

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D21/89

Profits tax– whether profits on sale of properties were taxable – weight to be given to evidence.

Panel: Henry Litton QC (chairman), Eric Lo King Chiu and Frank Wong Kuen Chun.

Dates of hearing: 5, 6, 7, 12, 14 and 15 June 1989.

Date of decision: 30 June 1989.

The taxpayer was a company owned by two brothers. The taxpayer acquired a number of properties which were carried in its books as trading stock. The first property was redeveloped and retained for a number of years during which rental income was collected. The property was ultimately sold at a profit. The other four properties which were the subject matter of the appeal had been acquired over a number of years. The four properties were sold together for the purpose of redevelopment. It was argued by the taxpayer that the four properties had been acquired originally as part of a business carried on by the taxpayer or the shareholders of the taxpayer which was unrelated to property development.

Held:

All of the properties in question were trading stock of the taxpayer and accordingly the profits arising on the sale of the properties were subject to profits tax. Contemporaneous documentary evidence and accounts which supported the Commissioner's case were considered to be of greater evidentiary value than evidence given by one of the brothers.

Appeal dismissed.

D J Gaskin for the Commissioner of Inland Revenue.

Wilson Chan instructed by Cheung Chan Chung and Fong for the taxpayer.

Decision:

Introduction

INLAND REVENUE BOARD OF REVIEW DECISIONS

1. This appeal is concerned with the profits realised by the Taxpayer Company ('the company') upon the sale of the following properties:

	<u>Property</u>	<u>Bought</u>	<u>Sold</u>
(a)	property A	August 1969	22-7-81
(b)	property B	May 1973	9-8-82
(c)	property C	January 1976	9-8-82
(d)	property D	June 1976	9-8-82
(e)	property E	August 1976	9-8-82

2. The profits on the sale of property A in the year ending 31 March 1982 were credited to the capital reserve account and was accepted originally by the assessor as a capital profit not liable to profits tax. However, when the further disposals of property were made in the following year, the assessor raised an additional assessment bringing in the profits realised on the disposal of property A as an additional assessment for the year of assessment 1981/82 under the provisions of section 60(1) of the Inland Revenue Ordinance.

3. As regards the disposals in the year ending 31 March 1983 (properties (b) to (e) above), the assessor came to the view that the profits realised on the sale of property B were assessable to profits tax and assessed the company accordingly. The assessor accepted, however, that properties (c), (d) and (e) above (that is, properties C, D and E) were capital assets the profits on the realisation of which were not chargeable to profits tax.

4. Upon the company objecting to the assessor's 1981/82 additional assessment in respect of property A and his 1982/83 assessment in respect of property B, the Commissioner in the exercise of his powers of determination concluded that not only were the properties under objection trading stock of the company; he went further and concluded that properties C, D and E were likewise part of the company's trading stock and accordingly increased the 1982/83 assessment to bring in the profits on the disposal of properties C, D and E.

5. It is against these assessments as varied by the Commissioner that the company now appeals to the Board of Review.

Background Facts

6. The company was incorporated in 1963 with an authorised capital of \$2,000,000 which was fully paid up during the year ending 31 March 1971.

7. The shareholding in the company has at all times been held in equal shares by two brothers, Mr X (the elder brother) and Mr Y. The elder brother died in 1988. The two brothers have throughout been the only directors of the company.

INLAND REVENUE BOARD OF REVIEW DECISIONS

8. For many years the two brothers have been operating bars in Hong Kong. There was first the T Bar which was operated from the ground floor of property F which the company purchased in late 1963.

9. In about 1965, the company purchased property G and the ground floor was used by the two brothers to set up the S Bar. The top floors of property G were let out for rental income.

10. In the financial statements of the company for the early years, the properties from which the T Bar and S Bar were operated were reflected as the capital assets of the company. In its early years, property letting was the company's major activity and rental income its major source of income.

11. What we are concerned with in this case are the activities of the company for the years ending 31 March 1970 and onwards, and what, in particular, were the intentions of the directors to be inferred from the acts and declarations of the company with reference to the properties in question.

Property A, Hong Kong

12. We deal, first of all, with property A. It is apparent from the financial statements of the company placed before us that, in the year ending 31 March 1970, the company embarked upon an aggressive programme of property acquisition. In the balance sheet of the company as at 31 March 1970, under the heading of 'property investment account', the balance brought forward from the previous year was the figure of \$1,461,933. In the course of that year (that is, the year ending 31 March 1970), the company made the following acquisitions:

<u>Property</u>	<u>Cost</u>
	\$
property H	562,750
property J	405,900
property A	128,050
property K	<u>207,500</u>
Total	<u>\$1,304,200</u>

13. Of the properties referred to in paragraph 12 above, the last three were vacant sites.

14. Property H was adjoining four-storied pre-war buildings, the ground floor of which was occupied by the W Bar. After the company had acquired property H, the two brothers took over the business of the W Bar. Rent was paid by the W Bar business to the company in respect of the ground floor of property H and the upper floors were let to sitting tenants.

