

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D48/88

Profits tax – sale of land – redevelopment – whether profits were trading gains or realization of capital – evidential matters: short-term financing, short holding period and transfer to related company in anticipation of redevelopment – s 14 of the Inland Revenue Ordinance.

Panel: Henry Litton QC (chairman), Chiu Chun Bong and Eleanor Wong.

Date of hearing: 21 October 1988.

Date of decision: 9 November 1988.

The taxpayer company purchased a property from a sister company in November 1978 for the purpose of redeveloping it. In October 1980, before an occupation permit had been issued, the taxpayer sold the property at a profit. The IRD assessed these profits to tax. The taxpayer appealed.

At the time of acquisition, there had been some thought given to developing part of the property for rental purposes. The evidence on this point, consisting of a minute of a meeting of the taxpayer's board of directors, was weak.

The acquisition of the property was financed by way of temporary interest-free loans from the taxpayer's directors. The directors expected early repayment on completion of the building. The redevelopment itself was financed by a related company.

The managing director of the taxpayer testified that the taxpayer sold the property because the property market was poor. However, the taxpayer's own evidence pointed to increasing property values at the time of resale.

At about the same time as the purchase and resale of this property took place, the taxpayer also acquired and resold another property. The taxpayer offered the profits from this other sale to profits tax, although the managing director testified that this property had also been acquired for rental purposes.

Held:

The taxpayer had engaged in an adventure in the nature of trade and its profits were therefore assessable.

INLAND REVENUE BOARD OF REVIEW DECISIONS

- (a) Contemporaneous minutes of the deliberations of a board of directors can constitute strong evidence of the intentions of a company at the material time. However, such minutes are not conclusive.
- (b) The transfer of property from one company to a related company for the purpose of effecting a redevelopment does not necessarily give rise to an inference of trading.
- (c) The short-term nature of the financing of the acquisition of the property indicated that a resale of at least part of the property would be necessary.

Appeal dismissed.

Lee Yun Hung for the Commissioner of Inland Revenue.
David Flux of Peat Marwick for the taxpayer.

Decision:

The Taxpayer company is a limited company incorporated in 1974, with very wide objects in its memorandum of association. In October 1980, the company sold a property in Kwun Tong ('the property'), realising a profit amounting to \$19,543,228. The question on this appeal is whether the profit arose from an adventure in the nature of trade, as claimed by the Commissioner, or whether it arose from the sale of a capital assets, as the company maintains.

2. The company is one of a group of companies owned by the X family. The property was, prior to November 1978, owned by another company within the same group, namely, A Company whose shareholders were virtually the same as those of the Taxpayer company. For a number of years, A Company derived rental income from letting the property to tenants.

3. Whilst the property was still in the ownership of A Company, plans were drawn up for the re-development of the property. In June 1977, plans for a multi-storied flatted factory building were approved by the Building Authority.

4. In November 1978, the company acquired the property by purchase from its sister company, A Company, and the project for re-development proceeded. After the re-development works were completed, but before the issue of the building permit, the company (in October 1980) sold the property at a considerable profit. It can be seen from this recital of facts that the period of time during which the property was owned by the company was less than two years.

Re-development

INLAND REVENUE BOARD OF REVIEW DECISIONS

5. At the forefront of the company's case is the proposition that originally the proposal for the re-development was that the first to fourth floors of the new building would be adapted for use as a cold store and that the company would, itself, conduct a cold storage business from those premises. Plainly, if this proposition were established by credible evidence, it would go a long way in showing that, for at least part of the property in question, the company's intention was to hold it as a capital asset. However, the evidence which was adduced before us on this point was extremely nebulous. The effect of that evidence can be summarised as follows:

