Privy Council Appeal No. 4 of 1990

Waylee Investment Limited *Appellant*

v.

The Commissioner of Inland Revenue *Respondent*

FROM

THE COURT OF APPEAL OF HONG KONG

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 13TH NOVEMBER 1990

Present at the hearing:-

LORD BRIDGE OF HARWICH
LORD OLIVER OF AYLMERTON
LORD GOFF OF CHIEVELEY
LORD JAUNCEY OF TULLICHETTLE
LORD LOWRY

*[Delivered by **Lord Bridge of Harwich**]*

The appellant company ("the taxpayer") is a wholly owned subsidiary of the Hong Kong and Shanghai Banking Corporation ("the bank"). The taxpayer was assessed to profits tax under section 14 of the Inland Revenue Ordinance for the year of assessment 1979/80 in respect of a profit of HK$517,539,670 accruing on the sale of 90 million ordinary shares in Hutchison Whampoa Limited and the assessment was confirmed by the respondent ("the Commissioner"). The taxpayer appealed to the Board of Review who discharged the assessment. The Commissioner's appeal by case stated to the High Court was dismissed by Barnett J., but was allowed on further appeal by the Court of Appeal of Hong Kong. The taxpayer now appeals to Her Majesty in Council by leave of the Court of Appeal.

Section 14 of the Ordinance provides:-

> "Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part:"

By definition in section 2(1) "'trade' includes every trade and manufacture, and every adventure and concern in the nature of trade". The issue in the case is whether, as the taxpayer contends, the profit on the sale of the shares in question was a profit arising from the sale of a capital asset, or whether, as the Commissioner contends, the acquisition and disposal of the shares by the taxpayer amounted to an adventure or concern in the nature of trade.

In the years 1972 to 1975 Hutchison International Limited ("HIL"), a very large Hong Kong trading company, was experiencing growing financial problems. HIL was a customer of the bank who held a debenture over its assets and by 1975 HIL was very heavily indebted to the bank. In August 1975 HIL was in urgent need of an infusion of liquid capital to avert imminent collapse. If HIL were forced into liquidation, the bank would suffer both as a creditor who might not be adequately secured and by the threat that the collapse of such a large Hong Kong concern would undermine public confidence in the economy of Hong Kong generally. Following an abortive proposal that HIL should raise new capital from existing shareholders by way of a rights issue, the bank offered to purchase 150 million new HK$1 ordinary shares in HIL at par which would give the bank a 30% share of the company's issued share capital, on terms designed to secure to the bank effective control over the management of the company by giving the bank the power to nominate the chief executive and to appoint two directors to the board, such powers to remain exercisable so long as the bank held not less than 20% of the issued share capital of the company.

HIL accepted the bank's offer, the new share issue and the necessary alterations of the Articles of Association were duly authorised and, in accordance with the bank's normal policy with respect to its long term investments, the shares were issued to a subsidiary company formed for the purpose, originally called Carlingford (NH) Limited, now the taxpayer. The purchase was financed by an interest free loan from the bank to its subsidiary with no date fixed for repayment. In the group consolidated balance sheet of the bank as at 31st December 1975 the group's interest in HIL is shown under the rubric "Fixed assets-investments in associated companies" and the relevant note to the accounts includes HIL in a list of a number of companies in which the bank has major shareholdings. In the taxpayer's audited accounts the holding has always been shown under the rubric "Non-current assets".

By 1977 HIL, under the new chief executive appointed by the bank, had sufficiently recovered from its difficulties to be able to resume payment of dividends. In December 1977 pursuant to a scheme of arrangement

approved by the court HIL merged with the Hong Kong and Whampoa Dock Company Limited to form Hutchison Whampoa Limited ("HWL"). Pursuant to this scheme the taxpayer received in exchange for its 150 million ordinary shares in HIL 90 million ordinary shares and 90 million preference shares in HWL. Between 1977 and 1979 the total received by the taxpayer in dividends from HIL and HWL and in turn paid as dividends by the taxpayer to the bank was HK$61,275,000. These attracted no liability to tax, since the Inland Revenue Ordinance imposes no tax on dividends as such. In September 1979 the chairman of the bank received an unsolicited offer from the chairman of another Hong Kong company to purchase the 90 million ordinary shares in HWL held by the taxpayer which resulted in a concluded sale on 24th September 1979. The purchase price received was paid by the taxpayer to the bank as a dividend. It was treated by the bank as an "extraordinary profit" and transferred direct to the bank's inner reserves. It is the profit on this sale which the Commissioner claims to tax under section 14 in the hands of the taxpayer. For completeness it should be added that the taxpayer retained its holding of 90 million preference shares in HWL until November 1983.

