Case No. D47/91

Profits tax – property trading – whether change of intention – standard of proof.

Profits tax – property trading – alleged sale at undervalue – Petrotim Securities Limited v Ayres – section 61 of the Inland Revenue Ordinance.

Profits tax – property trading – whether foreign exchange loss a deductible expense.

Panel: Henry Litton QC (chairman), Chen Yuan Chu and Kenneth Kwok Hing Wai.

Dates of hearing: 2, 3, 15, 16 and 17 July 1991.
Date of decision: 2 September 1991.

The taxpayer was a company engaged in property trading. In mid-1983, there was a property recession and the board of directors of the taxpayer passed a resolution purporting to resolve that some of the trading stock of the taxpayer would be held for long term capital purposes. The assessor refused to accept the validity of the resolution. The taxpayer borrowed foreign currency to finance its business. When the taxpayer repaid the foreign currency loan, a currency loss was sustained. The assessor decided that the loss was not deductible as a trading expense. One property unit was sold to an associated company at an undervalue. The assessor did not invoke section 61 of the Inland Revenue Ordinance but the Commissioner by his determination increased the assessment against which the taxpayer was objecting under the principle of Petrotim Securities Ltd v Ayres. The taxpayer appealed to the Board of Review.

Held:

On the evidence before the Board, the taxpayer had not discharged the burden of proof to prove a change of intention. The foreign currency loan was of a capital nature and not a trading nature and accordingly the currency loss was not a deductible expense. Petrotim Securities Ltd v Ayres has no application in Hong Kong and the Commissioner has no power to revalue property. The appeal was allowed in respect of the revaluation of the property only.

Appeal allowed in part.

[Editor's note: This decision can be usefully read with D41/91.]

Cases referred to:

Petrotim Securities Ltd v Ayres 41 TC 389
Beauchamp v F W Woolworth Plc [1989] STC 510

S P Barns for the Commissioner of Inland Revenue.
David Wong of International Taxation Advisory Services Ltd for the taxpayer.

Decision:

Background Facts

1. The Taxpayer was incorporated in 1978. The first directors named in the articles of association were Mr A, Mr B and Mr C who remained at all times the directors of the Taxpayer. The paid up capital of the Taxpayer has always been $100,000. Prior to mid-1983 Messrs A, B and C owned between them 30% of the issued shares of the Taxpayer. They acquired the remainder of the 70% of the shares in mid-1983 whereupon another director, Mr D, resigned. From the material which has been produced in evidence before us, such as the minute book, directors' reports and financial statements, it is apparent that the controllers of the Taxpayer have always been Messrs A, B and C even though they owned only 30% of the shares prior to mid-1983. Mr A was for many years the managing director.

Property Development

2. In 1979 the Taxpayer acquired a property ('the property') for a consideration of $29,208,000 and proceeded to redevelop the property into a new twenty-four storied industrial building ('the industrial building') comprising 164 industrial units and 37 car-parking spaces. It is common ground between the parties that this development was a trading activity of the Taxpayer. It was financed almost completely by borrowed money, and the Taxpayer organised a sales programme, offering the units for sale prior to completion of the development.

3. The occupation permit for the industrial building was issued in 1982. The total cost of the development was, including the cost of land, $76,426,355.

Sale of Units in the Industrial Building

4. The Taxpayer's financial year ends on 30 June each year. As at 30 June 1981, sales deposits received amounted to $5,908,151; as at 30 June 1982, sales deposits received amounted to $9,274,030.

5. There was a severe downturn in the property market shortly after the grant of the occupation permit, the Taxpayer started leasing some of the units in the industrial building, generally (but not invariably) by three year leases.

6. The position as at 30 June 1983 was that the Taxpayer had sold 53 units and 5 car-parking spaces, and the profits were treated as trading profits in the Taxpayer's profit and loss account. In the same financial year (ending 30 June 1983) a number of sales deposits were forfeited, amounting to $353,488, and in the profits tax return these were returned as income.

