INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D51/91

Profits tax – sale of properties at a profit – whether director nominee for taxpayer – intention of taxpayer.

Panel: William Turnbull (chairman), Raphael Chan Cheuk Yuen and John Haggarty.

Dates of hearing: 24 and 27 July 1991.
Date of decision: 19 September 1991.

The taxpayer was a company incorporated in Hong Kong which acquired and immediately resold at a profit certain property. It was argued by the taxpayer that the property had been acquired by it at an earlier date when its director acquired the property as trustee for the taxpayer.

Held:

The Board did not accept the evidence submitted that the director was a trustee for the taxpayer and further held that even if the director had been a trustee, the evidence would still point to the taxpayer having an intention to trade.

Appeal dismissed.

Lee Yun Hung for the Commissioner of Inland Revenue.
Lee Kwan Wai for the taxpayer.

Decision:

This is an appeal by a taxpayer against an assessment to profits tax in which the assessor assessed the Taxpayer to tax on profits which the Taxpayer made when it sold two properties. The facts are as follows:

1. The Taxpayer was incorporated as a private company in Hong Kong in 1985. The nature of its business as described in its profits tax returns for the years of assessment 1985/86 and 1986/87 was ‘properties dealings’ and for 1987/88 ‘property investment, property trading, fruit trading, commission agent and related business’.

2. Upon the Taxpayer's failing to submit a profits tax return for the year of assessment 1987/88 within the stipulated time, the assessor raised on it an estimated assessment as follows:

Year of assessment 1987/88

Assessable profits	$200,000
Less: Loss set off	35,450
Net assessable profits	$164,550
Tax payable thereon	$29,619

3. By letter dated 25 February 1989, the tax representative for the Taxpayer lodged objection against this estimated assessment and claimed that the Taxpayer had sustained a loss of $499,839 and not a profit. To validate the objection, the Taxpayer submitted its profits tax return for the year of assessment 1987/88 together with accounts for the year ended 31 March 1988 and a proposed profits tax computation.

4. In arriving at the loss of $499,839, the Taxpayer made a number of adjustments as follows:

   (a) Rental income in the amount of $181,657 derived from unsold flats was set off against the closing stock balance of properties to be carried forward to the next year instead of being treated as income in the year of receipt.

   (b) Profits in the amount of $1,762,632 on disposal of 'fixed assets' were treated as an exceptional item and not offered for assessment.

   (c) Legal fees in the amount of $100,125 incurred in respect of the following two properties were added back:

      (i) Property I

      (ii) Property II

   (d) Rebuilding allowance in respect of properties III and IV totalling $3,881 was claimed as a deduction. The Taxpayer previously advised that property IV was used as its office.

5. In response to enquiries from the assessor with regard to the profit of $1,762,632 made on the disposal of fixed assets, the tax representative of the Taxpayer provided the following information:

(a) Computation of the profits

		Date of Purchase	Purchase Consider-ation	Date of Sale	Sale Proceeds $	Profit $
(i)	Portion A2 of Property I (Pro-perty Ia)	16-11-87	923,056*	28-11-87	2,500,000	1,576,944
(ii)	Property III	20-12-85	585,000	31-7-87	836,000	251,000
						$1,827,944
(iii)	Other Assets					(65,312)
						$1,762,632

* Purchase consideration of Property I: $2,050,000

– Portion A2 ('Property Ia')

$2,050,000 x 249 square feet / 553 square feet = $923,056

– Portion A1 ('Property Ib')

$2,050,000 x 304 square feet / 553 square feet = $1,126,944

(b) Property Ia

Property I was purchased in 1986 in the name of Mr X with the intention of acquiring it on behalf of the Taxpayer and was used partly (304 square feet – portion Al) as office for the Taxpayer's estate agent business and partly (249 square feet – portion A2) for rent to a third party, … who had no other relationship with Mr X than as a tenant, at a monthly rent $18,000. The property was registered in Mr X's name because due to an oversight he placed a deposit with the developer by using his own cheque and the developer did not accept the Taxpayer as purchaser when the purchase and sale were finalised. The position was rectified in

November 1987 when the property was transferred to the name of the Taxpayer ... However, the fact remains that the property was held as a capital asset from the time it was purchased in 1986 as it was used partly to generate rental income and partly for the Taxpayer's own business. Portion A2 was sold when an offer to purchase it was received from a third party who had no relationship with Mr X. Portion A2 was sold for two reasons:

(1) to use the sales proceed to repay the loan owed to the bank, and

(2) to enable Mr X to obtain banking facilities from a bank with the remaining portion Al ...