At the hearing before the Board of Review evidence was given by Mr. Sayer, who was chairman of the bank from 1972 to 1977, as to the circumstances in which the shares in question were acquired. The bank was concerned to rescue an important customer but lacked confidence in the management of HIL and Mr. Sayer's view was that, if the rescue operation were to succeed, the bank would have to take effective control of the company. At the same time the bank was anxious to assure its own shareholders, the shareholders in HIL and the public generally that this venture did not indicate that the bank was entering the field of general trading.

In a statement to the bank's shareholders on 5th September 1975 Mr. Sayer described the acquisition of the HIL shares as "a sizeable investment of venture capital". Adverting to the future he said:-

> "It only remains for me to re-affirm that it is the intention of the bank to substantially reduce its shareholding as soon as conditions permit and that it will be done in an orderly manner. It is in nobody's interest to have a large block of shares overhanging the market and the bank will take steps to see the market in H.I.L. shares is not distorted or disturbed on account of its holding. I am not in a position to predict how long it will take for the company to return to a profitable basis but I am confident that given the cooperation we fully expect from the staff of H.I.L. and an improvement in world economic conditions the company does have good prospects in the long term."

In evidence Mr. Sayer said that there was no way of estimating at the time how long it would take before HIL could be returned to profitability and left to stand on its own feet, but that in the event this was achieved more quickly than anticipated. Even then, as the event showed, the declared intention to reduce the shareholding was not implemented.

Mr. Pinson, who has appeared as counsel for the taxpayer throughout, rightly insists, and Mr. Goldberg, for the Commissioner, accepts, that the issue is whether the acquisition of the shares in question in 1975 and their disposal in 1979 was an adventure or concern in the nature of trade on the part of the taxpayer which was a separate legal entity from the bank and which, it is accepted, was not acting as a mere agent for the bank. At the same time it is common ground that the taxpayer's purpose in relation to the transaction cannot be distinguished from the purpose of those who effectively controlled its activities. This means, in effect, that the taxpayer's purpose reflected the bank's purpose. The crucial passages in the decision of the Board of Review indicate that they were well aware of this. They said:-

> "Evidence was given before the Board as to the underlying circumstances relating to this investment. We accept the evidence of Mr. Sayer which was to the effect that this was not a normal banking transaction or a normal transaction falling within the business of the Bank. It was a most unusual and exceptional case. We also accept the evidence of Mr. Sayer when he said that the Bank drew a clear distinction between its business trading assets and its long term investments. He said that long term investments were held in the names of separate subsidiary companies to distinguish them from the Bank's trading investment. ... On the evidence given before us and the documents submitted by Mr. Sayer in the course of giving evidence this Board has no difficulty or hesitation in finding that the appellant was not engaging in trade or in a venture in the nature of trade but was making a long term investment. Without soliciting offers or attempting to market the investment it had made, the opportunity arose to dispose of the investment or part of it at a profit and this opportunity was taken. This was some four years after the investment was originally made. The profit which was realised is a capital gain on the sale of a capital investment and not subject to the charge to profits tax."

An appeal from the Board of Review's decision lies on a point of law only. Barnett J. held that there was evidence on which the Board of Review could properly have reached the conclusion it did and declined to interfere. The Court of Appeal took a different view. They held that on the primary facts the only reasonable

conclusion was that the purchase and sale of the shares by the taxpayer was an adventure in the nature of trade. Their reasoning appears from the following passages in the judgment of the court delivered by Kempster J.A.:-

> "... it is clear beyond a peradventure that the purpose of the Hong Kong & Shanghai Bank Group in taking the steps it did in the continuance of its trading or business relationship with Hutchison, including negotiations for the unwilling purchase of 150 million shares, was to safeguard such part of its HK$1 billion loan to Hutchison as was not secured by that company's assets, to ensure that Hutchison remained a profitable customer and to make a profit when the shares or the majority of them were sold as was to be done 'as soon as conditions permit' ... The profit realised by the respondents can only be construed as the result of an adventure and concern in the nature of trade rather than of capital investment. The shares were trading stock and not capital assets. No reasonable investor looks to the stock of a failing company affording little prospect of dividends for long term investment. By the same token had the shares directly been acquired by the bank the scheme would have been an aspect both of its business in general and with Hutchison in particular and the shares have formed part of its trading stock along with other monies and financial instruments available to meet the demands of depositors."

It appears to their Lordships that the salient features of the view taken by the Court of Appeal of the facts, as indicated by these passages, may be summarised as follows:-

1. The rescue operation involving the acquisition of the shares was undertaken in the course of the bank's ordinary business and in the bank's interest to ensure the solvency of its customer.

2. The shares were intended to be resold at a profit as soon as possible.

3. In the hands of the bank the shares would have represented trading stock as securities available to meet the demands of depositors.