7. In the following years, the sales pattern was as follows:

Year Ending	No of Units Sold	Total Sales Price
30 June 1984	7	$466,260
30 June 1985	9	$1,351,647
30 June 1986	4	$953,346
30 June 1987	21	$9,932,971
30 June 1988	10	$10,710,343

The Taxpayer's Case

8. It is the Taxpayer's case that not all of the sales set out in the preceding paragraph gave rise to assessable profits. In the Taxpayer's profits tax returns for the years of assessment 1985/86 to 1988/89, the profits on sale of certain units were treated as extraordinary items, arising from the sale of capital assets. They were as follows:

Year Ending	Sale of "Fixed Assets"	Total Sales Price
30 June 1984	nil	nil
30 June 1985	9	$1,351,647
30 June 1986	4	$953,346
30 June 1987	17	$7,200,235
30 June 1988	10	$10,710,343

9. At the hearing before us, there was adduced in evidence by the Taxpayer's representative an affirmation of Mr A to this effect:

(a) In mid-1983 the property market was in decline. This was on account of the general feeling of political uncertainty over the future of Hong Kong arising from the PRC Government's declaration that it would resume sovereignty over Hong Kong in 1997.

(b) In mid-1983 Mr D, a board member, suggested that the Taxpayer should sell all the remaining unsold units at the industrial building in order to alleviate further loss on the development.

(c) The board members discussed the matter but could not reach a consensus as to the future policy of the Taxpayer. Mr D, representing the 70% majority shareholders, had no confidence in Hong Kong's future and wished to

discontinue any involvement in the property market. On the other hand, Messrs A, B and C felt confident over the future.

(d) The matter was resolved by Messrs A, B and C buying out the interests of the majority shareholders. They became equal shareholders in the Taxpayer and resolved that the Taxpayer should change its original intention: retaining as long term investment those units in the industrial building which were let, selling only those units which were unlet.

(e) A board meeting was accordingly convened and held on 30 May 1983 at which it was decided that:

(i) all the unsold units which had been let out with leases of three years duration should be retained as 'long term investment for the purpose of producing rental income for [the Taxpayer]', and

(ii) the units on the second floor of the industrial building which were vacant should be leased to an associated company, the Taxpayer retaining the same as '[the Taxpayer's] long term investment'.

10. There was apparently tabled at the 30 May 1983 meeting a valuation report prepared by a firm of surveyors, and the directors resolved at the meeting that units identified in the report as those with three year leases, valued at $43,651,080, should be transferred as the Taxpayer's 'capital assets' and that the difference amounting to $2,868,426 as compared with the original book value of those units of $46,519,506 should be transferred to the profit and loss account so as to reflect the 'fair value of such capital assets in [the Taxpayer's] accounts'.

Was there change of intention?

11. The issue before us is whether, on all the evidence, we are satisfied that there was the change of intention with regard to some of the units as the Taxpayer alleged. Although the directors professed, at the board meeting of 30 May 1983, to retain the let units as long term investments, in fact within less than two years a number of those units were sold and, thereafter, in successive years, further units were sold so that out of the 95 units identified at the 30 May 1983 board meeting as 'long term investments', 40 had been sold by 30 June 1988. This casts a considerable doubt on the professed intention of the Taxpayer.

12. Looking at the schedule of properties set out in the surveyor's valuation report, we can detect no logical basis for the Taxpayer retaining certain units and treating others as trading stock, beyond the fact that those to be held as 'long term investments' happened to have been let at the time of the valuation report. Thus, for instance, of the six units on the fourth floor of the industrial building, three had been sold at the time of the valuation report. To retain those three units on the fourth floor as 'long term investments' meant, in effect,

that the Taxpayer was having to share the fourth floor in common ownership with outside parties.

13. When we come to the sales effected in the years ending 30 June 1985 and 30 June 1986, we see that none of the so-called 'trading stock' was sold at all whereas in those two years there was respectively nine and four tenanted units sold. Apparently all the units held as 'long term investments' were sold either to the sitting tenants or to companies who were already tenants of the industrial building or to related companies.

14. Furthermore, the so-called 'trading stock' did not all remain vacant after 30 May 1983. Some of them were subsequently let out to tenants and there were, accordingly, a number of sales of 'trading stock' which were made to either sitting tenants or companies which were occupiers of the industrial building.

15. From a commercial point of view, we are wholly unable to detect any logical basis for the differentiation between so-called 'capital assets' and 'trading stock'. From the slender evidence which was adduced before us, it seems that the Taxpayer undertook no sales programme in the years under consideration, but this fact is neutral. The Taxpayer apparently made no special effort to sell either the 'fixed assets' or the 'trading stock'. As far as letting out the 'trading stock' was concerned, the tenancies for those units seemed to have been similar in duration to those for the 'fixed assets'.

