inland Revenue Ordinance (IRO) because it represented trading income. However, the court concluded that the portion of the payment subject to tax should be based on the applicable tax principles (i.e. that the payment could be taxed on a net basis, rather than a gross basis) and referred the case back to the Board of Review to determine the amount of taxable profit. The Court of Appeal also determined that the use of the taxpayer's subsidiary to carry out property development and trading activities was a mechanism for implementing the taxpayer's intention to trade, and it seemed to disregard the separate legal identity of the subsidiary.

Background and facts of the case

Perfekta Enterprises Limited (Taxpayer) was incorporated in Hong Kong in 1965 and was engaged in the toy manufacturing business until it ceased activities in 1994. In 1969 and 1977, the Taxpayer acquired a piece of land in Kwun Tong (the Lot) that had an industrial building constructed on it. The taxpayer used the Lot as its manufacturing base in Hong Kong.

Beginning in July 1991, the Taxpayer made several attempts to apply for permission from the Town Planning Board (TPB) to develop a composite industrial/office building on the Lot. While approval from the TPB was pending, the Taxpayer received a proposal for consultancy services in relation to the redevelopment of the building on the Lot. The Taxpayer accepted the proposal in 1992, and in February

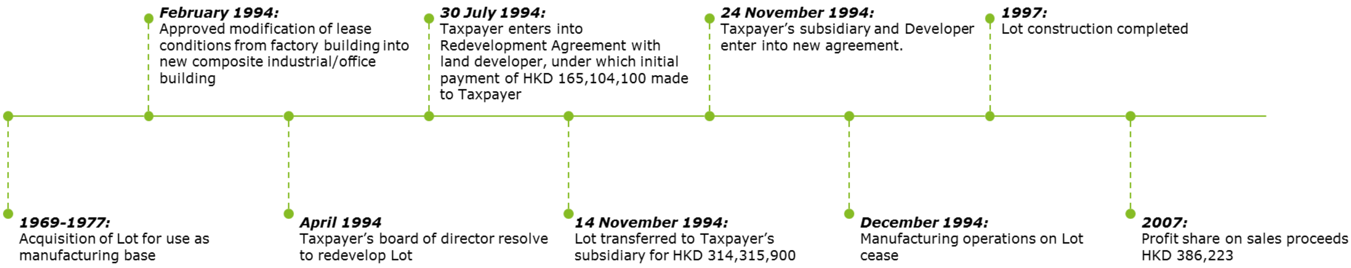
1994, the TPB approved the redevelopment application, subject to payment of a "land premium" of HKD 61,420,000 to the government for the Lot.

In April 1994, the Taxpayer's board held a meeting to discuss a proposal from another Hong Kong company (Cheung Kong) regarding the redevelopment of the Lot. Considering its redevelopment potential, the Lot was valued at HKD 418 million at that time.

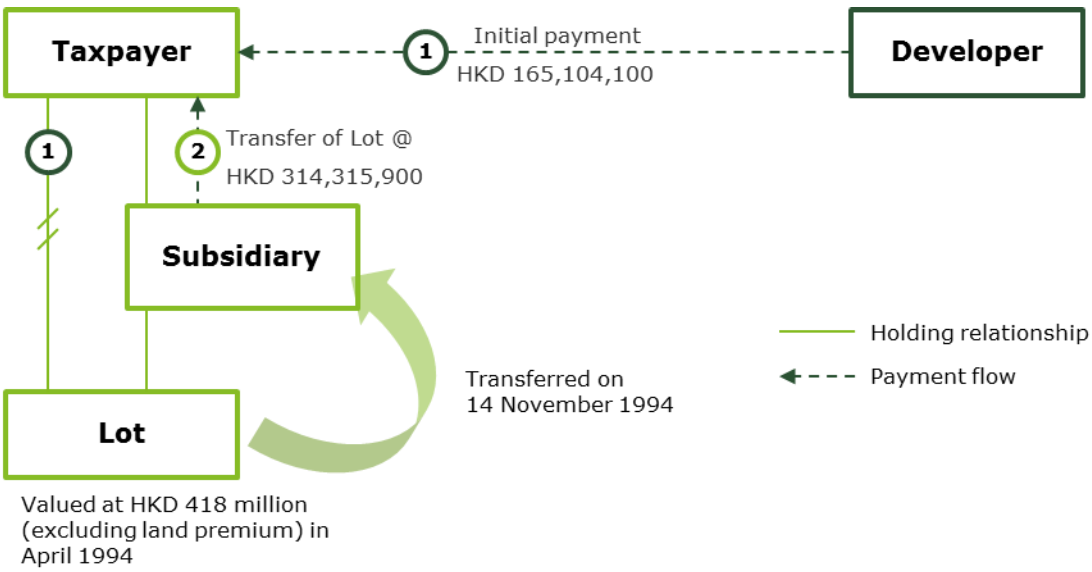
In May 1994, Cheung Kong proposed a joint venture for the redevelopment of the Lot to the Taxpayer. On 30 July 1994, the taxpayer entered into a Redevelopment Agreement with Cheung Kong's subsidiary, Great Poka, under which Great Poka would pay HKD 165,104,100 (the Initial Payment) to the Taxpayer for the right to redevelop the Lot. Great Poka also was responsible for paying the land premium of HKD 61,420,000 to the government.

