

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D23/87

Board of Review:

Robert W. N. Wei, *Chairman*, CHAN Cheuk-yuen, Raphael and Andrew J. Halkyard, *Members*.

25 August 1987.

Profits Tax—whether compensation received from the Hong Kong Government was taxable in the year of assessment 1981/82.

In January 1973 a property which was a pre-war building occupied by tenants was acquired by the Appellant with the intention of redeveloping it for the purpose of producing rental income and in 1977 the building was demolished. In the same year the Building Authority disapproved the taxpayer's piling plan as it would be incompatible with works required for the construction of the Mass Transit Railway. The property was therefore leased to the Hong Kong Government for use as a work site by the Mass Transit Railway Corporation up to April 1978 and the rent received was brought to charge to profits tax. The lease was extended for three years from April 1978 and at this stage the Appellant lodged a claim for compensation under Section 21 of the Mass Transit Railway (Land Resumption and Related Provisions) Ordinance. The claim was settled on the terms that among other things the Appellant would receive a compensation of \$3.25 million and a nominal rent for the next three years. No lease was in fact executed but the Mass Transit Railway Corporation remained in occupation of the property throughout the three year period. The amount of compensation was not assessed to profits tax.

In March 1981, the Government informed the taxpayer that it would require to occupy the property for a further period of six months from 1 May 1981. On 19 May 1981 the Appellant's directors resolved the redevelopment of the said property for sale instead of for rental purposes be ratified and confirmed. In July 1981 the Appellant lodged a claim for compensation in the sum of \$5.87 million on the same grounds as its 1978 claim and in November 1981 the Appellant accepted a sum of \$4.7 million in full and final settlement of all or any claim against the Government arising out of the occupation of the property. The property was reclassified from fixed assets to current assets in the Appellant's accounts for the year ended 31 March 1982 and the compensation of \$4.7 million was entered as an extraordinary item in the accounts.

The property remained occupied by the Government during the period 1 May 1981 to 28 September 1981. The compensation in question related to that period. The Appellant contended that the compensation of \$4.7 million was not chargeable to profits tax.

Held:

On the facts the Appellant's intention during the period 1 May 1981 to 28 September 1981 was to hold the property as a trading stock and not a long term investment and if it had sold the property, the proceeds of sale would have been treated as a trading receipt. Likewise the compensation of \$4.7 million for loss of its use and occupation as trading stock must also be

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treated as a trading receipt. The compensation of \$4.7 million was therefore chargeable to profits tax.

Appeal dismissed.

Cases referred to:

Burmah Steamship Co. Ltd. v. CIR 16 TC 67
Crabb v. Blue Star Line, Ltd. 39 TC 482
Johnson v. W.S. Try, Ltd. 27 TC 167
Lionel Simmons Properties Ltd. v. CIR 53 TC 461
London and Thames Haven Oil Wharves Ltd. v. Attwooll 43 TC 491

J. G. A. Grady for the Commissioner of Inland Revenue.
A. L. Brown of Messrs. Price Waterhouse for the Appellant.

Reasons:

1. This is an appeal by the taxpayer company against a profits tax assessment for the year of assessment 1981/82 on the grounds that a sum of compensation it received from the Hong Kong Government should not be chargeable to profits tax.

2. The facts stated in paragraph 1 of the Determination of the Commissioner of Inland Revenue dated 1 April 1986 are agreed.

3. The taxpayer called one witness L who was the deputy managing director of its parent company during the period 1 May 1981–28 September 1981.

4. The facts material to our decision are as follows:—

4.1 On 8 January 1973, the taxpayer acquired a property which was a pre-war building occupied by tenants, with the intention of redeveloping it for the purpose of producing rental income. Early in 1977, the building was demolished.

4.2 On 8 July 1977 the Building Authority disapproved the taxpayer's piling plan under Section 15 of the Mass Transit Railway (Land Resumption and Related Provisions) Ordinance (the MTR Ordinance) on the grounds that the proposed building works would be incompatible with works required for the construction of the Mass Transit Railway.

4.3 During the period from 1 November 1977 to 30 April 1978 the property was leased to the Hong Kong Government for use as a work site by the Mass Transit Railway Corporation (MTRC). The rent for this period was offered and brought to charge to profits tax.

4.4 By letter dated 12 April 1978 the Public Works Department advised the taxpayer that the property would be required for use by MTRC for a further period of three years.

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4.5 On 25 May 1978 the taxpayer lodged a claim for compensation in the sum of \$3,256,500 in accordance with Section 21 of the MTR Ordinance and on the basis of Item 11 of Part I of the First Schedule to that Ordinance. The claim was settled on 3 November 1978 on the terms that among other things the taxpayer would receive a compensation of that amount and that the property would be leased to the Government for three years from 1 May 1978 at a peppercorn rental. No lease was in fact executed nor was the peppercorn rental paid, but MTRC remained in occupation throughout the three year period.

