

Case No. D35/11

Profits tax – whether property acquired as capital asset or trading asset – badges of trade – sections 14(1), 16G, 33A, 36A, 39B and 40 of the Inland Revenue Ordinance.

Panel: Albert T da Rosa, Jr (chairman), Lo Pui Yin and Wong Wai Wah.

Date of hearing: 26 to 28 April 2011.

Date of decision: 16 November 2011.

The appellant ('the Company') was a member of a group of companies ('the Group'). The Group (including the Company) had prior to the acquisition of the Property engaged in property trading business. The Company objected to the chargeability to profits tax of the gain made by the Company from the disposal of the Property. The Company contended that at the time of the acquisition of the Property the Group had intended to hold the Property for long term for the serviced apartment business. The Group disposed of the Property because of various and frequent problems that had unexpectedly arisen in the running of the business.

Held :

The Board has to ascertain the nature of the transaction from the evidence and no matter whether one approach from the badges of trade or from the intention of the protagonist approach, the results would be the same. The Board found the evidence of the Company's witnesses credible and that the decision to sell was prompted by circumstances which did not exist at the time of acquisition. The Company did acquire the Property for long term and held the same as capital asset until disposal.

Appeal allowed.

Cases referred to:

D58/06, (2006-07) IRBRD, vol 21, 1071

D32/09, (2009-10) IRBRD, vol 24, 617

Simmons v IRC [1980] 1 WLR 1196

Real Estate Investments (NT) Ltd v CIR [2007] 1 HKLRD 198

Stewart Wong Counsel instructed by Messrs Chiu & Lau Solicitors & Notaries for the Taxpayer.

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Eugene Fung Counsel instructed by Francis Kwan, Senior Government Counsel of the Department of Justice for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This is an appeal by the Appellant, Company A ('the Company'), from the Determination ('the Determination') of the Commissioner of Inland Revenue ('CIR') dated 24 February 2010, against the assessment and additional assessment for the year of assessment 2005/06 as confirmed by the Determination.

2. The notice of appeal dated 15 March 2010 raises two grounds,

2.1. The first ground: relating to the chargeability to profits tax of the gain made by the Company from the disposal of the property at Address ZA ('the Property'), and

2.2. The second ground¹: relating to whether the loss brought forward to the year of assessment 2005/06 should be increased by various allowances and expenditures allowed in earlier years (and subsequently disallowed by the Revenue).

3. In particular, the second ground relates to the Company's claim for commercial building allowance, depreciation allowance and expenditure on computer hardware and software for the year of assessment 2005/06 in the total sum of \$1,387,351 as follows

	\$
Commercial building allowance	637,069
Depreciation allowance	579,562
Expenditure on computer hardware and software	<u>107,720</u>
Total	<u>1,387,351</u>

4. Both parties agree that both grounds raise one single issue, namely whether the Property was acquired and held by the Company as a capital asset, so that the gain on disposal is a capital gain which is exempted from profits tax liability under section 14(1) of the Inland Revenue Ordinance Chapter 112 ('the IRO'), and that the said allowances and expenditures had been correctly allowed to the Company in previous years².

¹ Based on sections 16G, 33A, 36A, 39B and 40 of the Inland Revenue Ordinance.

² It can be seen from paragraph 3(4) of the Determination, the allowances and expenditures do not raise separate issues or require separate considerations, but would follow from the decision on whether the Property was a capital asset or a trading asset.

5. Section 14(1) of the IRO provides that:

‘... 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) ...’

6. The key question is therefore whether the Company’s original intention of acquisition of the Property was to hold it for long term investment purpose so that its profit on disposal of the Property was capital in nature and not chargeable to profits tax.

The Law

7. In order to succeed in this appeal, the Company must positively show that the Property was a capital asset, that is its only intention was to retain it as a long term investment. The Board (comprising Messrs C Cohen, J Bertram and P Y Lo) said in D58/06, (2006-07) IRBRD, vol 21, 1071 (paragraph 18) quoted in paragraph 13 of D32/09, (2009-10) IRBRD, vol 24, 617 said:

*‘The authorities clearly show that the issue for us to decide is whether the Taxpayer has established to our satisfaction that the Taxpayer did not have such an intention to trade but rather had the intention to hold the property as a long term investment. The Taxpayer must satisfy us that the Subject Properties were capital assets and that their **only intention** was to retain them for a long term investment and for rent.’* (emphasis underlined and in bold)

8. In Simmons v IRC [1980] 1 WLR 1196 at 1199A-D, Lord Wilberforce said:

*‘Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment? **Often it is necessary to ask further questions: a permanent investment may be sold in order to acquire another investment thought to be more satisfactory; that does not involve an operation of trade, whether the first investment is sold at a profit or at a loss.** Intentions may be changed. What was first an investment may be put into the trading stock – and, I suppose, vice versa. If findings of this kind are to be made precision is required, since a shift of an asset from one category to another will involve changes in the company’s accounts, and, possibly, a liability to tax: see Sharkey v. Wernher [1956] A.C. 58. What I think is not possible is for an asset to be both trading stock and permanent investment at the same time, nor to possess an indeterminate status – neither trading stock nor permanent asset. It must be one or other, even though, and this seems to me legitimate and intelligible, the company, in whatever character it acquires the asset, may reserve an intention to change its character. To do so would, in fact, amount to*

little more than making explicit what is necessarily implicit in all commercial operations, namely the situations are open to review'. (emphasis underlined and in bold)

9. We understand the emphasized proposition in the above quote as only an instance of evaluation of evidence and not a principle of law that in every case where a taxpayer acquires a second piece of property with the proceeds of sale of the first piece of property the acquisition of the first piece of property is of a capital nature nor that anything other than the direct use of proceeds of sale by the taxpayer must be ignored in our evaluation. The nature has to be ascertained from the evidence surrounding the acquisition.