- (i) In about November 1978, there was a proposal to have the first four floors of the new building adapted for the purposes of cold storage. In this regard, there was put before us a piece of paper bearing the date 1 November 1978 (unsigned) containing an analysis of the rental yield of the new building, including a rental yield from the first to fourth floors, under the heading 'cold storage'. Curiously, the piece of paper was put in evidence by the Commissioner's representative in the course of cross-examination of the company's managing director, Mr X, and not by the company's representative. It is not clear from the evidence who was the maker of that statement, nor is it clear as to what use that piece of paper was put.
- (ii) There was also in evidence a letter from an architectural firm dated January 1979 which, in essence, suggests that any plans for a cold store were at the date of the letter at a very tentative stage.
- (iii) Within a very short time, such proposal as existed concerning the cold storage was abandoned. Some of the reasons given were that the street which gave access to the cold store was too narrow and too congested and that there were many cooked food stalls on the road which would have obstructed access to the cold store. Plainly, these matters would have been apparent from the very beginning when the property was in the ownership of A Company. The evidence left us very sceptical as to whether any serious consideration had been given to the proposal.
- (iv) It appears from the evidence that none of the directors of the company had any previous experience of running a cold store. There was no evidence put before us that the directors studied the economics involved, or indeed any other matters concerning such operation. The only documentary evidence is the unsigned piece of paper dated 1 November 1978 where there was an entry to this effect: 'cold storage equipment and, 28,230 square feet x \$25 ... \$705,750'. No witness was put forward by the company to explain what that meant.

6. We conclude from the evidence that, whilst the management of the company might have given some passing thought to the possibility of adapting the lower floors of the new building for use as a cold store, the matter never went beyond that point.

INLAND REVENUE BOARD OF REVIEW DECISIONS

Financing

7. The financial statements of the company were never put before us but, from the statement of facts in the Commissioner's determination, which were agreed by the company's representative, the position as regards the financing of the project was as follows:

- (i) The acquisition cost of the property was \$8,229,500.
- (ii) This was financed chiefly by loans from the directors.
- (iii) The re-development cost of the new 14 storey industrial building amounted to \$13,904,772 and this was almost entirely financed by a construction company, namely Y Company, which was another company within the X family group.

The testimony of the managing director

8. At the hearing before us, the managing director of the company, Mr X, was called to give evidence. He owned 50% of the shares in the company. Mr X gave no evidence as to how the company was managed and, although he spoke of a large number of persons being directors of the company, we obtained no enlightenment from his testimony as to whether the directors ever met formally as a board and, if so, how often. Nor do we know what was their relationship with Mr X.

9. At the hearing before us, a number of photocopies of board minutes, which had been enclosed as appendices to the Commissioner's determination, were adduced in evidence by agreement of the parties. There was one dated 25 November 1978 which recorded Mr X as Chairman and referred to a report by him in these terms.

‘It was unanimously passed by the last meeting that the land in Kwun Tong be acquired. All the legal proceedings regarding the transaction were completed. The meeting was requested to discuss the matters regarding the employment of an architect to do the architectural work and to re-develop the site into a 14 storey industrial building for use as cold storage and for rental collection purposes.’

Curiously, Mr X was asked no questions about the minutes by the company's representative at the hearing. On the face of it, the contemporaneous minutes of the deliberations of a board of directors constitutes strong evidence of the intentions of a company at the material time. A limited company is, by the provisions of the Companies Ordinance, required to ‘cause minutes of all proceedings at meetings of its directors or of its managers to be entered in books kept for that purpose’ (section 119(1) of the Companies Ordinance). Ultimately, however, the minutes do nothing more than to reflect the statements and resolutions made at the meeting by the persons who attended it. Here we

INLAND REVENUE BOARD OF REVIEW DECISIONS

have a family company with 50% of the shares owned by Mr X. According to his evidence, the remaining 50% of the shares belonged either to the estate of his elder brother or to his sister-in-law (the matter did not emerge with clarity in his evidence). In the minutes dated 25 November 1978, a number of persons were recorded as having been present at the meeting but we have no idea who those persons were nor their relationship with Mr X. At the end of the day, whilst we have to give some evidentiary weight to the minutes as evidence of the company's intentions, we cannot find that the matter is by any means conclusive. We must look wider at the acts and declarations of the directors to find out the intentions of the company.

