

INLAND REVENUE BOARD OF REVIEW DECISIONS

**Case No. D8/93**

Profits tax – sale of property – whether profit assessable to tax.

Panel: Howard F G Hobson (chairman), Lim Ken Y and Benny Wong Man Ying.

Date of hearing: 26 April 1993.

Date of decision: 24 May 1993.

The taxpayer was a limited company which bought certain property and subsequently sold it for a substantial profit. No evidence was called at the hearing but it was submitted on behalf of the taxpayer that the original intention was a long term capital investment.

Held:

As no witnesses had been called the Board formed a view on the agreed statement of facts before it. The Board found as a fact that it was the intention of the taxpayer to purchase the property and sell it at a profit.

Appeal dismissed.

Cases referred to:

Hillerns & Fowler v Murray 17 TC 77  
Shadford v H Fairweather & Co Ltd 43 TC 291  
D11/80, IRBRD, vol 1, 374  
D9/74, IRBRD, vol 1, 153  
Simmons v IRC 55 TC 461

Yim Kwok Cheong for the Commissioner of Inland Revenue.  
Cheung Tak Shun for the taxpayer.

Decision:

In 1987, the Taxpayer bought certain property which it sold some fourteen months later at a considerable profit. The difference was assessed to profits tax which was confirmed on objection to the Commissioner. The Taxpayer appealed to the Board contending that the difference was simply a capital gain not a trading profit.

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1. The following paraphrases the more relevant features of an agreed Statement of Facts and includes information taken from other papers produced to us.

1.1 The Taxpayer was incorporated in Hong Kong as a private company in 1987. Its directors and shareholders during that period were:

	<u>No. of Shares</u>
Mr A	5,000
Md E (wife of Mr B)	2,000
Mr C	2,000
Mr D	<u>1,000</u>
	<u>10,000</u>

1.2 In mid-1987 the Taxpayer purchased Shops C & D (the Shops), Main Roof and car parking spaces (the Car Parking Spaces) in X Building (the Premises) at a consideration of \$6,500,000. The purchase was financed by way of a \$5,850,000 mortgage loan and by advances totalling \$650,000 from directors. The mortgage loan was to be repaid by 60 monthly instalments of about \$120,000, which we assume includes interest.

1.3 The purchase of the Premises was subject to existing tenancies. The sitting tenant for the Shops was Y Company under a tenancy agreement for two years from 1986 to 1988 at a monthly rent of \$53,000. The partners of Y Company during the relevant period were:

<u>Name</u>	<u>Profit/Loss Sharing Ratio</u>
Mr D	1/5
Mr B (Husband of Md E)	2/5
Mr C	2/5

1.4 The Car Parking Spaces were let to other tenants. The papers before us indicated the total of the average rent from these spaces was at one period \$12,130.75 though in the Agreement for Sale referred to at 1.6 below it was said to be \$6,650.

1.5 The Taxpayer's 1987/88 profits tax return for the eight months period 1 August 1987 (date of first rental income) to 31 March 1988 disclosed assessable profits of \$164,102. The return contained the following relevant information:

### Rental Income

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The Shops	\$424,000	
Car Parking Space	97,046	\$521,046
<u>Total Expenses</u>		
(including Interest Paid	\$247,403	
Amortization	134,289)	
<u>Net Profit before Tax</u>		58,113
Add back:		
Legal and professional expenses	\$4,200	
Amortization	<u>\$134,289</u>	<u>\$138,489</u>
		\$196,602
		<u>\$32,500</u>
Deduct rebuilding allowance		<u>\$164,102</u>
<u>Share Capital fully paid</u>		\$10,000
<u>Mortgage Loan</u>		\$5,275,011
<u>Current Accounts with directors</u>		\$1,224,500

1.6 In late 1988 the Taxpayer entered into an agreement to sell the Premises for \$14,000,000. Completion was scheduled a month later. The Shops were sold with vacant possession and the Car Parking Spaces were sold subject to the existing sitting tenants.

1.7 The Taxpayer's 1988/89 profits tax return for the nine months period from 1 April 1988 to 7 December 1988 (date of last rental income) disclosed assessable profits of \$203,920. The return contained the following relevant information:

Rental Income		\$603,140
Interest Received (\$27,033 received after 7 December 1988)		<u>32,767</u>
Total		\$635,907
Total Expenses (including Interest Paid \$357,222)		<u>\$404,954</u>
Net Profit before Taxation and Extraordinary Item		<u>\$230,953</u>

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Extraordinary Item (net surplus on Sale of  
the Premises – excluded from assessable  
profit [and the subject of this appeal]) \$7,274,489

Current Accounts with Directors 799,447

A note to the Accounts reads 'Cessation of business – The Company's business was ceased on 7 December 1988 being date of last Rental Income'.

Dividends of \$7,000,000 were paid out during the year ended 31 March 1989.