Much of the argument before their Lordships and in the courts below has been directed to considerations arising from the separate legal identities of the bank and the taxpayer and it has been rightly pointed out that the *bona fides* of the bank's declared policy of holding long term investments through subsidiary companies has never been challenged nor has it ever been suggested that in this case the formation of a subsidiary company to hold the HIL shares was a device aimed at avoiding liability for tax. Nevertheless their

Lordships are content, in the first instance at all events, to approach the issue on the same basis as that adopted by the Court of Appeal, who were persuaded by certain authorities that the bank's purpose and the taxpayer's purpose were indistinguishable, without examining the question whether those authorities were correctly applied. Was it open to the Board of Review to find that the HIL shares were acquired by the bank as a long term investment and that the profit now sought to be taxed arose from the sale of a capital asset which, even if held directly by the bank, would not have been part of the bank's trading stock? If it was, the Court of Appeal were not entitled to reverse that finding.

The first of the three factors summarised above as prompting the Court of Appeal's decision, sc. the importance of the rescue operation to the bank's business generally, is, in their Lordships' judgment, a substantially neutral factor so far as the character of the bank's investment in the company was concerned. A bank may, for perfectly sound banking reasons, buy shares in a customer company either as trading stock or as a capital asset and the fact that the acquisition is prompted by the importance of the company as a customer of the bank will not necessarily characterise the shares as trading stock. Mr. Goldberg concedes that if the bank's investment acquired in the course of, and for the purpose of, the rescue operation had had a sufficient quality of permanence it would have been a capital asset.

Many authorities have been referred to in the course of argument, but it has to be recognised that the law has never succeeded in establishing precise rules which can be applied to all situations to distinguish between trading stock and capital assets. The stock in trade of a bank is money and securities readily convertible into money. But it is equally clear that a bank, like any other trader, may hold investments as capital assets. The clearest indication that an investment was acquired as a capital asset would be an indication that the bank intended to hold the investment as such for an indefinite period. The clearest indication that an investment was acquired as trading stock would be an indication that it was held by the bank as available to meet the demands of depositors whenever necessary. But the indications to show to which category a particular investment belongs may be uncertain, inconclusive or even conflicting.

Here, if one asks whether the bank ever intended that the HIL shares should be held as part of the bank's circulating assets available to meet depositors' demands, the answer must surely be no. An essential feature of the rescue operation was that the bank should be seen to have confidence in HIL. Resort to the shares as part of the bank's stock in trade would have been

entirely inimical to this purpose. Moreover, the decision that the shares should be held by the taxpayer, in accordance with the bank's unchallenged policy in respect of its long term investments, demonstrates, quite apart from any technical issue arising from the taxpayer's separate legal identity, that the bank never intended to treat the shares as, in this sense, part of the bank's stock in trade. Hence, in so far as the Court of Appeal relied on the third factor summarised above, their Lordships conclude that they erred.

The question nevertheless remains whether the Court of Appeal's decision should be upheld on the basis that "the shares or the majority of them" were intended to be sold at a profit "as soon as conditions permit". The passage from Mr. Sayer's statement from which this latter phrase is taken has been set out earlier in this judgment. The intended "substantial reduction" of the bank's investment in HIL to which the statement referred was clearly related to the bank's concern not to be seen as involving itself on a long term basis in the management of a general trading company. The intention was also qualified by the condition that the reduction should not be effected in such a way as to distort or disturb the market. Their Lordships' view is that this evidence with respect to the bank's intentions when the HIL shares were acquired has been allowed, in the argument for the Commissioner and in the judgment of the Court of Appeal, to assume too large a significance. The bank's purpose in relation to the shares has to be considered in the light of the whole of the evidence and the Board of Review were, in their Lordships' judgment, entitled to draw inferences with respect to that purpose from the circumstances that in the event the entire holding was retained for over four years, continuing long after HIL was again a profitable company paying dividends, and that the eventual sale of the 90 million ordinary shares in HWL representing part only of the original holding resulted, not from any trading in the market, but from the acceptance of an unsolicited offer to buy the shares en bloc. In the light of these considerations, without examining further the arguments arising from the separate legal identity of the taxpayer and considering the purchase and sale as if made by the bank, the Board of Review's conclusion that the profit arose from the sale of a capital asset is not, in their Lordships' judgment, shown to have been erroneous in law. It follows, of course, that the transaction did not involve an adventure or concern in the nature of trade on the part of the taxpayer.

An alternative argument for the Commissioner sought to attack the decision of the Board of Review on the ground that they had treated the bank's purpose in mounting the operation to rescue HIL as irrelevant. Their Lordships do not think this argument can be sustained. The Board of Review's decision fully sets out

the argument of the Commissioner on this aspect of the case and goes on to found upon the evidence of Mr. Sayer, albeit without reciting it in full, in which the significance of the rescue operation was fully recognised. There is no doubt that the Board of Review was not prepared to attach to the rescue operation the decisive weight which the Commissioner's argument sought to attribute to it, but their Lordships see no indication that they disregarded it as irrelevant.

Their Lordships will humbly advise Her Majesty that the appeal should be allowed, the order of the Court of Appeal set aside and the order of Barnett J. restored. The Commissioner must pay the taxpayer's costs in the Court of Appeal and before the Board.