16. The only viva voce evidence called at the hearing before us came from the Taxpayer's accountant who was unable to shed further light on the Taxpayer's policy with regard to the sale of units in the industrial building, beyond what was stated in Mr A's affirmation.

17. The difficulty we face in evaluating the evidence before us is this. There is, on the one hand, a board resolution of the Taxpayer whereby the directors resolved that certain of the units should be held as capital investments. The question is what weight we should attach to the board minutes, recording that resolution. There is no doubt that some kind of meeting along the lines evidenced by the board minutes of 30 May 1983 was indeed held. A copy of the resolution was forwarded to the Commissioner together with a copy of the surveyor's valuation report under cover of a letter dated 16 June 1983. Is there any reason why we, as the Board of Review, should not give effect to it and find as a fact that the Taxpayer had indeed changed its intentions with regard to certain of the units in the industrial building as a result of this board resolution? Looking at the document alone, there is none. On the other hand, the subsequent actions of the Taxpayer in no way bear out the professed intention of the board. A number of relevant questions remain unanswered in our minds. What were the commercial reasons for the arbitrary distinction between 'capital assets' and 'trading stock' subsequently let? Would it not have been more advantageous to sell with vacant possession? When approached by 'neighbours' in the industrial building to sell, why did the Taxpayer not simply sell the 'trading stock'? Why sell at all? (One possible answer to the last question is this: the Taxpayer was saddled with enormous debts and had to sell to reduce its liabilities.) As there was no evidence put before us from the Taxpayer's directors, apart from the affirmation of Mr A, none of these questions could be

satisfactorily answered. The Taxpayer's intention is that of the board consisting of the three directors who were also the only three shareholders at the material time. It would have been a simple matter for one of the directors to step forward and give evidence concerning the alleged intention. All we have instead is an affirmation from the managing director. As regards the board meeting, the production of the minutes (in English) gives us little of the flavour of that meeting. Was it in fact conducted in the English language? We notice from the minute book produced to us for examination that some other board minutes were recorded in Chinese. Did the meeting in fact proceed along the lines as recorded in the minutes, or was this a case where a professional advisor had prepared the document beforehand and the directors simply adopted it at the meeting?

18. The burden of proof is on the Taxpayer to satisfy us that there was, indeed, the change of intention as stated in the board minutes of 30 May 1983. In Mr A's affirmation he stated that he was 65 years old and had been advised by members of his family to refrain from attending to give evidence because he should refrain from exposing himself to the 'tension and anxiety which may be caused as the result of cross-examination which I may not be able to withstand'. This is certainly no reassurance to us that if questions along the lines adumbrated in the preceding paragraph had been put to Mr A he would have been able to supply satisfactory answers. Mr A is only one of the three directors, and if the matter had been discussed and agreed as professed in his affirmation, then the other two directors could have given evidence before us to substantiate the Taxpayer's intentions.

19. The reality of the situation is, of course, this: given the huge debt the Taxpayer incurred in redeveloping the property, there was no way out for the Taxpayer except to sell. As the Taxpayer had intended from inception to trade, and continued, with a small gap, to sell from year to year, why should such activity not be treated as the continuation of its trade?

20. Having regard to all the circumstances of the case, we are not satisfied that the burden of proof has been discharged. The Taxpayer has failed to persuade us on the evidence that there was the change of intention with regard to some of the units in the industrial building as alleged. We find as a fact that all the units in the industrial building remained the Taxpayer's trading stock. It follows from our finding that:

(a) In the Taxpayer's 1983/84 profits tax return, the Taxpayer is entitled to a deduction of $4,432,772 on account of the diminution in value of its unsold trading stock, applying ordinary commercial principles of valuation of trading stock.

(b) The claimed industrial building allowance in respect of the units classified as 'fixed assets' cannot be allowed.

<u>Sale of a ground floor unit at the industrial building</u>

21. In paragraph 34 of the Commissioner's determination, he said this:

> ' It has since come to the attention of the assessor that the sale of [a ground floor unit] in the year ended 30 June 1988 was to a non-arm's length party [X Ltd]. Although the sales price stipulated was $6,000,000, the Commissioner of Rating and Valuation has advised that, as at the date of sale, the unit's valuation was $9,500,000.'