10. Simmons was approved by Cheung JA in Real Estate Investments (NT) Ltd v CIR [2007] 1 HKLRD 198, who said at paragraph 25 of his judgment:

'The question then becomes: which approach should one adopt in deciding whether the transaction was a sale of a capital asset and not a trading activity? It is clear from a reading of the judgment of Simmons that although Lord Wilberforce focused on the question of the taxpayer's intention at the time of the acquisition of the property, this issue cannot be dealt with in isolation and has to be considered by examining all the circumstances of the case. As often said the state of a man's mind is as much a question of fact as the state of his digestion. One needs to consider all the circumstances in order to ascertain a person's intention. Once this point is clear then there really is no conflict between the approach in Simmons and the badges of trade approach. Both approaches will lead to the same destiny, namely, the answer to the question of whether profits arise from the sale of a trading stock or a capital asset. This is because both involve a consideration of the circumstances of the case. The badges of trade are convenient categorisation of the relevant factors when one considers the circumstances of the case. The intention to trade or to hold the property as an investment is one of the circumstances to be considered in deciding whether the property that is eventually disposed of is a capital property. At the same time if after considering all the circumstances one can conclude on the nature of the intention then this will help to answer the question posed in the enquiry'.

11. On further appeal, the Court of Final Appeal ((2008) 11 HKCFAR 433), in dismissing the appeal, did not deal with this point specifically.

12. Thus the Board has to ascertain the nature of the transaction from the evidence and no matter whether one approach from the badges of trade or from the intention of the protagonist approach, the results would be the same.

The Company's evidence

Overview

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13. The parties were able to agree to the Statement of Agreed Facts as per Schedule 1 hereto.

14. The Company called two witnesses namely Mr ZB and Ms ZC.

Mr ZB's evidence

15. The gist of Mr ZB's evidence are as follows:

The Group

15.1. The Company was one of a number of companies ultimately controlled by Mr ZB as to 25% and Mr ZD as to 75% (loosely the 'Group') and they were the minds of the Group making decisions in relation to the business of each member of the Group.

15.2. The Group has been held by Mr ZB and Mr ZD through the following holding companies

(a) the 'Group B': Prior to 2007 through Company C and thereafter through Company D the following subsidiaries: Company E acting as the Group's treasury; Company F and its subsidiaries including Company G, as owner of the Guest House ZE; Company H, operating the Guest House ZE; and the Appellant, as owner of the Property.

(b) the 'Group J': Company K holding the following companies: Company L holding the Property ZF on which the Guest House ZF was operated; Company M and Company N.

15.3. The relevant companies under Company C at the material times are shown in the following chart modified from the chart in Schedule 2.

The minds

15.4. Reference was made to the description of Mr ZB and Mr ZD in the website of Company D in page 3 of bundle A1. Both of them were businessmen with corporate finance background connected with Company P and were persons of substantial means and vast business experience.

Other property transactions

15.5. The Group (including the Company) had prior to the acquisition of the Property engaged in the following property trading business:

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- (a) certain units at Address ZG ('Property ZG') acquired on 11 February 2002 at \$49 million and sold 11 days later, on 22 February 2002 at \$55 million,
- (b) some equity interest in three companies which owned a number of shops and kiosks in Building ZH, Address ZH. The agreement was entered into on 30 November 2002 by the Company for \$85 million, but the Company did not complete the transaction and forfeited the deposit of \$8.5 million. The Company claimed that it had planned to purchase the equity interest in the three companies for the purpose of trading in certain shops and kiosks in Building ZH. See paragraph 6 Statement of Agreed Facts in Schedule 1.

15.6. Nevertheless, the Property was acquired for long term serviced apartment business of the Group.

Serviced apartment business

- 15.7. The Group's serviced apartment business first started with the property at Address ZE acquired by Company G (a member of the Group) in December 1999, at which the Group operated the serviced apartment known as Guest House ZE and sold on 15 March 2005, which gave the Group an appetite for more serviced apartment business.
- 15.8. He produced the accounts of the Group. In particular they show that in the years 2002 to 2005, the financial position of the group of companies headed by Company C was as follows:

<u>Year</u>	<u>Profit after taxation</u> \$m	<u>Net assets</u> \$m	<u>Financial reserves</u> \$m	<u>Retained earnings portion of financial reserves</u> \$m
2002	3	119	113	65
2003	43	148	142	109
2004	25	207	202	134
2005	74	280	275	159

15.9. The Group, through the Company, started to consider purchasing the Property in March 2003, started to negotiate for the purchase of the Property in April 2003, entered into agreement for purchase in May 2003, and took up assignment thereof at the price of \$26 million in October 2003, and operated the serviced apartment Guest House ZA2 because while it was an office building its peculiar layout with a toilet constructed for each office was eminently suitable for serviced apartment business.

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- 15.10. At the time of the acquisition, Hong Kong was going through the period of SARS. The Group intended to hold the Property for long term for the serviced apartment business.
- 15.11. Substantial efforts were made by Company Q, the operating company, to start, build up and operate a guesthouse business at the Property, including (a long drawn-out) application for guesthouse licences (see paragraph 36(2) of the statement of Mr ZB and substantial renovation works carried out at the Property to the tune of more than \$8 million (various promotional activities (see paragraph 36(3) of the statement of Mr ZB), the devotion of manpower to build up a team of experienced staff, and not to convert and sell but to operate and manage a serviced apartments business (see paragraph 36(4) of the statement of Mr ZB).
- 15.12. The Group disposed of the Property at \$110 million in June 2005. The disposal was made because of various and frequent problems that had unexpectedly arisen in the running of the business (mainly due to poor workmanship and poor or defective equipment), so that the Company decided, instead of seeking to rectify the problems (which had been causing a lot of management problems and loss of reputation in the meantime), it was better to sell off and started again with another block, this time with better equipment and workmanship (See paragraphs 38 to 41 of the statement of Mr ZB).
- 15.13. Shortly before the hearing before us, the Group on 8 April 2011 entered into agreement to dispose of its property at Address ZF at which it operated a serviced apartment business called Guest House ZF.
- 15.14. The Group still continued to own and operate the following serviced apartments:
- (a) Guest House ZJ at Address ZJ acquired through [*], a member of the Group, in July 2007;
 - (b) Guest House ZK at Address ZK acquired through [*], a member of the Group, in February 2008.
- 15.15. The Group entered into agreement to dispose of the property on which Guest House ZF is situated and would use the proceeds to acquire a block of 45% of the undivided shares in the property at Address ZL (the Group already owned 35% of the undivided shares in the property at Address ZL and the remaining outstanding undivided shares and redevelop it into another serviced apartment under the brand name of Guest House ZF.