In these circumstances, Mr X claims that the profit obtained from the sale of portion A2 was a capital gain. Please also note that Mr X has distinguished other properties by separately listing them in its balance sheet as trading stock.

(c) Property III

The property was used as the general office of the Taxpayer since the date of its purchase. After the sale of this property, Mr X bought property II and moved its general office to this new address. Accordingly, the profit arising from the sale of the captioned property was considered as capital gain.

6. The assessor made further enquiries and ascertained the following additional facts:

(a) At all relevant times, Mr X was a director of the Taxpayer.

(b) Mr X had carried on a separate business in his own name and the nature of the business was 'property dealing'.

(c) Property I was acquired by Mr X in mid-1986 at a total cost of $1,825,000. Property Ia, being part of property I, was then let out for rental. Before it was sold to the Taxpayer in late 1987, the rental income was declared by Mr X in his own profits tax returns and duly assessed.

(d) Property I has not been included in the Taxpayer's balance sheets prior to its acquisition in late 1987 and no deed of trust has been entered into between the Taxpayer and Mr X.

(e) Properties I to IV have all along been classified as fixed assets in the Taxpayer's balance sheets.

(f) In the year of assessment 1986/87, the Taxpayer sold a car park and a property ('property V') at a profit of $10,000 and $70,046 respectively. In a schedule attached to the profits tax return for the year of assessment 1986/87, the Taxpayer advised that property V was used as its office and was previously rented by it before acquisition. Both the car park and property V were classified as fixed assets in the Taxpayer's balance sheets prior to their disposal. The profits so derived were offered by the Taxpayer for assessment and duly assessed in the year of assessment 1986/87.

7. The assessor formed the opinion that the profit on the disposal of properties Ia and III should be assessed to tax and that the assessment for the year of assessment 1987/88 should be increased accordingly.

8. The Taxpayer duly gave notice of objection to the Commissioner who by his determination dated 28 February 1991 agreed with the assessor and determined that the assessment for the year of assessment 1987/88 should be increased accordingly.

9. The Taxpayer duly appealed to the Board of Review.

At the hearing of the appeal a director of the Taxpayer, Mr X, was called to give evidence and the following further additional facts were proved to the satisfaction of the Board of Review:

1. The Taxpayer was a company formed by the director and his wife, both of whom were actively carrying on or involved with the carrying on of estate agency and property trading business.

2. The Taxpayer was formed with its main business as an estate agent and also carried on decoration work and had sold fruit.

3. In June 1986, an opportunity arose for the director to acquire property I which was a large shop space which he proceeded to acquire in his own name. The area of the shop space was too large for his own purposes and/or those of the Taxpayer and he decided to use half for his and the Taxpayer's own business and to let out half of property I to third parties for rental income to help to pay the mortgage loan which he had obtained when he acquired property I.

4. In 1987, the director decided to sell that part of property I which had been let out to third parties. To effect this sale, he decided to sell the entirety of property I to the Taxpayer for $2,050,000 being a price which was very substantially below its then market value but which would realise a small profit to the director after taking into account his original cost of purchase of property I plus the interest which he had paid to the bank and other associated expenses. Having agreed to acquire property I from the director by agreement dated 19

October 1987, the Taxpayer immediately on the next day agreed to sell that part of property I which had been let out to third parties at a substantial profit to the Taxpayer. Both the sale to the Taxpayer and by the Taxpayer were completed in late 1987. The Taxpayer retained the remainder of property I which was then occupied by the Taxpayer for its own business.

5. The rental income collected by the director in respect of the part of property I which had been let was retained by him for his own use and benefit and he did not account to the Taxpayer with regard thereto.

6. The mortgage which the director obtained to purchase property I was in his own name. Instalments thereon were paid by himself and he did not account to the Taxpayer nor did the Taxpayer account to him with regard to the payments of interest and capital which he made with regard to the mortgage.

7. The director filed a profits tax return in respect of property I in which he stated that he had made a taxable profit of $99,010.56 which was the difference between the price at which he had sold property I to the Taxpayer, namely, $2,050,000, plus the rental income received by the director and less the cost to him of purchasing property I including bank interest and other charges.

No evidence was given at the hearing by the director or any other person with regard to property III.

At the hearing of the appeal, the Taxpayer was represented by a qualified lawyer who appeared as the representative of the Taxpayer or friend of the director. She submitted to the Board that the director when he had purchased property I had done so as a trustee for the Taxpayer, that the property belonged beneficially to the Taxpayer, that the Taxpayer intended property I as a long term capital investment and that accordingly the profit which arose when the Taxpayer sold part of property I was a capital profit and not subject to profits tax.

