

Case No. D21/07

Profits tax – commercial building allowance – basis of calculation absent actual costs of construction – sections 33A & 36 of Inland Revenue Ordinance (‘IRO’)

Panel: Chow Wai Shun (chairman), Peter F T Roberts and William Tin Ding Hong.

Date of hearing: 21 June 2007.

Date of decision: 5 September 2007.

The appellant objected to the additional profits tax assessment for the year of assessment 1998/99 and profits tax assessment for the year of assessment 1999/2000 raised on it. The appellant claimed that the commercial building allowance to which it was entitled in respect of certain properties should be based on one-half of the costs it had incurred in acquiring those properties.

The assessor was of the view that the rebuilding allowance under section 36(1) of the IRO or commercial building allowance under section 33A of the IRO in respect of the Appellant’s properties in question (‘the Properties’) should be based on the capital expenditures incurred on construction and estimated that the costs of construction should not be more than one-half of the first assignment prices of the Properties.

The crux of this appeal was how the commercial building allowance, under section 33A of the IRO with effect from the year of assessment 1998/99 onwards, should be calculated. Specifically, the issue was in the absence of any evidence of the actual cost of construction, how the basis for calculating the commercial building allowance was to be worked out.

Held:

1. Both the rebuilding allowance and the commercial building allowance were computed by reference to the cost of construction of the building or structure. The cost of construction of the building or structure was a question of fact.
2. The appellant did not adduce any evidence to establish how much the actual cost of construction of the Properties was. Indeed, the appellant admitted that it could not be so ascertained because the Properties were built decades ago. The representative of the Inland Revenue also acknowledged that they did not ascertain

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the actual cost of construction with regard to the Properties although they managed to do so from time to time in some other cases.

3. The Board rejected the appellant's argument that the Revenue should be estopped from departing its former practice (D16/90, IRBRD, vol 5, 126 followed). The Board was of the view that what was relevant in ascertaining the basis for the commercial building allowance as from 1998/99 onwards under section 33A of the IRO was the amount of pre-1998/99 rebuilding allowance that *would have been* deducted under section 36 of the IRO, rather than that *had actually been* made to the appellant.
4. In the absence of evidence on the actual construction cost or another more appropriate approach, the Board accepted the approach taken by the Inland Revenue (Encyclopaedia of Hong Kong Taxation, Volume 3, paragraph II [13862.10] considered).

Appeal dismissed.

Case referred to:

D16/90, IRBRD, vol 5, 136

Leung Siu Yin of Messrs S Y Leung and Co for the taxpayer.
Tsui Siu Fong and Chan Sze Wai for the Commissioner of Inland Revenue.

Decision:

Background

1. This is an appeal against the determination of the Deputy Commissioner of Inland Revenue dated 26 February 2007 ('the Determination') whereby:

- (1) Additional profits tax assessment for the year of assessment 1998/99 under charge number 1-1125725-99-9, dated 8 February 2005, showing additional assessable profits of \$172,934 with additional tax payable thereon of \$27,669 was increased to additional assessable profits of \$206,085 with additional tax payable thereon of \$32,973.
- (2) Profits tax assessment for the year of assessment 1999/2000 under charge number 1-1122897-00-4, dated 31 March 2006, showing assessable profits

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of \$116,535 with tax payable thereon of \$18,645 was increased to assessable profits of \$149,686 with tax payable thereon of \$23,949.

2. The crux of this appeal is how the Commercial Building Allowance, under section 33A of the Inland Revenue Ordinance with effect from the year of assessment 1998/99 onwards, should be calculated. Specifically, the issue is in the absence of any evidence of the actual cost of construction, how the basis for calculating the Commercial Building Allowance is to be worked out.

Facts

3. In response to the question from this Board at the outset if they received any instructions from the Appellant to dispute any of the facts upon which the Determination was arrived at, the tax representatives of the Appellant said that Facts (6), (7) and (11) in the Determination (as will be seen in paragraph 4 below) were not agreed. However, the Appellant did not adduce any evidence in this regard. We further noted that the tax representatives did file a statement by Mr A, director of the Appellant, and asked if Mr A be called to give further evidence or to confirm the statement. Not without surprise, the tax representative chose not to call Mr A to swear to give any evidence before us.

