

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D36/94

Profits tax – disposal of properties – whether properties capital assets or trading stock.

Panel: Robert Wei Wen Nam QC (chairman), John C Broadley and Peter F Rhodes.

Dates of hearing: 16 and 17 June 1994.

Date of decision: 15 September 1994

The taxpayer was a private limited company which acquired a number of properties on different occasions. Subsequently it sold the properties at a profit. The taxpayer submitted that the properties were capital assets and that when it made four separate sales of different properties it was disposing of capital assets.

Held:

The correct test to apply is the subjective intention of the taxpayer at the time that each of the properties was acquired and that intention must be viewed in the light of the objective circumstances. Applying this test to the facts of the case the properties had been acquired as trading stock and not capital assets.

Appeal dismissed.

Case referred to:

Chinachem Investment Co Ltd v CIR 2 HKTC 261

S P Barns for the Commissioner of Inland Revenue.

Lau Kam Cheuk of Messrs S Y Leung & Co for the taxpayer.

Decision:

Preliminaries

1. This is an appeal by a private limited company (the Taxpayer) against the profits tax assessments raised on it for the years of assessment 1987/88, 1988/89, 1989/90 and 1990/91 (as confirmed or revised by the Commissioner of Inland Revenue as the case may be). The Taxpayer claims that the profits on the disposal of certain properties are non-taxable capital gains and that industrial building allowances and rebuilding allowances should be granted in respect of certain properties it owned.

INLAND REVENUE BOARD OF REVIEW DECISIONS

The Facts

2. The following facts are agreed or not in dispute:
 - (1) In August 1984, the Taxpayer was incorporated. At all relevant times, its issued share capital was \$1,200,000.
 - (2) In October 1986, the Taxpayer suspended business after the completion of a development for sale. The Taxpayer made a profit of \$514,101 on the disposal of the flats in the development and offered the profits for assessment for the year of assessment 1986/87.
 - (3) On 18 March 1987, the Taxpayer entered into an agreement for the purchase of an 11 storeyed factory building with sitting tenants: as to the ground floor, the first floor (including the mezzanine floor) and the seventh floor thereof (the G/F, the 1/F and the 7/F) for and on behalf of itself and as to the remaining floors thereof for and on behalf of certain other parties.
 - (4) On 20 March 1987, two directors resigned and a new director was appointed to the board of the Taxpayer, while Mr X, one of the other 4 directors who continued in office, also continued to be the chairman of the Taxpayer.
 - (5) On 23 March 1987, certain changes occurred in the shareholders of the Taxpayer.
 - (6) On 18 May 1987, the Taxpayer obtained a fixed loan facility from a bank for the amount of \$4,800,000 repayable by 83 equal monthly instalments of \$57,142 each and a final instalment of \$57,214 commencing one month after drawdown; the loan was subject to repayment on demand.
 - (7) On 30 May 1987, the Taxpayer completed the purchase of the G/F, 1/F and 7/F with sitting tenants at a cost of \$7,396,032. The purchase was financed by the bank loan of \$4,800,000 which was secured by a mortgage on the G/F, 1/F and 7/F, which respectively yielded a monthly rental income of \$50,000, \$25,000 and \$16,000, totalling \$91,000.
 - (8) On 7 November 1987, the Taxpayer sold the 1/F with sitting tenants, making a profit of \$148,306 in the year of assessment 1987/88; the profit was not offered for assessment but was treated as an 'Extraordinary Item - Disposal of Fixed Asset' in the accounts.
 - (9) On 18 March 1988, the Taxpayer purchased Units A, B, C and D on 15/F of Block I in an industrial development (Units A, B, C and D) for a consideration of \$12,470,000, which was paid by a down payment of \$2,470,000 and a mortgage loan of \$10,000,000 repayable by 95 monthly instalments of \$104,200 each.

INLAND REVENUE BOARD OF REVIEW DECISIONS

- (10) On 19 March 1988, the Taxpayer let Units A, B, C and D to a single tenant for two years commencing on that day at a rent of \$151,809 per month.
- (11) On 21 March 1988, the Taxpayer sold the 7/F with sitting tenants for \$2,260,000 making a profit of \$712,362 in the year of assessment 1988/89; the profit was not offered for assessment but was treated as an 'Extraordinary Item - Disposal of Fixed Asset' in the accounts.
- (12) On 28 December 1989, the Taxpayer sold Units A and C for \$7,898,300, making a profit of \$1,189,834 in the year of assessment 1989/90; the profit was not offered for assessment but was treated as an 'Extraordinary Item - Disposal of Fixed Asset' in the accounts.
- (13) On 25 May 1990, the Taxpayer sold Units B and D for \$7,690,450, making a profit of \$1,089,351 in the year of assessment 1990/91; the profit was not offered for assessment but was treated as an 'Extraordinary Item - Disposal of Fixed Asset' in the accounts.
- (14) Rebuilding allowance was claimed in respect of the G/F for the 4 years of assessment in question, while industrial building allowance was claimed in respect of the 7/F, and the Units A, B, C and D until they were respectively sold.

Reasons

3. The Taxpayer's case is that the 3 floors and 4 units mentioned in paragraph 2 above were all fixed assets. It relied principally on the minutes dated 30 May 1987 of a board meeting held on that day which stated:

'It was passed unanimously that the industrial premises on G/F, 1/F and 7/F ... which were not yet vacated, be purchased at the consideration of \$7,396,032 for the purpose of acquiring rental income.'