Ms ZC's Evidence

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16. The gist of Ms ZC's evidence are as follows:
- 16.1. she joined the Group in October 2002 as manager to run Guest House ZE
 - 16.2. She became a director of the Company since 22 April 2008
 - 16.3. She echoed Mr ZB's evidence that the Property was acquired for long term and pointed to the absence of any early termination clause in the licenses and leases made by the Company in respect of the Property
 - 16.4. the Guest House ZA2 experienced a lot of problems arising from defects which prompted the Company to dispose of it.
17. Ms ZC in her statement and testimony informed us that the problems relating to air-conditioning, pests, and water leakage could not really be permanently fixed if at all (instead of being band-aided which had been done and which the Revenue had been looking at with Ms ZC during cross-examination) without full evacuation of the building and with substantial costs and time wasted, which was an option which the Company was unwilling to take:
- 17.1. For air-conditioning, because the permanent solution would be not just to replace the individual units piecemeal as and when a problem was found, but to replace them all with a central air-conditioning system once and for all. Ceilings would have to be opened up to replace the pipes, and there would be noise and dust which would affect the tenants;
 - 17.2. For water leakage, waterproofing would have to be done to the floors, and for the pipes relating to the toilets, apart from noise and dust, clearly the grave problem was that if the pipes of some of the units were replaced at the time (involving digging up the toilet floor), other floors could not use the toilets as well. Every tenant in the building would be affected even if their own units were not being worked on. As for the water seepage through external walls, what was needed was to replace such walls, which mean at least that part of the building could not be occupied. Fixing with epoxy would not solve the problem permanently because as Ms ZC said the leakage would just move from one area to another;
 - 17.3. For pests, to treat the problems with the doorframe required the use of strong pesticide which could not be done when there were tenants around. And there was no solution to the termite problems.
18. If the Company was to fix all these permanently, an alternative to evacuating the whole building was to do it in stages (but this could not be done for the termites anyway). But that would mean that the building was, for quite some time, a permanent building site at various parts with all the noise, dust and smell (and with no toilet facilities for the tenants) around.

19. Further, as Ms ZC said, it was not just one problem for one room, but a few problems for one room. To re-do one room properly to solve all the widespread and common problems once and for all, for each room the Company would need to at least: replace the doorframe, waterproof the floor, open up the ceiling to lay the pipes for the central air-conditioning, open up the floors to replace all toilet pipings, and to replace the external walls. In effect, the Company would have to spend a fortune to rebuild and renovate the whole building bit by bit from within (whether at one go or in stages).

Respondent's attacks

20. A number of points were raised by the Respondent.

Activities from incorporation from May 2001 to April 2003

21. The Company had a history of property trading and the principal activities of the Company was described as 'trading in properties and shares' and accounted for the results of such activities as trading profits chargeable to profits tax and deductible expenses under profits tax.

The 'good experience explanation' questionable

22. The Respondents says that it is questionable that Mr ZB could have come to the conclusion that Guest House ZE was 'good experience' so much so that he could come to conclusion (in March 2003 when he considered buying the Property) that the Group should invest in another guesthouse for long term. The Respondent submitted:

- 22.1. As stated by Mr ZB, 'Guest House ZE' was the Group's 'first venture into the guesthouse or service apartments ... business' (paragraph 18 of Mr ZB's first statement).
- 22.2. The guesthouse licences for 16 floors of 'Guest House ZE' (10/F to 13/F, 15/F to 23/F and 25/F to 27/F) were first issued on 1 August 2002. The remaining licences were not issued until after July 2003, that is after the Company had already purchased the Property. See paragraph 17(d) Statement of Agreed Facts in Schedule 1.
- 22.3. There were two units on each of the floor from 10/F to 27/F of 'Guest House ZE'.
- 22.4. Even though 1 August 2002 was the first date when 32 units of 'Guest House ZE' had the licence to operate,³ no leasing and marketing activities had started until the arrival of Ms ZC in October 2002. Ms ZC was the manager responsible for 'leasing, marketing and customer service' of 'Guest House ZE', Ms ZC, did not join the Group until

³ See also paragraph 7 of Ms ZC's statement.

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October 2002 (paragraphs 3 and 8 of Ms ZC's statement). In cross-examination, Mr ZB accepted that all the leasing and marketing activities of 'Guest House ZE' only started after Ms ZC joined the Group in October 2002.