On 14 November 1994, the Lot was assigned to Prodes Company Limited (Prodes), the Taxpayer's wholly owned subsidiary, for consideration of HKD 314,315,900. On 24 November 1994, Prodes entered into a new agreement with Great Poka and Cheung Kong.

Key sequence of events:



Flow of key payments:



History of the dispute

The Inland Revenue Department (IRD) raised a tax assessment on the "gain on the granting of redevelopment rights" (representing the Initial Payment) disclosed by the Taxpayer in its tax computation. The Taxpayer appealed the assessment to the Board of Review (BoR), claiming that the payment should not be subject to profits tax because it represented non-taxable income from capital rather than taxable "revenue" income from trading. The Taxpayer also presented an additional ground for appeal at the last minute, claiming that, if the payment were subject to profits tax, the tax should be applied to the net trading profit (after deducting the value of the land and other expenses), rather than the gross amount of the Initial Payment, but the BoR rejected the Taxpayer's request to amend the grounds for its appeal. However, the BoR ruled in favor of the Taxpayer that the Initial Payment was non-taxable and characterized it as a "reinvestment balance," i.e. a balancing payment made to equalize the joint venturers' contributions to the redevelopment project before trading commenced.

The IRD filed an appeal to the Court of First Instance (CFI), which held that the Initial Payment represented taxable trading receipts. As with the BoR, the CFI rejected the Taxpayer's request to amend the grounds for its appeal to claim that tax should be applied to the net trading profit. The case was then appealed to the Court of Appeal (CA).

Decision of the CA

The CA held that there was a change of the Taxpayer's intention in holding the property from investment to trading purposes when it signed the Redevelopment Agreement, and that the Initial Payment, therefore, should be taxable as trading profit.[1] However, the CA allowed the Taxpayer to amend its grounds for appeal to claim that profits tax should be applied to the net trading profit, and referred the issue of the valuation of the Lot for the purposes of assessing the taxable profit and remitted the amount of tax involved to the BoR for its determination.

Major issues discussed and comments

<u>Change of intention</u>

To determine whether the Initial Payment represented non-taxable income from capital or taxable income from trading, the CA had to determine whether the Taxpayer's intention in holding the property changed from investment to trading purposes, and if so, when that change occurred. The CA ruled that there was a change of intention from holding the Lot as investment property to holding it as trading stock when the Redevelopment Agreement was entered into by the Taxpayer and Cheung Kong on 30 July 1994. This was in line with the conclusions of both the BoR and the CFI. The ruling also was similar to a decision made by the Court of Final Appeal in the *Church Body of Hong Kong Sheng Kung Hui v. Commissioner of Inland Revenue* (2016) case (the *SKH* case), where the court determined that a change of intention likely occurred at the time the joint venture agreement was signed, not when other activities were performed prior to the signing of the joint venture agreement (the court referred the case back to the BoR to determine when the change of intention occurred).

It is a difficult, practical matter of fact whether a change of intention occurs and, if so, the exact timing of when the change occurs. Evidence must exist to establish the change of intention, and all facts and circumstances will be taken into consideration by the authorities, including steps taken before entering into a formal agreement. For example, seeking the government's approval to change the use of the land, incurring professional fees for the projection of the redevelopment costs and the value of the land, etc. may be considered in determining whether there has been a change of intention from holding land as a capital asset to holding it for trading purposes.

In the case considered by the CA, the Redevelopment Agreement to formalize the deal provided express terms binding on the Taxpayer that went beyond mere enhancements to maximize the valuation of the Lot and indicated the Taxpayer planned to engage in a trade to redevelop the Lot for sale. As such, the CA determined that there was a change of intention, and that the change occurred when the Redevelopment Agreement was signed.

Although the CA did not conclude that the Taxpayer's activities before signing the Redevelopment Agreement rose to the level of a change in intention, where taxpayers are considering changing the use of their capital assets, e.g. investment properties, and incur fees, costs and expenses during the process of exploring the feasibility of the project, the IRD could consider that there already has been a change of intention in holding the property from long-term investment to trading purposes. The IRD will consider all facts and evidence available to determine the exact date of when the change occurs for profits tax purposes.

[1] Although one of the judges held a different opinion on the change of intention and the separate legal entity issues.