INLAND REVENUE BOARD OF REVIEW DECISIONS

15. It is apparent from the financial statements for the year after acquisition (year ending 31 March 1971) that the company proceeded to develop the vacant sites at property J, and at property A. Construction costs were incurred, architects fees paid. There were also other items of expenditure such as foundation stabilisation costs for property A.

16. Property A was developed together with an adjoining property owned by the mother of a friend of Mr Y. The development was completed in 1971 and property A consisted of a residential block with six floors, one domestic unit of approximately 600 square feet per floor. The total development cost (including land cost) came to approximately \$318,853 and the property was let thereafter by the company for rental income which represented a considerable return on its outlay. For the first five years after the development was completed, property A yielded rental income as follows:

<u>Calendar Year</u>	<u>Rental Income</u>
	\$
1971	44,100
1972	75,600
1973	73,100
1974	85,700
1975	82,200

The property continued to be let by the company until it was sold in July 1981: that is to say, some 10 years after the property was developed and let for rental income.

17. Pausing at this point in our findings of fact, there would seem at first blush to be a strong case for saying that property A was intended by the company to be held for investment purposes and that its realisation in July 1981 gave rise to no assessable profit.

18. However, there have been adduced in evidence before us statements and declarations made on behalf of the company shortly after property A was acquired which suggest that the property was bought for re-development and sale and that the company treated the property, at least in the earlier years, as trading stock. It is to these matters that we now turn.

19. Firstly, in relation to the four properties set out in paragraph 12 above which the company acquired in the year ending 31 March 1970, the company made a clear distinction between the developed property H (the ground floor of which was occupied by the business of the W Bar) on the one hand, and the three vacant sites (including property A) on the other. In the financial statements of the company for the year ending 31 March 1971, whilst property H was classified as 'properties (land and building) bought for rental' (together with some other properties which were clearly held for long-term investment), the three vacant sites were classified as 'properties bought for re-development and sale'. The balance sheet was signed by the two directors of the company (the two brothers) and the

INLAND REVENUE BOARD OF REVIEW DECISIONS

costs of development of property J and of property A were included with the land cost in the schedule.

20. Secondly, by a letter dated 23 November 1970, a firm of certified public accountants told the assessor that property J and property A were acquired for the purposes of development and sale.

21. Thirdly, in the audited accounts of the company for all the years up to 31 March 1974, property A was always classified as property bought for re-development and sale. (Thereafter, the company adopted a different method of presentation in its balance sheet so that no distinction was made after 31 March 1974 between properties held for rental income and properties held for re-development and sale).

22. Fourthly, in relation to the other two vacant sites acquired in the year when the site of property A was purchased, the disposals by the company were clearly treated as chargeable under section 14 of the Inland Revenue Ordinance. The details are as follows:

<u>Property</u>	<u>Date of Sale</u> (year ended)	<u>Profit/(Loss)</u> \$
property L	31 March 1972	804,073
property K	31 March 1973	(2,508)

23. Mr Y gave evidence before us at the hearing to the effect that from the beginning property A was intended to be retained for investment. He said that the company's books and accounts were, at all material times, kept by a book-keeper and that the financial statements and tax returns were prepared by a clerk employed a firm of certified public accountants. Mr Y said that he knew no English and signed the financial statements of the company without the least understanding of what they said. The effect of Mr Y's evidence is that the financial statements showing the property A as acquired for 're-development and sale', and the letter dated 23 November 1970 written by the firm of certified public accountants to the assessor to the same effect, were pure concoctions of this clerk and did not represent the truth.

24. We should add, for the sake of completeness, that in the course of the tax objection, the accountant firm placed before the assessor a series of minutes of board meetings. The minutes were supposedly taken by the book-keeper in the Chinese language and, insofar as they affect property A, the minutes of a meeting purportedly held on 3 September 1973 (at 11:00 a.m.) recorded the following:

1. The building at property A was originally planned to be sold after completing construction. But the building was left un-sold after putting up advertisements for several months. Therefore, it was rented out for investment purpose and for the normal income receipt of the company'.