- 22.5. Further, time would obviously be needed for those 32 units to be filled with occupants from October 2002, and for the Group to assess how well it was doing in this new business. Teething problems were still being encountered.
- 22.6. Moreover, as Mr ZB confirmed in cross-examination, it would take up to a year for a guesthouse to reach a good occupation rate.
- 22.7. In March 2003, 'Guest House ZE' only had a maximum capacity of 58% full because there were only 32 operable rooms.⁴ Mr ZB agreed in cross-examination that at this time, he could not have had the idea of what the business of 'Guest House ZE' would be like in the summer of 2003. In the answer to the question on how quickly he came to the view that the guesthouse business of 'Guest House ZE' was a 'very promising and profitable line of business', his answer was 'not very quickly'. He also accepted in cross-examination that no one would know how long 'Guest House ZE' would perform in the long run.
- 22.8. In these circumstances, it would obviously be unrealistic for Mr ZD and Mr ZB to have already formed the view in March 2003 that their brand new business in 'Guest House ZE' was 'a very promising and profitable line of business for [them] to further develop and go into' (cf paragraph 23 of Mr ZB's first statement).
- 22.9. Moreover, as at March 2003, Mr ZD and Mr ZB could **not** have acquired 'the good and valuable experience ... gained in operating this 55-room serviced apartments business at [Guest House ZE]' (cf paragraph 23 of Mr ZB's first statement).
- 22.10. In cross-examination, Mr ZB tried to justify why he was nonetheless content with 'Guest House ZE' in spite of the above matters. He said that before the conversion of the 32 units of the 'Guest House ZE', the Group was stuck with two tenants for a lengthy period of time. So he regarded the switchover as something which could not be worse than before. Whilst all of this might be true, it does **not** support Mr ZB's contentions in paragraph 23 of his first statement that as at March 2003 (a) he 'quickly came to the view that [Guest House ZE] was a very promising and profitable line of business for us to further develop and go into' and

⁴ There were 55 rooms in Guest House ZE: paragraph 23 of Mr ZB's first statement.

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(b) he had acquired ‘the good and valuable experience ... gained in operating this 55-room serviced apartments business at [Guest House ZE]’.

22.11. What is more likely to have happened is this. As an experienced businessman, Mr ZB decided that he would get the Company to buy the Property. Rather than selling it straight away, Mr ZB thought he could convert it into a guesthouse just like ‘Guest House ZE’ which he just had a taste of running, run it for a while to build up the Group’s reputation and enhance the value of the Property, and then sell it when the property market had picked up to an acceptable level after SARS.

Absence of prior feasibility study

23. At the time of the acquisition of the Property the Company had no feasibility study as to its suitability for operation of serviced apartments. Thus, in inference is that the use of the Property for such business was an afterthought.

Absence of contemporaneous documents of intention in May 2003

24. The accounts and other documents are not contemporaneous documents to show the state of mind of the Company as at the time for purchase of the Property. The contemporaneous minutes of the Company on acquisition of the Property did not state the intention of the Company to hold it for long term.

Neutral nature of conversion into guesthouse from June 2003 to April 2004

25. These steps are all consistent with the Company having an intention to run a successful converted guest house to enhance the value of the Property, to improve its reputation in the guesthouse industry, and to sell the Property at an opportune time.

Absence of early termination clause in standard licence and lease irrelevant

26. The Property was bought by the Company with existing tenancies and sold by the Company with existing tenancies. Early termination clause is neither here nor there in so far as proof of any intention to hold the Property for long term or otherwise.

Viewing for sale

27. The Company has disclosed the Property’s occurrence books for 2003 to 2005. According to the entries therein, there were repeated visits to the Property from April to June 2004 for viewing for the purpose of sale and purchase:

27.1. 27 April 2004: ‘...帶同 4 名客人睇樓(售)’

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- 27.2. 27 April 2004: ‘...帶同 1 名客人睇樓(售)’
- 27.3. 4 May 2004: ‘... 陪同 4 名老闆到場睇樓(買賣)’
- 27.4. 12 May 2004: ‘... 帶同 1 客人到 25/F 睇樓(買賣)’
- 27.5. 14 May 2004: ‘兩名客人到場睇樓(買賣), 原約[Mr ZM of Company A]接洽’
- 27.6. 15 May 2004: ‘... 及兩名客人到全幢睇樓(買賣)’
- 27.7. 17 May 2004: ‘[...]帶客睇樓(買樓)’
- 27.8. 19 May 2004: ‘街客[...]睇樓(買樓)’
- 27.9. 2 June 2004: ‘[...]帶同兩名客人到場睇樓(買賣)有 25/F 及 G/F 舖位等’

28. The Respondent submits that if the Company had absolutely no intention to sell the Property, one would have expected it to have given instructions to the estate manager not to allow outsiders (including estate agents) to come and view the Property for the purpose of purchase. It cannot be in the interest of the guests to have outsiders wondering around the Property when such outsiders’ interests were totally opposite to those of the Company.

29. In Ms ZC’s oral testimony, she said she had no knowledge about these visits at the time. She said that estate agents were allowed to view the Property because the Company wanted to maintain good relationship with them.

30. The Respondent further submits that in any event, Ms ZC’s explanation does not explain the entry made on 14 May 2004 ‘兩名客人到場睇樓(買賣), 原約[Mr ZM of Company A]接洽’. As confirmed by Ms ZC in cross-examination, the ‘Mr ZM of Company A’ was likely to be Mr ZM, a director of the Company. Such an entry clearly suggests that Mr ZM had an appointment with the two clients to view the Property for the purpose of sale and purchase.

Problems encountered from April 2004 to April 2005

- 31. The Respondent’s takes the view of the alleged problems as follows:
 - 31.1. These are not insurmountable and if the Company is determined to hold for long term it should have found a way to remedy rather than sell;
 - 31.2. The Company opened the Property for business as soon as it obtained the licence in April 2004 (paragraph 39 of Mr ZB’s first statement). However, from the occurrence books produced by the Company, it

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appears that the Property was still in the process of being renovated or refurbished shortly after April 2004. Therefore, it was not the case that the Property was 100% fully ready for operation on day one of its business. Thus, the problems were just teething problems.

- 31.3. Despite all the problems encountered by the Company from May 2004 to June 2005, the occupancy rate of the Property as at 13 June 2005 was 94.8% (91 occupied rooms out of a total of 96).⁵ Again, this was acknowledged by Mr ZB in his cross-examination.
- 31.4. The defects were covered by warranties of the suppliers and contractors.
- 31.5. Up to the date of hearing the Property was still run as a guesthouse by the purchaser from the Company.
- 31.6. Since the Company decided to sell the Property in April 2005, it should only have taken the period from April 2004 to April (instead of September) 2005 as the relevant period to note the number of incidents of problem and if so the number dropped by half and so the problem was not as serious as portrayed.