4. We agree with the submission of the Inland Revenue that what the Appellant intended to dispute is the approach taken by the Inland Revenue with regard to the calculation of the allowance. The Appellant did not, and indeed cannot, dispute the existence of such assessments as well as the presence of such views taken by the assessors on which those assessments had arrived at as referred to in those Facts. As such, we find the following facts upon which the Determination was arrived at as facts of this case:

- (1) The Appellant objected to the additional profits tax assessment for the year of assessment 1998/99 and profits tax assessment for the year of assessment 1999/2000 raised on it. The Appellant claimed that the Commercial Building Allowance to which it was entitled in respect of certain properties should be based on one-half of the costs it had incurred in acquiring those properties.
- (2) The Appellant is a private company incorporated in Hong Kong on 1 May 1990. In its tax returns, the Appellant described the nature of its business as 'properties owning for rental income'. It made up its accounts to 31 March each year.
- (3) At all relevant times, the Appellant held a number of properties [hereafter collectively referred to as 'the Properties'], details of which are as follows:

Location	Date of acquisition	Cost of acquisition
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		\$
Address B ['Property 1']	29-6-1990	5,900,000
Address C ['Property 2']	8-11-1990	2,000,000
Address D ['Property 3']	29-8-1995	1,520,000
Address E ['Property 4']	17-7-1997	3,080,000

The Properties were let out for rental income during the years of assessment 1998/99 and 1999/2000.

- (4) (a) In its tax returns for the years of assessment 1998/99 and 1999/2000, the Appellant declared the following profits/(losses):

Year of assessment	Returned profit/(loss)
	\$
1998/99	951,995
1999/2000	(56,399)

- (b) In arriving at the returned profits or losses, the Appellant deducted, inter alia, Commercial Building Allowance in the amount of \$221,664 each for the years of assessment 1998/99 and 1999/2000 in respect of the Properties. The basis of computation is shown below:

Property	Cost of acquisition ⁽¹⁾	Deemed costs of construction ⁽²⁾	Accumulated rebuilding allowance claimed up to 1997/98	Residue value ⁽³⁾	Commercial building allowance ⁽⁴⁾
	\$	\$	\$	\$	\$
1	5,900,000	2,950,000	472,000	2,478,000	99,120
2	2,000,000	1,000,000	160,000	840,000	33,600
3	1,520,000	760,000	45,600	714,400	28,576
4	3,080,000	1,540,000	30,800	1,509,200	<u>60,368</u>

Note :

- (1) See Fact (3)
- (2) Cost of acquisition x 1/2
- (3) Deemed costs of construction – Accumulated rebuilding allowance claimed up to 1997/98
- (4) Residue value x 4%
- (5) On divers dates, the assessor issued the following 1998/99 profits tax assessment and 1999/2000 statement of loss to the Appellant:

(a) 1998/99 profits tax assessment issued on 27 October 1999

Assessable profits [Fact (4)(a)]	<u>\$951,995</u>
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Tax payable thereon	<u>\$152,319</u>
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(b) 1999/2000 Statement of loss issued on 28 June 2000

Loss for the year and carried forward [Fact (4)(a)]	<u>\$(56,399)</u>
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The Appellant neither objected to the 1998/99 profits tax assessment nor disputed the 1999/2000 statement of loss.

- (6) Upon detailed examination, the assessor formed the view that the Rebuilding Allowance or Commercial Building Allowance in respect of the Properties should be based on the capital expenditures incurred on construction and estimated that the costs of construction should not be more than one-half of the first assignment prices of the Properties. The assessor considered that the Appellant should only be granted Commercial Building Allowance in the amount of \$48,730 each for the years of assessment 1998/99 and 1999/2000.
- (7) In view of Fact (6), the assessor raised on the Appellant the following 1998/99 additional profits tax assessment and 1999/2000 profits tax assessment:

(a) 1998/99 additional profits tax assessment issued on 8 February 2005

\$

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Profits per return [Fact (4)(a)]	951,995
<u>Add</u> : Commercial building allowance claimed [Fact (4)(b)]	<u>221,664</u>
	1,173,659
<u>Less</u> : Commercial building allowance [Fact (6)]	<u>(48,730)</u>
Assessable profits	1,124,929
<u>Less</u> : Profits previously assessed [Fact (5)(a)]	<u>(951,995)</u>
Additional assessable profits	<u>172,934</u>
Tax payable thereon	<u>27,669</u>

Assessor's note

‘ Additional assessment is raised to adjust the Commercial Building Allowance overclaimed. For the purpose of calculation of the Allowance, 1/2 of the first assignment cost is taken as cost of construction.’