INLAND REVENUE BOARD OF REVIEW DECISIONS

25. Mr Y in his testimony before us said that although he signed these minutes, they were in fact pure concoctions, intended to be put forward to mislead the Inland Revenue Department. He said that he had never, in the course of his life, sat down with his brother at any formal meeting to discuss the affairs of the company and that these purported minutes simply did not represent the truth. Mr Y said that the suggestion in these so-called minutes that the building at property A was 'originally planned to be sold after completing construction' was completely untrue and he added that, in his experience, there had never been any instance where a building upon completion in Hong Kong had been 'left un-sold' after advertisements had been put up for several months.

26. As regards property L Mr Y said that this was intended to be developed also for the purposes of a bar, but upon completion he found the location unsuitable for such purpose and he therefore sold it. Why this unsuitability was not apparent from the very beginning was never explained.

27. We place very little reliance upon the testimony of Mr Y regarding the purported intentions of the company in relation to property A. The company's 'intentions' are, in effect, the state of mind of the two brothers combined, insofar as their minds were applied with regard to the affairs of the company. The elder brother of Mr Y is dead; a bare declaration of intent by a self-interested witness like Mr Y, years after the event, unsupported by contemporaneous and objective facts, carries very little weight.

28. In evaluating the evidence before us, two broad and opposing factors emerge:

- (i) the various factors which we have summarised in paragraphs 19 to 22 above all point to the company intending to treat property A as trading stock;
- (ii) the factors which we have enumerated in paragraph 16 above tend to suggest that it was intended for long-term investment. We add here in parenthesis another factor: when, because of economic constraints brought about by the share crash in March 1973, the site of property K was sold by the company, the company nevertheless retained property A.

In evaluating the evidence, we were inclined at one point to lean towards the conclusion that the company had, some time in the mid-1970's, changed its intention regarding property A: that is, from treating it initially as trading stock, the company then resolving later on to hold it as a long-term investment. However, we are in effect precluded from drawing such a conclusion because Mr Y (who now, in effect, is the sole voice of the company), stated categorically in his evidence that the company had never changed its intentions regarding the property. In view of this, we did not pursue this line of thought any further and turned our attention to the fundamental question: was the property intended, as Mr Y now asserts, to be held throughout for long-term investment (until, of course, the time when the company decided to sell it) or was it, as the contemporaneous records show, intended for re-development and sale?

INLAND REVENUE BOARD OF REVIEW DECISIONS

29. In viewing Mr Y's evidence, we do not believe that Mr Y was as ignorant of the contents of the company's financial statements as he now professes. He has been in business for very many years and has, in other dealings with other parties, been heavily engaged in property development (a list of such developments were put to Mr Y in the course of cross-examination which Mr Y said was correct). Moreover, we must view with some scepticism the testimony of a self-interested witness who, on his own admission, is prepared to put his signature on false minutes which he must have realised were intended to be put forward to mislead: here, he was no excuse for linguistic handicap because the false minutes which he signed were expressed in Chinese.

30. Against the written and contemporaneous records on the one hand, as summarised in paragraphs 19 to 21 above, and Mr Y's oral evidence before us on the other, we come down heavily in favour of the former. In our view, property A was acquired as trading stock, developed for re-sale, and sold as trading stock.

Property B, property C, property D and property E

31. Property E is separate from properties B, C and D by a scavenging lane. They are all pre-war four-storied buildings, acquired by the company progressively from November 1965 to June 1976 and conveyed eventually as one block to a subsidiary of a property development company for the purpose of re-development into an office block. The properties in question formed part of a larger block which comprised also property M and property N; the consideration for the company's properties was satisfied partly in cash and partly in shares in the subsidiary of the property development company.

32. The company first acquired property P in 1965 and there seems little doubt that these were acquired and retained as capital assets for long-term investment. The two brothers used the ground floor of property P (together with the ground floor of property C which, at that time, they rented) to operate a new bar known as the U Bar. Property P was acquired with funds belonging to the company and, thereafter, the business of U Bar paid rent to the company for the ground floor of the premises, the upper floors being rented out to sitting tenants for rental income. It made sense to acquire the properties for the purposes then contemplated: that is, running the bar businesses. As they were pre-war premises, there was no question of acquiring title to part of the premises.

33. As we have mentioned in paragraph 14 above, property H was acquired in February 1970 together with the existing business of the W Bar. Properties P and H have throughout the proceedings been treated by the Inland Revenue Department as capital assets – until the opening of the appeal before us when Mr Gaskin, on behalf of the Commissioner, said that he wished to 'reserve' his position regarding property P and property H. As the matter is not formally before us by way of appeal under the provisions of section 68 of the Inland Revenue Ordinance, we cannot, of course, express any firm views on the matter; property P and property H only come into the picture by way of background facts; but it would be proper to add that, from the evidence before us, there is nothing to

INLAND REVENUE BOARD OF REVIEW DECISIONS

indicate that with regard to these properties the view formed by the Inland Revenue Department in the past that they constituted capital assets of the company was in any way erroneous.