Use of proceeds

- 31.7. There is no evidence that the Company actually used the proceeds of sale of the Property for any acquisition of other property.

The Board's analysis:

Badges of trade

32. Adopting the 'badges of trade' approach in the present case, the questions listed out by McHugh NPJ are readily answered as follows:

- 32.1. Whether the Company has frequently engaged in similar transactions? The term 'similar transaction' means in the context of this case the buying of property for resale. The answer is therefore '**Yes**' (see paragraphs 19 to 26 above).
- 32.2. Whether the Company has held the Property for a lengthy period? The relevant period is 19 months from October 2003 (when the Property was assigned to the Company) to April 2005 (when the Company decided to sell the Property). The answer is therefore '**No**'.

⁵ This is confirmed by Mr ZB at paragraph 40 of his first statement.

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- 32.3. Whether the Company has acquired the asset that is normally the subject of trading rather than investment? Real property can be the subject of trading or investment. This question therefore yields a '**Neutral**' answer.
- 32.4. Whether the Company has bought or acquired large quantities of land? The Company bought (or contracted to buy) three pieces of real properties in 2002 and 2003. The quantity of purchase in the relative short period of time is fairly substantial but not so substantial as to render it unarguable that the Property is for long term investment. This question therefore yields a '**Neutral**' answer.
- 32.5. Whether the Company has sold the asset for reasons that would not exist if it had an intention to resell at the time of acquisition? This is subject to strong contest between the parties. **See further analysis below.**
- 32.6. Whether the Company has sought to add resale value to the Property by additions or repairs? **Yes.**
- 32.7. Whether the Company has expended time, money and effort in selling the asset that goes beyond what might be expected of a non-trader seeking to sell an asset of that class? **See further analysis below.**
- 32.8. Whether the Company has conceded an actual intention to resell at a profit when the Property was acquired? **No.**
- 32.9. Whether the Company has purchased the Property for personal use or pleasure or for income? **For income.**

33. This is not a mathematical scoreboard.

The Company's appetite in guesthouse business

34. On the Board's analysis, we find that in 2003, the financial position of the Group of companies headed by Company C is strong and that the Group has the financial capability to hold the Property for long term. [See paragraph 15.8. herein]

35. Part of the monies came from Mr ZD and Mr ZB, the rest from the Group B (see paragraphs 28 and 29 of the statement of Mr ZB). The money did not come from the Bank ZN loan referred to at Statement of Agreed Facts, paragraph 7(c) to (d).

36. As regards the basis for Mr ZB to find that his experience from operating the Guest House ZE gave him the appetite to invest more in the guesthouse business we note:

- 36.1. in 2001, the entire building where Guest House ZE was situate was earning \$345,933 or less than \$360,000 or averaging less than \$30,000 a

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month – mainly from the rental of the bar and restaurant at the lower floors;

36.2. the Group then converted part of the building (10/F to 27/F) into a guesthouse;

36.3. for the five-month period from August to December 2002 this brought on an income of \$1,112,240 or the equivalent of \$2,669,376 per year which is 7.7 times the annual income of 2001.

37. We find Mr ZB's evidence credible. There is nothing inherently improbable to cause us to doubt his evidence that as directing minds of the Company he and Mr ZD wanted to venture further into the guesthouse business at the time when uncertainty of the business environment caused by SARS remained, spent money in renovation and waited for the relevant licenses in the hope that the business would one day be listed.

Allowing the Property to be viewed for sale from April to June 2004

38. Ms ZC's explanation of why persons apparently looking to buy the Property were allowed to inspect was credible: why would they want to be unfriendly to, or to antagonise, estate agents or persons in the real property market including estate agents? There was no marketing or invitation to prospective buyers by the Group, and there were only a very few such inspections spanning a short time frame (the first and last being on 5 May 2004 and 2 June 2004 respectively). The Property was not 'private' premises as such and exposure must have been good, so there is nothing inherently incredible for the Group to allow inspection provided there was registration and no damage.

39. In the light of Ms ZC's evidence, the fact that Mr ZM (just as any other employee of the Group) would entertain requests by estate agents to arrange for viewing is not surprising.

40. The fact remains that both Mr ZB and Ms ZC say that the Company had not given any instructions to market the Property for sale at the material time. Thus for the question posed in paragraph 32.7 herein, our answer is no.

The Company's reason to sell: problems encountered from April 2004 to March 2005

41. As agreed by both counsel, we take the period of only up to March 2005 as the relevant period for considering the impact of the problems encountered with the state of the building towards influencing the decision to sell the Property.

42. We accept the evidence of Mr ZB and Ms ZC and the submission by counsel for the Company:

42.1. That there is no comfort from the warranties where the contractors giving them are not substantial;

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42.2. That the Company considered the problems could not be fixed on an ad hoc basis.

43. These views of the Company could not be faulted as irrational or unrealistic.

44. For a businessman in such a situation to decide to get rid of this irritation rather than to fix it is perfectly credible and sensible.

45. Thus for the question posed in paragraph 32.5 herein, we find that the decision to sell was prompted by circumstances which did not exist at the time of acquisition.

Miscellaneous points

46. We consider that the following elements are non-determinative and neutral:

46.1. Absence of early termination clause in the standard licence and lease

46.2. Absence of feasibility studies before acquisition of the Property

46.3. Choice of the Company as the corporate vehicle to acquire the Property

Board's findings

47. We find both witnesses credible and the Company did acquire the Property for long term and held the same as capital asset until disposal.

Decision

48. For reasons given, we allow the appeal,

48.1. increase the loss brought forward to the year of assessment 2005/06 by the commercial building allowance, depreciation allowance and expenditure on computer hardware and software in the total sum of \$1,387,351 set out in paragraph 3 herein so that the net assessable profits is reduced from \$4,545,332 to \$3,157,981; and

48.2. annul the additional profits tax assessment for the year of assessment 2005/06 under charge number X-XXXXXXX-XX-X dated 27 April 2009, showing additional assessment profits of \$71,159,365 with tax payable thereon of \$12,452,888.