Parallel transaction

10. About one month before the acquisition of the property in Kwun Tong by the company, the company acquired a residential property in Kowloon, which property was sold at a considerable profit about two months after the sale of the property in Kwun Tong. Mr X, in his evidence, claimed that this property in Kowloon was acquired for rental income purposes and not for trading purposes: and yet, as the company by its representative clearly admitted, the profit on resale of this property was offered for assessment to profits tax. This gives rise to some doubt as regards the value of Mr X's statement of intent when he declared in his testimony that the property was acquired for rental purposes.

Other evidential factors

11. According to Mr X, the property in Kwun Tong was likewise acquired for rental purposes. What reliance can we place upon this statement?

First, we note that no explanation has been given at all as to why the company acquired the property from A Company in the first place, since the beneficial owners of the shares in the two companies were virtually the same. Such a transfer would certainly be consistent with an intention to redevelop the property for sale, since the profit would, in consequence of the transfer to the company, be computed not at the historic cost of the property but at the cost of acquisition (which presumably reflected the market value in November 1978). We place, however, no great reliance on this point because, if the directors of A Company had intended to turn the property to trading purposes and had made their intentions sufficiently clear, the property would have been revalued (for profits tax purposes) at the date of commencement of the trade. The transfer to another company is consistent, and perhaps no more than this, with a desire to underline the intention to redevelop – which on one view could be quite neutral.

Secondly, we note that the property was held by the company for less than two years, and the site together with the building thereon was sold in its entirety even before the occupation permit for the new building was issued.

Thirdly, and this is perhaps the most clear indication of the company's intentions, Mr X stated in evidence that the directors of the company, in financing the

INLAND REVENUE BOARD OF REVIEW DECISIONS

acquisition and redevelopment costs, were doing so interest-free, and that the directors only intended to meet the urgent needs of the company and expected repayment of their loans in full on completion of the building. Plainly, such a purpose could only have been achieved by resale of at least part of the building.

Reasons for sale

12. In opening the case for the Taxpayer, the company's representative said that the reason for the disposal of the property was the wholly unexpected rise in property values in the period 1978-1980 which rendered the rental yield from the property no longer attractive, as compared with the interest yield on the proceeds of realisation. This, said the representative, was the reason why the directors of the company decided to sell the property in 1980.

However, when Mr X came to give evidence, he said that the market was poor, and remained poor – a statement somewhat contradicted by the statistics put in evidence by agreement which indicated a strong rising trend in property values during the period in question. Despite Mr X's statement that the property was always intended to be retained for rental income, the only explanation he gave for the sale of the property, within less than two years of its acquisition, was that the directors had always regarded their own investment of funds as a temporary one: the advances were interest-free, and the lenders wanted their money back within a short time.

Conclusion

13. Ultimately, it is our function as a Board of Review to evaluate all the circumstances of the case, from the time of acquisition to the time of sale, and from the facts of the case to infer the true intentions of the company. Whilst the minutes of the directors' meeting of 25 November 1980 do support the company's case on this appeal, the weight to be attached to those minutes is somewhat lessened by the company's failure to explain the circumstances surrounding the meeting. Indeed, the minute book (if such ever existed) was never produced in evidence. When the other factors of the case are put in the balance, we have come firmly to the conclusion that the company has failed to discharge the burden of showing that the assessment, based on the company being engaged in a trading operation, was incorrect. The appeal must therefore be dismissed.

14. In our judgment, the company, when it acquired the property from its sister company, embarked upon an adventure in the nature of trade. It follows therefore that the profits realised on the sale of the property are subject to profits tax and, accordingly, this appeal is dismissed.