It also relied on the fact that all the subject properties were listed under the head 'Fixed Assets' in the balance sheets of the relevant years, that the profits on disposal were treated as extraordinary items in the profit and loss accounts and that industrial building or rebuilding allowance, as the case may be, was claimed in respect of the subject properties.

4. The representative of the Commissioner referred to a statement of Sir Alan Huggins, V-P, at page 305 of Chinachem Investment Co Ltd v CIR 2 HKTC 261:

'There is no dispute that the test is what was the subjective intention of the taxpayer at the time each parcel was acquired, that intention being viewed in the light of the objective circumstances.'

The facts of that case are not comparable, but the principle stated by Sir Alan Huggins is axiomatic and is in our view applicable in the present case.

INLAND REVENUE BOARD OF REVIEW DECISIONS

5. The 4 sales in question were all profitable, each taking place within a relatively short period of time after acquisition: a little over 5 months in the case of the 1/F (see paragraphs 2(7) and (8) above); about 10 months in the case of the 7/F (see paragraphs 2(7) and (11) above); about 1 year 9 months in the case of Units A and C (see paragraphs 2(9) and (12) above), and about 2 years 2 months in the case of Units B and D (see paragraphs 2(9) and (13) above).

6. **1/F and 7/F** The purchase of the G/F, 1/F and 7/F were financed by a bank loan of \$4,800,000 repayable by 84 monthly instalments of a little over \$57,000 each (see paragraph 2(6) above) while the existing tenancies yielded a total monthly rental income of \$91,000 (see paragraph 2(7) above). The 1/F was sold in November 1987 (see paragraph 2(8) above); the reason given for the sale was that the directors were apprehensive that the stockmarket crash in October 1987 might lead to a credit squeeze prompting the bank to call in the loan of \$4,800,000 or the outstanding balance thereof. Apart from a vague answer by Mr X, who was one of the two directors who gave evidence, that the bank would normally give oral notice, there was no evidence of any demand by the bank for repayment, whether oral or in writing. Furthermore, the sale was taking place only a little over 5 months after the date of acquisition; if the 3 floors had been purchased for the purpose of acquiring rental income as recorded in the board minutes of 30 May 1987 (see paragraph 3 above), one would have expected to see a board resolution to authorize the sale and explain why the declared long-term purpose of acquiring rental income was being abandoned. No such resolution was produced, nor was any explanation offered for its absence. The 7/F was sold in March 1988 (see paragraph 2(11) above). Evidence was inconsistent as to the reason for the sale: while the tax representative had by letter stated to the assessor, profits tax, that 'it is due to the demand of repayment of advances by an associated company, Company A Ltd', the two directors both stated in evidence that the 7/F was sold to the owner of the 10/F, 11/F and 12/F of the same building at his request, and that at that time the Taxpayer was buying the 4 Units A, B, C and D and needed funds for the purchase. We are not impressed by the fact that the two directors only confirmed the demand-for-repayment story after being reminded in cross-examination of the tax representative's letter to the assessor. Likewise, there was no evidence of any board resolution to record the sale and explain why the long-term-investment purpose was abandoned.

7. **Units A, B, C and D** The purchase of the 4 units was financed by the bank loan of \$10,000,000 repayable by 95 monthly instalments of \$104,200 each (see paragraph 2(9) above). The Taxpayer's ability to perform the terms of repayment was backed by the 2-year lease yielding a rental income of \$153,809 per month. One of the directors stated in evidence that 6 months before the tenancy was to expire the tenant gave oral notice that it would not renew the tenancy. No representative from the tenant was called to give corroborative evidence. Evidence was inconsistent as to the steps taken by the Taxpayer in consequence of the alleged oral notice: the tax representative had stated to the assessor that 'our clients preferred to dispose [of] the investment, so as to avoid the risk of difficulty in seeking new tenant', thereby suggesting that the Taxpayer simply went ahead to sell the units without first endeavouring to let them, while one of the two directors' evidence was to the effect that estate agents employed by the Taxpayer had been looking for tenants, but without success. No estate agent was called to corroborate this. From the fact that Units A and C were sold 3 months before the expiry date of the tenancy (see paragraphs 2(10) and (12) above), it seems to us that the probability was that the Taxpayer sold the units without

INLAND REVENUE BOARD OF REVIEW DECISIONS

seeking to let them first. Furthermore, as in the case of the 1/F and 7/F, there was no board resolution to authorize the sales and to put on record the reason why the 4 alleged long-term investments were sold.

8. For the above reasons, we are unable to accept the reasons given for the 4 sales, nor can we give any weight to the board minutes dated 30 May 1987, or the accounting treatment of the subject properties. We accept the submission by the representative of the Commissioner that a pattern of trading can be seen from the 4 sales and that the Taxpayer has not been repeatedly realizing capital assets. We also agree with the Commissioner's conclusion that the 3 floors and 4 units were acquired with the intention to turn them to profitable account by selling them when the appropriate moment came, and that as such they were the Taxpayer's trading stock, not capital assets. In reaching our conclusion, we have not taken into account the trading record of the Taxpayer prior to the year of assessment 1987/88.

Decision

9. It follows that this appeal is dismissed and that the 4 assessments in question, as confirmed or revised by the Commissioner as the case may be, are hereby confirmed.