34. We come then to the circumstances surrounding the acquisition of property B in May 1973.

It is the company's case that property B was acquired by the company to enable the business of the U Bar to expand into the ground floor of property B. The evidence indicates that the premises of the U Bar were indeed enlarged and the U Bar did indeed occupy the ground floor of property B as well. The question is whether the acquisition of the property was solely for this purpose as Mr Y maintains in the witness box, or whether the dominant purpose was for re-development and sale.

35. The factors which are against the company's contentions are as follows:

- (i) Up to and including the year ending 31 March 1972, the company's activities were financed by shareholders funds and advances from directors. Thereafter, it borrowed extensively from banks and, as at 31 March 1973, the bank overdraft balance of the company stood at a figure of \$2,469,568.
- (ii) The rental yield from property B was negligible compared to the mortgage interest attributable to the property. In a schedule produced by an accountant called by Counsel for the company, and placed before us the rental income from property B for the calendar year 1973 was stated to be \$16,716; for the same period, the mortgage interest referable to property B was \$161,862.
- (iii) In the financial statements for the year ending 31 March 1973, property B was classified under the heading 'properties bought for re-development and sales'.
- (iv) In a letter dated 4 August 1986 from the company's tax representatives, the representatives stated as follows:

‘ Our clients owned a number of properties. It had always been our clients' ambition to erect a big office block comprising [sic] these properties.
- (v) In the year ending 31 March 1975, the company engaged the services of architects to draw up plans for the re-development of properties B, H and P and incurred fees amounting to \$35,000. The company also engaged the services of surveyors to negotiate with the Government to

INLAND REVENUE BOARD OF REVIEW DECISIONS

consolidate the properties B – H and M – P (eliminating the scavenging lane) and paid fees amounting to \$50,000.

- (vi) By about 1975, with the ending of the Vietnam War, the business of the W Bar operated at property H was so poor that the W Bar was closed by the two brothers.

36. Although Mr Y in evidence maintained that the conclusion of the Vietnam War did not have much effect on the business of the U Bar (because, unlike the W Bar, the business of U Bar, he maintained, depended more on local customers than visiting American sailors) we can place little reliance upon this statement. It seems to us that the pattern which emerged from the company's activities from about 1973 when property B was acquired was a policy of acquisitions for the purposes of development. In January 1976 the company acquired property C where, on the ground floor, the business of U Bar had been located for some time. This was followed in June 1976 with the acquisition of property D. Mr Y in evidence said that the company intended to further expand the business of the U Bar to the ground floor of property D as well: but this in fact did not take place. He claims this was because it was too costly, and too disruptive of the business of the U Bar to do so. But we have little difficulty in concluding that, by that stage, the bar business of the two brothers was very much a secondary matter. The borrowings of the company had increased very substantially (the bank overdraft balance as at 31 March 1977 was \$4,367,153) and the rental yield from the properties B, C and D was small compared to the mortgage interest which the company was paying in respect of those properties. We should add here in parenthesis that the schedule produced by the accountant Mr Z was a thoroughly unsatisfactory piece of evidence in that the basis for the attribution of mortgage interest to the various properties was never explained: but, as a statement against the company's case, it carries a little weight.

Circumstances of sale

37. The agreement by which the company sold the properties in question is dated 12 April 1979. The vendors under that agreement were (i) the company and (ii) another company called R Limited who, by the same instrument, sold to the same purchaser property Q. Property Q had been acquired by R Limited a few months before (in November 1978). The relationship between the two brothers and the directors and shareholders of R Limited is obscure and has never been satisfactorily explained by Mr Y in the witness box. We conclude from all the circumstances that there was in fact a very close relationship between the Y brothers and the shareholders of R Limited; the two brothers clearly had some interest (direct or indirect) in the acquisition of property Q in November 1978; the probabilities are that property Q was acquired (in November 1978) to make the package for re-development of the company's properties more attractive.

38. By 31 March 1979, the bank overdraft balance of the company stood at the figure of \$9,832,923.

INLAND REVENUE BOARD OF REVIEW DECISIONS

39. It is difficult to see how the company, with its resources, could have re-developed all these properties as an investment for long-term rental yield. The sale to the subsidiary of property development company in April 1979 (but not completed until 9 August 1982 because of a pending piece of litigation) merely completed a process of re-development and re-sale which commenced with the acquisition of property B in 1973.

Conclusion

40. We are satisfied, having regard to all the circumstances of this case, that the properties in question constituted the trading stock of the company and the profits realised upon sale are assessable to profits tax. The appeal is accordingly dismissed.