Schedule 1

BOARD OF REVIEW

Company A
and
Commissioner of Inland Revenue

Statement of Agreed Facts

- (1) Company A ('the Company') has objected to the profits tax assessment and additional profits tax assessment for the year of assessment 2005/06 raised on it. The Company claims that the profit on disposal of a building is capital in nature and should not be chargeable to profits tax. The Company also claims that the quantum of loss brought forward for set off against the assessable profits for the year of assessment 2005/06 is incorrect.
- (2) (a) The Company was incorporated in Country ZP on 9 May 2001 in the name of Company Q. In April 2002, its name was changed to the present name.
- (b) In March 2002, the Company registered with the Companies Registry as an overseas company in Hong Kong. The records at the Companies Registry showed that the Company ceased to have a place of business in Hong Kong in November 2008.
- (c) At all relevant times, the Company's paid up share capital remained at US\$1. Company C, a company incorporated in Hong Kong, was considered the Company's ultimate holding company.
- (d) The Company's directors were:
- | | Appointed on |
|-------|--------------|
| Mr ZB | - |
| Mr ZD | 14-6-2004 |
| Mr ZM | 14-6-2004 |
- (e) The Company closed its accounts on 31 December annually.
- (3) Company Q is a private company incorporated in Hong Kong in February 2003. At all relevant times, Company Q described its principal activity as the provision of property management services and considered Company C as its ultimate holding company.
- (4) Company E, now known as Company R, is a private company incorporated in

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Hong Kong in June 2001. At all relevant times, Company E described its principal activity as the provision of financial arrangement services for group companies and considered Company C as its ultimate holding company.

- (5) (a) By an assignment dated 11 February 2002, the Company purchased, subject to existing tenancy, certain units at Address ZG ('Property ZG') at a consideration of \$49 million.
- (b) By a provisional agreement for sale and purchase dated 22 February 2002, the Company sold Property ZG for \$55 million. The sale was completed on 11 November 2002. The Company declared that the profits so derived from the sale were trading profits chargeable to profits tax.
- (6) (a) By an agreement for sale and purchase of shares dated 30 November 2002, Company S agreed to sell to the Company at a consideration of \$85 million a portion of its equity interest in Company T, Company U and Company V (collectively referred to as 'the Property Holding Companies'). The Property Holding Companies were owners of a number of shops and kiosks in Building ZH, Address ZH. Such shops and kiosks had been let out for rental income.
- (b) The Company did not complete the transaction and forfeited the deposit paid of \$8,500,000 in accordance with the terms of the agreement. The Company claimed that it had planned to purchase the equity interest in the Property Holding Companies for the purposes of trading in certain shops and kiosks in Building ZH. It regarded the deposit forfeited as deductible expense under profits tax.
- (7) (a) By a provisional agreement for sale and purchase dated 6 May 2003, the Company purchased, subject to existing tenancy, the whole block of Building ZA at Address ZA ('the Property') at a consideration of \$26 million. The Property was assigned to the Company on 15 October 2003. At the time of acquisition, the Property was a non-residential building of 25 storeys from G/F to 27/F (designations of 4/F, 14/F and 24/F omitted).

A copy of the provisional sale and purchase agreement dated 6 May 2003 is attached at Appendix A to the Determination.

- (b) By two separate applications both of 26 June 2003, Company Q applied to the Office of the Licensing Authority of the Home Affairs Department ('the Authority') for licences to operate a guesthouse called Guest House ZA1 at 1/F to 25/F and at 26/F to 27/F of the Property respectively for a period of 12 months. The licences were issued to Company Q on 21 April 2004 and were valid until 20 April 2005. Application for

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renewal of licence had to be made not less than three months prior to the licence expiry date.

Copies of the application forms and the licences are at Appendices B1 to B4 to the Determination.

- (c) On 15 September 2003, Bank ZN, as lender, and Company E, as borrower, entered into a loan agreement. Under the loan agreement, Bank ZN would at Company E's request:
- (i) issue an irrevocable standby letter of credit for a maximum amount of \$78,176,465 for guaranteeing Company C's capital investment in Company W; and
 - (ii) make available to Company E revolving loan facility of up to \$78,200,000,

for a period of 36 months commencing from the agreement date. A number of properties, including the Property, held by group of companies of Group B were used as security.

- (d) By a mortgage dated 15 October 2003, the Company, as mortgagor, charged the Property to Bank ZN pursuant to the loan agreement of 15 September 2003 [paragraph (7)(c) above].
- (e) Renovation works were carried out and the Property was converted into a guesthouse under the name of Guest House ZA2 with a total of 96 units.
- (f) On 25 April 2005, the Authority issued a guesthouse licence to Company Q in respect of the guesthouse called Guest House ZA1 at 1/F to 27/F of the Property. The licence was valid for a period of three years from 21 April 2005 to 20 April 2008.

A copy of the licence is at Appendix B5 to the Determination.

- (g) In June 2005, the Company accepted an offer dated 10 June 2005 from Company X to acquire the Property at a consideration of \$110 million. As listed in appendix 2 to the agreement for sale and purchase dated 23 June 2005, except for five rooms, all the other units at the Property were subject to existing licences or tenancy. The transaction was completed on 9 September 2005.

Copies of the offer letter dated 10 June 2005 and the agreement for sale and purchase dated 23 June 2005 are at Appendices C1 and C2 to the Determination respectively.