(b) 1999/2000 profits tax assessment issued on 31 March 2006

	\$
Loss per return [Fact (4)(a)]	(56,399)
<u>Add</u> : Commercial building allowance claimed [Fact (4)(b)]	<u>221,664</u>
	165,265
<u>Less</u> : Commercial building allowance [Fact (6)]	<u>(48,730)</u>
Assessable profits	<u>116,535</u>
Tax payable thereon	<u>\$18,645</u>

(8) The Appellant, through its tax representatives, objected against the assessments referred to in Fact (7) above in the following terms:

- (a) ‘ The cost of construction has already been agreed and accepted, ... The deeming construction cost (effective 1998/99) is the residue value of the cost of construction as reduced by the aggregate of allowances that were allowable to the person under the former provisions, i.e. Section 36, since the date of acquisition by that person...

The deeming cost of construction under Section 33A(4) has been in use since 1998/99 and there is no change in the I.R.O. since then.’

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(b) ‘ The original Profits Tax Assessment 1998/1999 and 1999/2000 dated 27th October, 1999 and 28th June, 2000 respectively were issued under S.33A of the I.R.O. and became final and conclusive under S.70 of I.R.O. unless you found error or omission.’

(9) In response to the assessor’s enquiry on the costs of construction of the Properties, the tax representatives stated as follows:

‘ ... The cost of construction was already possessed by the Inland Revenue Department, and our clients are puzzled why you seek the information of the cost of construction...

The cost of construction was ascertained by your Department prior to 1997/98. The cost of construction must be known to your predecessor, otherwise, how could the Assessments be made prior to 1997/98.’

(10) Records maintained by the Land Registry and the Rating and Valuation Department revealed the following information in relation to the Properties:

Property	Year built	Date of first assignment	Price for first assignment
			\$
1	1967	13-12-1967	80,000
2	1967	12-6-1969	64,000
3	1983	24-4-1984	420,480*
4	1977	31-8-1978	268,000

* \$206,800 (for one of the two Units) + \$213,680 (for the other Unit)

(11) Having ascertained the first assignment prices of the Properties as per Fact (10), the assessor opined that the Commercial Building Allowance to which the Appellant was entitled for the years of assessment 1998/99 and 1999/2000 should be recomputed as follows:

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(b) 1999/2000 profits tax assessment

	\$
Loss per return [Fact (4)(a)]	(56,399)
<u>Add</u> : Commercial building allowance claimed [Fact (4)(b)]	<u>221,664</u>
	165,265
<u>Less</u> : Commercial building allowance [Fact (11)]	<u>(15,579)</u>
Assessable profits	<u>149,686</u>
 Tax payable thereon	 <u>\$23,949</u>

Commercial Building Allowance

5. Section 36(1) of the Inland Revenue Ordinance, which provides for Rebuilding Allowance for the years up to and including the year 1997/98, reads:

'(1) Subject to subsection (2), where at the end of the basis period for any year of assessment a person is entitled to an interest in a commercial building or structure and where that interest is the relevant interest in relation to the capital expenditure incurred on the construction of that building or structure, an allowance to be known as a "rebuilding allowance" equal to 2% of the capital expenditure incurred on the construction of such building or structure shall be made to him for that year of assessment.'

6. For the years of assessment 1998/99 and after, section 36(1) ceased to apply insofar as the granting of the Rebuilding Allowance is concerned. Instead section 33A was added by the Inland Revenue (Amendment) (No 2) Ordinance 1998 (32 of 1998), and enacted on 17 April 1998, to provide for the Commercial Building Allowance instead. Section 33A reads:

'(1) Where any person is, at the end of the basis period for any year of assessment, entitled to an interest in a building or structure which is a commercial building or structure and where that interest is the relevant interest in relation to the capital expenditure incurred on the construction of that building or structure, an allowance for depreciation for wear and tear of that building or structure, to be known as an "annual allowance" of an amount equal to, subject to subsection (2), one-twenty-fifth of the expenditure, shall be made to the person for that year of assessment.'