Separate legal identity

The CA concluded that the redevelopment and subsequent sale of the developed property undertaken by Prodes pursuant to the new agreement entered into with Great Poka and Cheung Kong was merely a "method" used by the Taxpayer to carry out a trade. Accordingly, whether the Taxpayer intended to carry out the redevelopment work itself or to have it carried out by a subsidiary was irrelevant in determining whether a change in the Taxpayer's intention in holding the Lot occurred at the time the Taxpayer signed the Redevelopment Agreement. Under the Redevelopment Agreement, if the Taxpayer did not procure Prodes to sign the new agreement, it would have been deemed to step into Prodes's position in the new agreement and would have come under an obligation to sign the agreement. The use of Prodes to carry out the redevelopment was intended to be an "internal" arrangement. The Taxpayer's change of intention occurred before Prodes came into existence. Therefore, the intention to trade was that of the Taxpayer and not Prodes, and it was irrelevant that the Lot was assigned to Prodes and Prodes had a legal and binding development agreement with the developer and took up the actual redevelopment work.

In supporting its position, the CA quoted from the decision in the *Tai Hing Cotton Mill Ltd. v. CIR* case, that the parties (the Taxpayer and Prodes in this case) were "*parent and subsidiary; in economic terms the same enterprise under the same direction…the land was simply being passed from one pocket to the other. It did not matter to the parties what terms of sale were. In economic terms, the result would have been exactly the same whatever the taxpayer agreed to pay.*"

The CA's decision indicates that, even though trading activities may be undertaken by a separate legal entity, the intention of the overall arrangement may be taken into consideration when determining whether income is of a capital or a revenue nature. Although Prodes was the entity that actually engaged in the trading activities, this did not mean that the Taxpayer had not engaged in trade when it changed its intention in holding the Lot. The court considered that the Taxpayer changed its intention in holding the Lot from capital to trading purposes when it signed the Redevelopment Agreement and received the Initial Payment. As such, the Initial Payment was a trading receipt and should be chargeable to profits tax.

It is uncommon for Hong Kong courts to disregard the separate legal personalities of companies. It appears that the substance of the transaction in this case outweighed its commercial form when the CA considered the Taxpayer's intention. If such an approach is applied in other situations, the common practice of using separate legal entities to carry out business activities for risk mitigation and/or liability limitation purposes could no longer be effective if, under certain circumstances, the separate "boundary" between legal entities can be disregarded. As such, taxpayers should consider consulting professional advisors when conducting long-term business planning, to assess the effectiveness of the arrangements.

Valuation of the Lot

The Taxpayer had tried to present a new ground for appeal (i.e. that the calculation of profit should take into account all expenses and outflows, especially the value of the Lot) at the last minute before the BoR. However, the request was rejected by both the BoR and the CFI, mainly because the Taxpayer's proposed amendments were lacking certain factual particulars and the Taxpayer did not claim any deduction in its tax computation. The CA agreed that the Taxpayer should be entitled to adjust the amount presented in its financial statements for tax assessment purposes, if the amount did not conform to the tax principles. Therefore, CA referred the issue of the valuation of the Lot for the purposes of assessing the taxable profit and the amount of tax due to the BoR for its determination.

This aspect of the decision provides two useful reminders to taxpayers. First, if incomplete, insufficient or contradictory information and documents are presented to the BoR, that information will not be considered. Second, a tax assessment generally should be based on profits, instead of gross receipts or turnover. As such, the Taxpayer's request that it be entitled to deduct at least the cost of the Lot at the time the change of intention occurred (which requires professional valuation) in determining the amount of chargeable profits, rather than being taxed on the gross amount of the Initial Payment, effectively was accepted by the CA. We consider the Taxpayer's request reasonable, since profits tax should be imposed on profits rather than on turnover.

Reinvestment position

The BoR reached an interesting result in its ruling, that the Initial Payment was a balancing payment made to equalize the contributions of the parties to the joint venture before trading commenced. Under the BoR's position, the Initial Payment represented the carving out of part of a capital asset, i.e. the Lot, which was larger than required to contribute to a joint venture project where profit was to be shared equally. The BoR considered that the Initial Payment was a reinvestment balance, and hence non-taxable. Although both the CFI and the CA overturned this finding because none of the terms in the Redevelopment Agreement expressly stated that the Taxpayer "re-invested" by contributing part of the value of the land to the redevelopment project and that the value of the contributions would be equal, it is worth noting that if taxpayers reinvest capital assets by forming a joint venture, retaining proper documentation could help to support the position that a lump-sum payment received is a non-taxable reinvestment balance.

Concluding remarks

The *Perfekta* case is a useful reference for determining the taxability of a lump-sum receipt, whether there is a change of intention from investment to trade, how to differentiate capital and revenue income, etc. The case also serves as precedent for situations where the "boundary" between two separate legal entities was disregarded, which is seemingly contrary to the general understanding and legal principle that the IRD will treat the tax position of each legal entity separately.

In addition, both the *Perfekta* and the *SKH* cases demonstrate the importance of determining the timing of a change of intention in holding a property. The disposal of a self-used property held for a long period of time at a profit does not guarantee that it will be deemed to be "capital" in nature. Even though a taxpayer may be able to demonstrate that a property was first acquired for long-term investment purposes, any change of intention during the holding period may lead to a gain on a future disposal being regarded a revenue receipt, and thus taxable. All facts and circumstances before the taxpayer enters into a formal agreement may be considered in determining if there has been a change of intention, which would directly affect the taxable trading profits.

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