22. Based on this fact, the Commissioner applied the 'principles set out in Petrotim Securities Ltd v Ayers 41 TC 389' and, in dealing with the year of assessment 1988/89, the stated sale price of $6,000,000 for the ground floor unit was 'replaced by the valuation of $9,500,000'.

23. When the appeal first came before us, this was not challenged by the Taxpayer but, in consequence of certain observations we made in the course of the hearing, the Taxpayer's representative applied to amend the grounds of appeal and, as a result, the following grounds of appeal were added:

> ' 1. There presently exists no legislation, case law or precedent in Hong Kong to empower the Commissioner of Inland Revenue to adjust proceeds on transactions between closely related parties which are both Hong Kong persons.
>
> 2. The ground floor unit disposed of by [the Taxpayer] to its related company was considered by its directors to be at its fair market value of $6,000,000. This unit has no loading facilities and is in effect a basement unit with limited access.'

Valuation of the ground floor unit

24. Valuation of property is, generally speaking, an inexact science. The unit in question has certain disadvantages, for instance, part of the unit has a low sloping ceiling formed by the ramp leading to the first floor car-park. It has no loading facilities for vehicles. The Government valuer in conducting his valuation exercise took the adjacent unit on the ground floor of the same building (sold about a year prior to the sale of the said unit) as his best comparable. He has placed on the property in question a unit price of $8,398 per square metre which, on the evidence before us, seems reasonable; the sale to the related company at $6,000,000 means that the price per square metre was approximately $5,304 which, on the evidence, is a considerable discount to the market price. We are therefore satisfied as regards the factual basis of the Commissioner's approach.

The question remains as to whether he is justified in law to disregard the actual price at which the unit was sold, and to substitute a notional price based on market value which the Taxpayer never received.

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25. We ask ourselves this question: what is the legal foundation for the Commissioner, in assessing the Taxpayer to profits tax, replacing the actual figure of $6,000,000 by the 'valuation' figure of $9,500,000 for the ground floor unit?

26. Section 61 of the Inland Revenue Ordinance is in these terms:

> '61. Where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessable accordingly.'

27. The power under section 61 is given to the assessor as part of his process of assessment. It is plain in this case that the assessor never applied his mind to section 61. Far from considering the sale of the ground floor unit as 'artificial' or 'fictitious' or 'not intended to be given effect to', the assessor gave effect to it and assessed the Taxpayer on the basis of the profits derived from that sale. The 'discovery' of undervalue only came after the objection to the assessment had been lodged.

28. The Commissioner's position in dealing with the objection under section 64 is not that section 61 is relevant but that 'Petrotim Securities Ltd v Ayres should apply', to 'replace' the actual sales figure of $6,000,000 by the notional figure of $9,500,000.

29. Petrotim Securities Ltd v Ayres was a case where the 'sale' of assets was at figures so derisory that the Special Commissioners found as a fact that what the taxpayer was doing was in fact to 'deliberately set out to make a very substantial loss' (see 41 TC 389 at 395). The conclusion which they reached was this:

> '… it therefore seems a fair inference to draw that in relation to those transactions the company, at the time of the sales, was no longer acting as a dealer or financier and accordingly the sales were not made in the course of the company's trade.'

In relation to one parcel of stocks and shares, these had been acquired by the taxpayer for £478,573. At the time of the transaction in question, the realisable market value on the stock exchange of those shares was £835,505. The taxpayer 'sold' the shares to a wholly owned subsidiary for £205,000. In relation to the other transaction which was impeached, the taxpayer had bought bonds (3% war loans) for £104,769 and, four days later, 'sold' these to a wholly owned subsidiary for £10,000. In these circumstances, it is not surprising that the Special Commissioners came to the view that, in truth, the taxpayer was simply setting out deliberately to make a loss on the transactions.