...

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- (4) *For the purposes of this section, where immediately prior to the commencement [on 17 April 1998] of the Inland Revenue (Amendment) (No. 2) Ordinance 1998 (32 of 1998), a person was entitled to an interest in a building or structure which is a commercial building or structure and where that interest is the relevant interest in relation to the capital expenditure incurred on the construction of the building or structure -*
- (a) *the capital expenditure incurred on the construction of the building or structure shall be deemed to have been reduced by the aggregate of the amount of the rebuilding allowances that would have been made to the person under section 36 in respect of that building or structure in all prior years of assessment if at all times during the period of the person's entitlement to the relevant interest it had been used for the purposes of producing profits chargeable to [Profits Tax]; and*
- (b) *the year of assessment commencing on 1 April 1998 shall be deemed to be the year of assessment in which the building or structure was first used.'*

The Appellant's Submissions

7. It is the Appellant's case that since, in the absence of any available information as to the actual cost of construction, the Rebuilding Allowance in all years of assessment after its acquisition of the Properties up to the amendments to the Inland Revenue Ordinance in this respect with effect from the year of assessment 1998/99 was calculated and allowed on the basis of the acquisition costs incurred by the Appellant, the cost of construction for the purposes of calculating the Commercial Building Allowance for the year of assessment 1998/99 was deemed to be the residue value at the year of assessment 1997/98.

8. On such basis and with reference to the proviso to section 70A of the Inland Revenue Ordinance, the Appellant submitted that no correction to any assessment made on the basis of or in accordance with the then prevailing practice could have been permitted.

9. The Appellant further contended that it had not been notified of the change in the basis of calculating the deemed cost of construction and the onus has shifted back to the Inland Revenue to show and explain which one is the correct approach.

Analysis

Onus of proof

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10. We do not agree with the last point of the Appellant's submissions. We agree with the Inland Revenue that there is nothing provided in the Inland Revenue Ordinance requiring any notification before an assessment or an additional assessment can be made. In contrast, section 68(4) of the Inland Revenue Ordinance clearly provides that the onus of proving that the assessment appealed against is excessive or incorrect shall be on the Appellant.

Section 70A

11. Section 70A reads:

'(1) Notwithstanding the provisions of section 70, if, upon application made within 6 years after the end of a year of assessment or within 6 months after the date on which the relative notice of assessment was served, whichever is the later, it is established to the satisfaction of an assessor that the tax charged for that year of assessment is excessive by reason of an error or omission in any return or statement submitted in respect thereof, or by reason of any arithmetical error or omission in the calculation of the amount of the net assessable value (within the meaning of section 5(1A)), assessable income or profits assessed or in the amount of the tax charged, the assessor shall correct such assessment:

Provided that under this section no correction shall be made to any assessment in respect of an error or omission in any return or statement submitted in respect thereof as to the basis on which the liability to tax ought to have been computed where the return or statement was in fact made on the basis of or in accordance with the practice generally prevailing at the time when the return or statement was made.

(2) ...'

12. We cannot accept the Appellant's submission in this regard either. We agree with the Inland Revenue that this is not a case on section 70A. Section 70A(1) allows a taxpayer to apply to correct an assessment, notwithstanding that it had become final and conclusive under section 70, by establishing to the satisfaction of an assessor that the tax charged is excessive due to certain prescribed errors or omissions. This has not been the course taken by the Appellant; this has been an objection under section 64.

Actual Cost of Construction

13. Both the Rebuilding Allowance and the Commercial Building Allowance are computed by reference to the cost of construction of the building or structure. The cost of construction of the building or structure is a question of fact.

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14. The Appellant did not adduce any evidence to establish how much the actual cost of construction of the Properties was. Indeed, the Appellant admitted that it could not be so ascertained because the Properties were built decades ago. The representative of the Inland Revenue also acknowledged that they did not ascertain the actual cost of construction with regard to the Properties although they managed to do so from time to time in some other cases.

Deemed Cost of Construction

The 'estoppel' argument

15. The Appellant relied on the letter from the Inland Revenue informing its assessed loss with regard to the year of assessment 1990/91 in which the deemed cost of construction for the calculation of the then Rebuilding Allowance was taken to be half of the acquisition cost incurred by the Appellant in its purchase of Property 1 and Property 2. In essence, the Appellant argued that the Revenue should be estopped from departing from its former practice.