4.6 The compensation of \$3,256,500 was credited as an extra-ordinary item in the taxpayer's accounts for the year ended 31 March 1979. It did not offer this sum for profits tax assessment, nor did the Revenue raise a profits tax assessment on the sum.

4.7 In March 1981 the Government informed the taxpayer that it required to occupy the property for a further period of six months from 1 May 1981.

4.8 On 19 May 1981 the taxpayer's directors resolved that "redevelopment of the said property for sale instead of for rental purposes as from the successful flotation of HC (the taxpayer's holding company) on 8 January 1981 be ratified and confirmed and accordingly that the said property be re-classified for accounting purposes from Fixed Assets to Current Assets."

4.9 On July 1981 the taxpayer lodged a claim for compensation in the sum of \$5,870,000 on the same grounds as its 1978 claim.

4.10 The Government for MTRC remained in occupation until 28 September 1981 when the property was released to the taxpayer.

4.11 On 6 November 1981 the taxpayer's claim was settled by the taxpayer's acceptance of the sum of \$4,700,000 in full and final settlement of all or any claim against the Government connected with or arising out of the occupation of the property. In accepting the Government offer, the taxpayer agreed not to claim any compensation to which it might otherwise have been entitled under the MTR Ordinance and at common law or otherwise.

4.12 Pursuant to the resolution the property was reclassified as "current assets" in the taxpayer's accounts for the year ended 31 March 1982 and the compensation of \$4,700,000 was entered as an extraordinary item in the accounts.

5. The question for this board is whether the compensation of \$4.7 million is chargeable to profits tax. Our answer is Yes and our reasons are as follows.

6. During the period 1 May 1981–28 September 1981 the property remained occupied by the Government. The compensation in question related to this period. The crucial question is what was the taxpayer's intention during this period. Did it intend to hold the property as a long-term investment or as trading stock? It must be one or the other, for it is

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impossible for an asset to be both trading stock and long-term investment at the same time, nor to possess an indeterminate status (*Lionel Simmons Properties Ltd. v. CIR* 53TC 461 at 491). On the facts, particularly those contained in paragraphs 4.8 and 4.12, we have no doubt that the taxpayer's intention was to hold the property as trading stock. True, the property was occupied by the Government at all material times, but in our view that could not and did not stop the taxpayer from treating the property as stock in trade. We think that the principles applied by Macnaghten, J. in *Johnson v. W.S. Try, Ltd.* TC 167 are applicable to the present case. If land is trading stock, as is the case here, then if it is sold the proceeds of sale must come into the vendor's trading account as a trading receipt. Likewise, compensation for loss of its use and occupation as trading stock must also be treated as a trading receipt. For these reasons we conclude that the compensation of \$4.7 million is chargeable to profit tax.

7. That disposes of this appeal. However, in view of the fact that both parties devoted a substantial part of their time to arguments predicated on the premise that the property was a fixed asset during the period 1 May 1981–28 September 1981, we consider it appropriate to state our views on that assumption. We think the principles of *Crabb v. Blue Star Line, Ltd.* 19 TC 482 would have applied. In that case a company purchased ships and insured for the payment of fixed daily sums if delivery of the ships was delayed. Delivery was in fact delayed. It was held that the premium and recoveries under the policies were of a capital nature because the insurance was incidental to the acquisition of the ships which were fixed assets. In the present case, the land, a fixed asset, was going to form part of a new fixed asset i.e., a new building to generate rental income. The Government's delay in returning the land to the taxpayer caused a delay in the implementation of the redevelopment scheme and the building of a profit making structure. In these circumstances, the compensation of \$4.7 million would have been something incidental to the building of a new fixed asset and, by analogy with *Crabb v. Blue Star Line, Ltd.*, a capital receipt not chargeable to profits tax.

8. Mr. Grady for the Revenue cited a number of authorities including *Burmah Steamship Co. Ltd. v. IRC* 16 TC 67 and *London and Thames Haven Oil Wharves Ltd. v. Attwooll* 43 TC 491 to illustrate the application of the principal that where damages or compensation are paid to compensate a taxpayer for loss of profits which he otherwise might have earned and are not in respect of the deprivation of any portion of his capital assets, they are of an income nature. We do not think that this principle can apply in the present case because the land was at no material time in a condition to earn rental income, the taxpayer's proven intention being to redevelop it by the construction of a new building on it.

9. Following upon our conclusion that the compensation of \$4.7 million is chargeable to profits tax, we dismiss this appeal and hereby confirm the profits tax assessment for 1981/82.