30. It is worth emphasising that, under the scheme of the Income Tax Acts in the United Kingdom, there is no statutory equivalent to section 61 of the Inland Revenue Ordinance. We find it difficult to see any justification for the Commissioner in Hong Kong exercising some 'common law' power to disregard a transaction, outside the scope of

section 61 of the Ordinance, by invoking Petrotim Securities Ltd v Ayres, a decision under a tax regime wholly different from that of Hong Kong. If the sale was not made 'in the course of [the Taxpayer's] trade' (and this is how the 'principle' in Petrotim Securities Ltd v Ayres is articulated) then how could the profit come within the charge to profits tax under section 14? If in truth what the Commissioner is saying is that the 'sale' to X Ltd was a sham, a device in order to disguise the fact that the Taxpayer was simply giving its property away to a related company, this could have been stated in plain terms. But the consideration of $6,000,000 was real and not illusory, so any conclusion based upon the proposition that the transaction was a sham must be plainly flawed.

31. The charge on 'profit' in section 14 of the Inland Revenue Ordinance is a charge on real profit, not on notional profit which a taxpayer never made. The Inland Revenue Ordinance contains no provisions similar to section 27 of the Stamp Duty Ordinance Chapter 113 which enables the collector to assess stamp duty based upon the 'gift' element of a transaction. Assume, for instance, that X Ltd were themselves traders in real estate and, in turn, sold the ground floor unit a year or two later at a profit. Would their tax liability as traders under section 14 be computed on the basis of a notional sale to them at $9,500,000, or on the actual cost price of $6,000,000 (thereby yielding a higher figure for profits tax purposes)? The answer must be that they would be assessed on the basis of the actual cost of the trading stock, not the higher notional cost. When it comes then to assess the Taxpayer on the sale of the property to X Ltd, what principles of law, or of commercial accountancy, require the Taxpayer to be assessed on the basis of a sale at a notional figure and not the actual figure? We are aware of none.

Exchange Losses

32. As a result of US dollars loans which the Taxpayer borrowed, and subsequently repaid, the Taxpayer has incurred realised exchange loss both in respect of the payment of interest on such loans and on the repayment of the principal. The Commissioner in his determination allowed the deductions claimed by the Taxpayer in respect of the interest, but not as regards the principal. Hence the appeal.

33. The matter arises in this way:

(i) The financing of the original purchase of the property was by way of directors' loans and advances. As at 30 June 1981 these loans and advances, together with bank overdraft facilities, were the only sources of financing the redevelopment.

(ii) On 31 August 1981 the Taxpayer entered into a loan agreement with another company called Y Ltd. Under the terms of the agreement, Y Ltd provided funds to the Taxpayer up to a maximum of US$7,000,000, with an initial draw-down of at least US$5,000,000 to be made by 30 November 1981, the loan to be repaid within ten years of the initial draw-down, the Taxpayer retaining the right to demand early repayment by giving not less than three months notice in writing.

(iii) In September 1981 the Taxpayer drew down $31,700,000 (equivalent to US$5,283,332 at the rate of US$1 = HK$6) and used the money to repay the shareholders' advances.

(iv) On 29 June 1983 an associated company advanced $31,850,000 (equivalent to US$4,000,000) to enable the Taxpayer to repay that US dollar amount to Y Ltd.

(v) The balance of the Y Ltd loan was repaid in March 1985.

(vi) As a result of the diminution in the value of the Hong Kong dollar vis-a-viz the US dollar for the period of the Y Ltd loan, the Taxpayer suffered the exchange losses which were claimed as deductions in the tax returns.

34. It seems to us that, on these facts, it is beyond argument that the borrowings were on capital account, and accordingly the exchange losses were on capital account. The entire development had cost the Taxpayer over $76,000,000 and it had only an issued capital of $100,000. The development was first sustained by directors' and shareholders' loans. By the time the Y Ltd loan agreement was signed, the development was well underway and the Taxpayer had embarked upon its programme of pre-selling units in the industrial building. This is not a case of the Taxpayer undertaking 'temporary and fluctuating borrowings' in the course of transacting its business of trading; it borrowed a 'fixed amount for a definition period' and it is clear from Beauchamp v F W Woolworth Plc [1989] STC 510 (at 514(e) to (f)) that, as a matter of law the Y Ltd loan was of a capital nature.

Conclusion

35. It follows from what we have said above that except for the profits on the sale of ground floor unit of the industrial building the appeal is dismissed. In regard to the profits on the sale of the ground floor unit we direct that the assessment as made by the assessor for the year of assessment 1988/89 be restored; that is to say, that the profits be assessed on the actual receipt by the Taxpayer of $6,000,000, and not on the figure (as valued by the Commissioner for Rating and Valuation) of $9,500,000.