16. In light of D16/90, IRBRD, vol 5, 136, one of the authorities included in the Revenue's submissions in which the 'estoppel' argument was rejected, we asked the tax representative of the Appellant if this appeal be distinguished and, if so, how. Apart from saying that the former case dealt with education allowance in computing the rental value for assessment in salaries tax, the tax representative rendered no useful assistance in this regard. We hold the view that the principles equally apply to these two cases despite the fact that different subject matters were being involved.

17. In any event, we accept the submission of the Inland Revenue that what is relevant in ascertaining the basis for the Commercial Building Allowance as from 1998/99 onwards under section 33A of the Ordinance is the amount of pre-1998/1999 Rebuilding Allowance *would have been* deducted under section 36 of the Inland Revenue Ordinance, rather than that *had actually been* made to the Appellant.

First Assignment Price or Acquisition price incurred by the Appellant?

18. We are not aware of any judicial interpretation directly on or relevant to this issue.

19. The tax representatives of the Appellant allegedly referred in their written submission another assessment made by a different assessor in respect of the year of assessment 1990/91 without disclosing the name of the taxpayer in which the same approach as described in paragraph 15 was taken and claimed that it was the prevailing practice of the Inland Revenue at that time to refer to the acquisition cost incurred by the taxpayer in calculating the then Rebuilding Allowance. The tax representatives did not take this any further at the hearing. The document was not even referred to in the statement of the Mr A (see paragraph 3 above). In such circumstances, we decide

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not to attach any value to the document.

20. The Appellant referred us to Part B of the Departmental Interpretation and Practice Notes No 2 (revised April 1999) and extract of notes of a tax seminar on lodgement of 1998/99 tax returns allegedly conducted by the Inland Revenue. We note that neither of these documents would have rendered any assistance to this case as the cost of construction was given in the examples.

21. On this issue, the representative of the Commissioner submitted that having regard to the years in which the Properties were respectively built and the general property market trend since their construction, taking half of the first assignment price as the deemed cost of construction is fair, reasonable and appropriate. The logic of this approach, as explained by the representative of the Commissioner, is this:

- (1) the acquisition cost incurred (that is, the purchase price paid) for a property comprises three elements: (i) construction cost, (ii) land cost and (iii) the appreciation or depreciation in value over time, of which the first two elements are static as historical cost whereas the third element would vary depending on the market conditions.
- (2) The first assignment price of a newly completed property likewise comprises the first two elements and in addition usually a profit margin for the developer. It is unlikely to be on the low side to estimate the first element by taking it as half of the first selling price.
- (3) In Hong Kong, it is generally known to be a case of appreciation before the property prices reached their record high in late 1997. With inflation and a buoyant property market, the acquisition cost is substantially higher than the original construction cost over the years. The appreciation in turn comprises the upsurge in the land value and the profits of the subsequent sellers. As time goes by, the third element far exceeds the other two elements but only the first element would qualify for the Rebuilding Allowance or the Commercial Building Allowance. To take half of the acquisition cost incurred by the Appellant in the 1990s as cost of construction of the Properties would be a gross over-estimate of the cost of construction by merging with it the big appreciation in value of the property over time.

22. The representative of the Commissioner further added that for many years it has been the practice of the Inland Revenue to determine the cost of construction based on the first assignment price. In this regard, she further directed us to the Encyclopaedia of Hong Kong Taxation, Volume 3:

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‘For many years the Inland Revenue Department’s practice has been to determine the cost of construction based on the first assignment value. For buildings purchased prior to 1 April 1998, normally one-half of the first assignment value is taken as the relevant cost. (Source: Minutes of Annual Meeting between representatives of the Hong Kong Society of Accountants and the Inland Revenue Department, held in March 2000).’ (paragraph II [13862.10])

23. To this approach, the tax representatives of the Appellant chose to give no reply. In the absence of evidence on the actual construction cost or another more appropriate approach, we accept the submission of the Inland Revenue.

Our decision

24. We do not find any basis, legal or factual, to disturb the Determination. We dismiss the appeal accordingly. It remains for us to thank the representative of the Inland Revenue for her useful and thorough written submissions.