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- (8) (a) On divers dates, the Company submitted its profits tax returns for the years of assessment 2004/05 and 2005/06 together with its audited financial statements and tax computations.
- (b) The following was extracted from the Company's detailed profit and loss accounts for the years ended 31 December 2004 and 2005:

	<u>31-12-2004</u>	<u>31-12-2005</u>
	\$	\$
Rental income	2,979,254	5,656,090
Gain on disposal of investment properties	-	73,815,673
Other income	<u>55,383</u>	<u>429,546</u>
	3,034,637	79,901,309
Expenses		
Repairs and maintenance	(122,768)	(98,318)
Renovation	(70,113)	(85,900)
Promotion fee	(55,114)	(29,280)
Other expenses	<u>(4,171,581)</u>	<u>(1,969,815)</u>
	4,419,576	2,183,313
Profit/(loss) before taxation	<u>(1,384,939)</u>	<u>77,717,996</u>

- (9) In its profits tax return for the year of assessment 2004/05, the Company declared adjusted loss of \$1,490,273, which was arrived at after deducting, inter alia, the following in relation to the Property and the related renovation works:

	\$
Commercial building allowance	637,069
Depreciation allowance	579,562
Expenditure on computer hardware and software	<u>170,720</u>
	<u>1,387,351</u>

Copies of the profits tax return for the year of assessment 2004/05 and the supporting financial statements and tax computation are at Appendices D1 to D3 to the Determination respectively.

- (10) In its profits tax return for the year of assessment 2005/06, the Company declared assessable profits of \$5,091,716. In arriving at the assessable profits -
- (a) the Company did not offer for assessment the profit on disposal of the Property in the amount of \$73,740,951, which was computed as follows:

	\$	\$
Sales proceeds		110,000,000

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	\$	\$
Less: Associated expenses on sale		<u>1,185,480</u>
		108,814,520
Purchase cost	26,000,000	
Associated expenses on purchase	1,296,395	
Additions (renovation, etc)	653,330	
Leasehold improvement	7,360,063	
Furniture and fixture	19,705	
Equipment	938,311	
Accumulated depreciation	<u>(1,194,235)</u>	<u>35,073,569</u>
Profit on disposal		<u><u>73,740,951</u></u>

- (b) the Company claimed deduction of depreciation allowance of \$23,514 and deduction of expenditure on prescribed fixed assets of \$13,640 on additions to fixed assets in relation to the Property; and
- (c) the Company offered for assessment the following in relation to the Property and the related renovation works:

	\$
Balancing charge on commercial building	637,069
Balancing charge on fixed assets	603,076
Sales proceeds of prescribed fixed assets	<u>184,360</u>
	<u><u>1,424,505</u></u>

Copies of the profits tax return for the year of assessment 2005/06 and the supporting financial statements and tax computation are at Appendices E1 to E3 to the Determination respectively.

- (11) The Assessor was not satisfied that the Property was for long term investment purposes and considered that the Company should not be allowed the relevant commercial building allowance, depreciation allowance and deduction of expenditure on prescribed fixed assets in relation to the Property for the year of assessment 2004/05. She issued to the Company the following statement of loss for the year of assessment 2004/05:

	\$
Loss per return [paragraph (9) above]	1,490,273
<u>Less: Commercial building allowance [paragraph (9) above]</u>	(637,069)
Depreciation allowance [paragraph (9)]	(579,562)
Expenditure on computer hardware and software [paragraph (9) above]	<u>(170,720)</u>
Adjusted loss	102,922
<u>Add: Loss brought forward</u>	<u>443,462</u>
Loss carried forward	<u><u>546,384</u></u>

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(12) Company Y ('the Representative'), on behalf of the Company, disagreed to the statement of loss for the year of assessment 2004/05 on the following grounds:

(a) The Property and the other fixed assets in question were intended and actually put into letting business for the production of chargeable rental income. They were held for long term and should not be regarded as trading assets.

(b) The Company disagreed that no allowances were granted. The loss for the year of assessment 2004/05 should be \$1,490,273 and the total losses carried forward for set off against the Company's future profits should be \$1,933,735 (\$1,490,273 + \$443,462).

(13) The Assessor raised enquires on the Company regarding the purchase and disposal of the Property. At the same time, the Assessor issued to the Company the following profits tax assessment for the year of assessment 2005/06:

	\$
Assessable profits per return [Paragraph (10) above]	5,091,716
<u>Less: Loss set off [paragraph (11) above]</u>	<u>(546,384)</u>
Net assessable profits	<u>4,545,332</u>
Tax payable thereon	<u>795,433</u>

	\$
<u>Statement of Loss</u>	
Loss brought forward [paragraph (11) above]	546,384
<u>Less: Loss set off</u>	<u>(546,384)</u>
Loss carried forward	<u>0</u>

(14) The Company, through the Representative, objected against the profits tax assessment for the year of assessment 2005/06 on the grounds that the Company should be granted depreciation allowance, commercial building allowance and deduction of expenditure on prescribed fixed assets in an aggregate amount of \$1,387,351 for the year of assessment 2004/05 [paragraph (9) above] and that, therefore, the quantum of loss brought forward for set-off in the year of assessment 2005/06 was understated.

(15) The Assessor did not accept the Company's claims that the Property was acquired for investment purpose and raised on the Company the following additional profits tax assessment for the year of assessment 2005/06:

	\$	\$
Profits per return [paragraph (10) above]		5,091,716
<u>Add:</u>		

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	\$	\$
Profits on disposal of the Property [paragraph (10)(a) above]	73,740,951	
<u>Less: Depreciation</u> [paragraph (10)(a) above]	<u>(1,194,235)</u>	72,546,716
Depreciation allowance and expenditure on prescribed fixed assets [paragraph (10)(b) above]		<u>37,154</u>
		77,675,586
<u>Less:</u>		
Balancing charges (\$637,069 + \$603,076) [paragraph (10)(c) above]		(1,240,145)
Sales proceeds for prescribed fixed assets [paragraph (10)(c) above]		(184,360)
Assessable profits		76,251,081
<u>Less: Profits previously assessed</u> [paragraph (13) above]		<u>(5,091,716)</u>
Additional assessable profits		<u>71,159,365</u>
Additional tax payable thereon		<u>12,452,888</u>