She explained that according to the evidence of the director, it had been the intention of himself and the Taxpayer that the Taxpayer would acquire property I. Due to a mistake by the director, he had paid the initial deposit to the vendor in his own name and the vendor had refused to proceed with the sale in the name of the Taxpayer. For this reason property I was registered in the name of the director but in reality he was just a trustee for the Taxpayer. She said that property I was not transferred into the name of the Taxpayer at an earlier date because to do so would incur stamp duty and legal fees. However, when the director decided to sell part of property I the opportunity arose for him to transfer the entirety of property I to the Taxpayer so that the Taxpayer could then resell part and retain the remainder for its own use.

With due respect to the submission by the representative, we are not able to accept it. We do not accept the evidence of the director when he said that he was a trustee for the Taxpayer. It is well known in Hong Kong that when a purchaser of property enters

into a sale and purchase agreement, it is common practice for the purchaser to sub-sell to another person. No sale and purchase agreement was placed before the Board to disprove this common practice and no evidence was called to substantiate the statement by the director that the vendor of property I refused to put the ultimate assignment in the name of the Taxpayer. We note that when part of property I was sold by the Taxpayer, it was done by way of sub-sale and that the transaction comprised a sale and purchase agreement between the director and the Taxpayer for the whole of property I and a sub-sale of part of property I by the Taxpayer to the third party purchaser. This is a very common procedure in Hong Kong and must have been well known to the director. We are not satisfied that the vendor of the premises refused to agree to the assignment of property I to the Taxpayer. The evidence of the director was to the effect that the vendor would only agree to sell property I to the director. This is of course a totally different matter. It may well be that the vendor would only agree to sell property I to the director but that would not have stopped the director from on-selling or sub-selling it to the Taxpayer and at completion directing the vendor to make the assignment direct to the Taxpayer with the director acting as confirmor.

All of the other evidence before us is to the effect that the director did purchase property I in his own name as the beneficial owner thereof and not as a trustee. In his evidence, he said that he could obtained a more beneficial mortgage if the property was purchased by himself as opposed to being purchased by the Taxpayer. This would have been a cogent reason for the director owning the property as opposed to the Taxpayer. Part of property I was let out to third parties. The rent received was retained by the director for his own use and benefit and was included in his own tax return. He did not account to the Taxpayer for this rent as he would have done if property I had in fact been owned beneficially by the Taxpayer. Likewise he paid the bank instalments out of his own funds and was not reimbursed by the Taxpayer as would have been the case if the property was beneficially owned by the Taxpayer.

When property I was eventually assigned into the name of the Taxpayer it was not an assignment by a trustee to a beneficiary but was an arm's length transaction with a separate sale and purchase agreement at a price of $2,050,000 which though substantially below the market value at that time was more than the cost to the director. Here again, if the director had been a trustee, then there should have been an adjustment made so that the director did not make a profit. It is a fundamental rule of trust law that a trustee is not entitled to make a profit for himself out of trust property.

We find as a fact that the director did not acquire property I as a trustee for the Taxpayer but acquired it in his own name beneficially.

As the case was argued before us on the basis that the director was a trustee, our having found to the contrary would be sufficient to dismiss this appeal so far as it relates to the sale of part of property I. However, we feel that we should point out that even if the director had acquired property I as a trustee, we would still dismiss the appeal because the question which then must be asked is the intention of the Taxpayer when the property was acquired. On the fact before us, we would come to the conclusion that the Taxpayer did so with the intention of selling part or all of property I at a profit as soon as the opportunity

arose. It is clear that the Taxpayer was a property trading company and clear evidence would be necessary to show that at the time of its acquisition property I was acquired by the Taxpayer as a long term capital investment. We have no such evidence before us. Indeed, the evidence is to the effect that the Taxpayer would not have been able to afford to retain all of property I and that the intention was to temporarily let out part of it and in due course sell at a profit that part of property I which was not required by the Taxpayer for its own use.

No evidence or arguments were placed before us with regard to property III which is the subject matter of this appeal. The representative for the Taxpayer was asked at the conclusion of the case as to what was the position of the Taxpayer with regard to property III and the Board was informed that the Taxpayer conceded that the profit on the sale of property III was taxable.

For the reasons given, this appeal is dismissed and the assessment is remitted back to the Commissioner so that the assessment which is the subject matter of this appeal can be increased in accordance with the determination of the Commissioner.