- (16) The Company objected to the additional profits tax assessment for the year of assessment 2005/06 on the ground that the gain on disposal of the Property was capital in nature and should not be subject to profits tax.
- (17) (a) On 13 December 1999, Address ZE, Hong Kong was assigned to Company G, a member of Group B, at a consideration of \$39 million. At the time of assignment, there was a commercial building under construction on the site.
- (b) Company G continued the construction of the commercial building and occupation permit of the new building was issued on 27 December 2000.
- (c) In late 2001, Company G started to convert the building into a guesthouse by phases. The guesthouse was named Guest House ZE.
- (d) On divers dates, Company H, a member of Group B, applied to the Authority for guesthouse licences in respect of the guesthouse to be operated at Address ZE, Hong Kong. Guesthouse licences, all valid for one year, were issued by the Authority to Company H on the following dates:

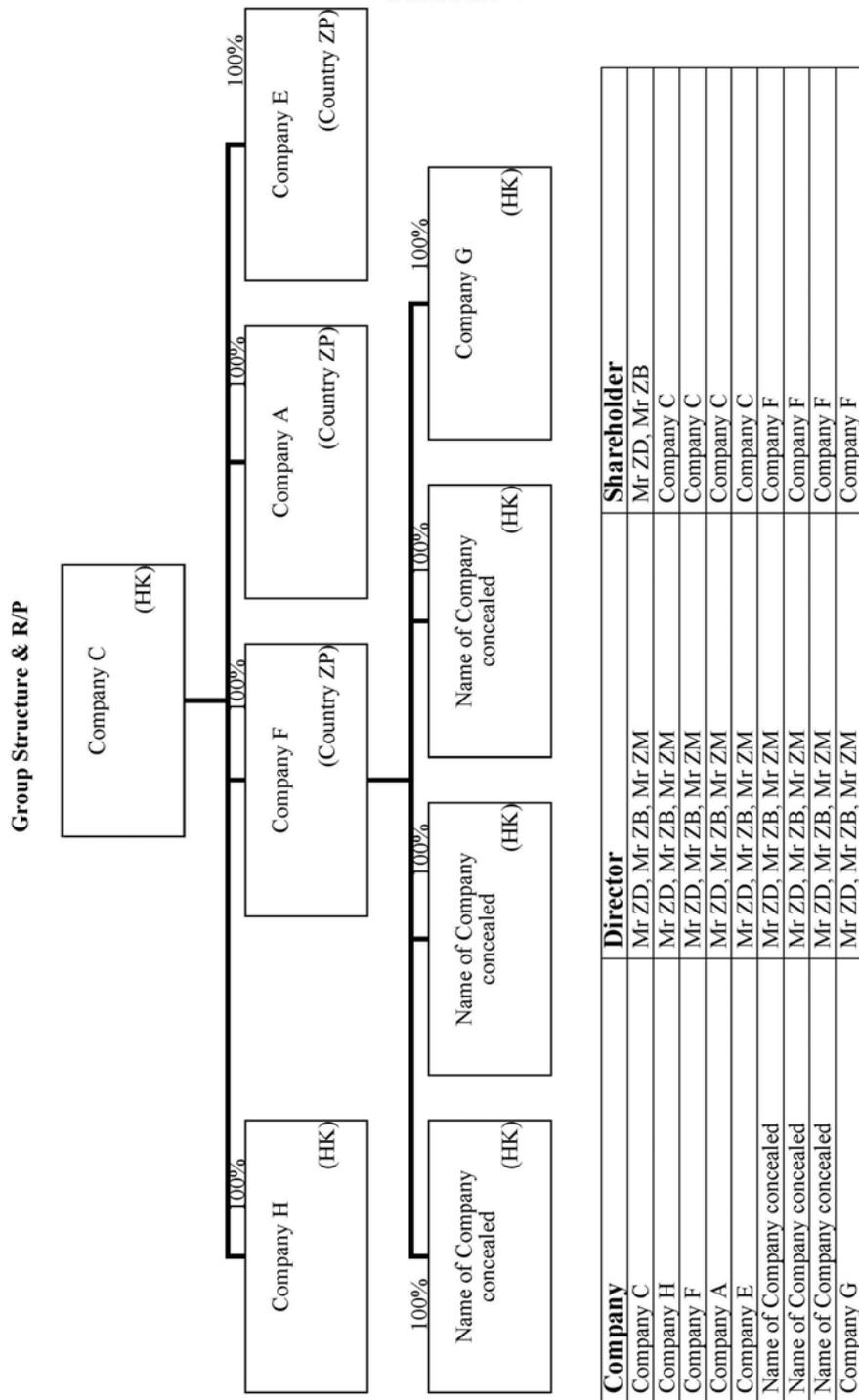
<u>Licence issue date</u>	<u>Floors covered</u>
1-8-2002	10/F to 13/F
1-8-2002	15/F to 23/F, 25/F to 27/F
1-7-2003	5/F to 8/F

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<u>Licence issue date</u>	<u>Floors covered</u>
1-7-2003	2/F to 3/F
1-7-2003	1/F
1-11-2003	9/F

- (e) By an agreement for sale and purchase dated 7 January 2005, Company G sold the building at Address ZE, Hong Kong with existing licences and tenancy for \$142 million.
- (18) By a Determination dated 24 February 2010, the Commissioner of Inland Revenue:
- (1) confirmed the profits tax assessment for the year of assessment 2005/06 under charge number X-XXXXXXXX-XX-X, dated 16 June 2006, showing net assessable profits of \$4,545,332 (after loss set off of \$546,384) with tax payable thereon of \$795,433; and
 - (2) confirmed the additional profits tax assessment for the year of assessment 2005/06 under charge number X-XXXXXXXX-XX-X, dated 27 April 2009, showing additional assessable profits of \$71,159,365 with tax payable thereon of \$12,452,888.
- (19) By a notice of appeal dated 15 March 2010, the Company appealed to the Board of Review under section 66 of the Inland Revenue Ordinance (Chapter 112).

Schedule 2



Remark: All other irrelevant Group companies are not included.