1.8 On 17 November 1989 the assessor raised a 1988/89 profits tax assessment on the Taxpayer based on the said assessable profits of \$203,920. He also raised enquiries with the Taxpayer's representatives concerning the profit on disposal of the Premises, directors' current accounts and interest income.

1.9 In response to these enquiries the assessor was advised as follows:

1.9.1 The status of the directors' current accounts was as follows:

<u>Name</u>	<u>Outstanding Balances</u>	
	<u>at 31-3-88</u>	<u>at 31-3-89</u>
	\$	\$
Mr A	524,500	386,411
Md E	280,000	165,214
Mr C	280,000	165,214
Mr D	<u>140,000</u>	<u>82,608</u>
	<u>\$1,224,500</u>	<u>\$799,447</u>

These outstanding balances represent directors' advances to the Taxpayer for the purchase of the Premises including the monthly repayments of the bank loan.

1.9.2 The Premises had been bought to enable Y Company of which a majority of shareholders were partners to use them as a showroom and shop. The former owner had expressed its intention to sell and since Y Company's fixed tenancy ran only to 6 June 1988 if it sold to third parties Y Company might have to evacuate and its business which had been operating from the Premises since May 1984 would be jeopardized.

1.9.3 The sale of the Premises was prompted by Mr C's stated intention to emigrate. It was claimed that he played an important role in Y Company therefore his absence necessitated the cessation of that firm's business.

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1.9.4 A new company (Z Company) commenced business in 1989 at rented premises. The partners in that firm were:

<u>Name</u>	<u>Profits Sharing Ratio</u>
Mr B	23.8%
Mr C	34.8%
Mr D	13.8%
*Mr F	13.8%
*Mr G	13.8%

(\*) Not shareholders of the Taxpayer and not partners in Y Company.

1.10 Not being convinced by the assertions of the Taxpayer's representative an additional 1988/89 assessment was raised, in effect taking into account the surplus of \$7,274,489 referred to at 1.7 above.

1.11 Y Company trading accounts for the 12 months ended 31 March 1988 disclosed an assessable profit of \$428,401 or about \$360,000 after tax.

2. The main grounds of objection (some of which were alluded to at 1.9) may reasonably be summarized as follows:

2.1 Although Mr A was not a shareholder of the Taxpayer he was the brother of Mr B who was a partner of Y Company to the extent of 40%.

2.2 Y Company had carried on business at the Premises for more than three years before the Taxpayer's purchase.

2.3 The Premises were purchased as a long-term investment, the Shops of which were to be let to Y Company.

2.4 The mortgage instalments would be financed from the rental received from Y Company and the tenants of the Car Parking Spaces and any shortfall would be funded from the profits of Y Company and by the shareholders.

2.5 Mr C's stated intention to emigrate precipitated the sale because that would necessitate the closing down of Y Company and hence the Premises would have to be sold, the shareholders having no intention of letting them to third parties.

2.6 Although Mr C did not take steps to begin the emigration process for several months, the delay was due to his attempts to discover a suitable country and searching for a satisfactory consultant. He engaged a consultant in July 1989 and paid him \$12,500.

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2.7 As the consultant advised Mr C that it may take many years to process his application, Mr C joined the new partnership referred to at 1.9.4.

3. The Taxpayer was represented by a gentleman who acknowledged he had no qualifications relevant to the appeal. Apart from adopting the grounds of appeal, he had nothing to say and offered no comment regarding the submissions by the Commissioner's representative. No witnesses were called.

4. Mr Yim Kwok Cheong appeared for the Commissioner. We are obliged to him for his thoughtful and comprehensive presentation. Having lead us through the relevant statutory provisions he referred to passages in reported cases in support of the following propositions.

4.1 The Taxpayer's intention at the time of acquisition is crucial (Simmons v IRC 55 TC 461 at 491 and 492).

4.2 A self-serving declaration of intention has to be tested against objective facts (Hillerns & Fowler v Murray 17 TC 77 at 87).

4.3 Where in regard to the purchase of land for development no firm intention to sell or let is reached at the outset one way or the other – the decision being left in abeyance until the prospects are clearer – and the property is sold undeveloped and the profit assessed as a trading profit the Taxpayer will be unable to discharge the onus upon him to show that the property was acquired as a long-term investment (Shadford v H Fairweather & Co Ltd 43 TC 291 at 299 and 300).

4.4 Intention connotes an ability to carry it out (D11/80, IRBRD, vol 1, 374 at 379 and D9/74, IRBRD, vol 1, 153 at 157). The Taxpayer's own financial resources were insufficient to enable it to hold the Premises on a long-term basis. The monthly rental from the Premises was about \$65,000 but the monthly loan instalments were \$120,000, resulting in a cash shortfall of \$55,000 per month. By 31 March 1988, the total of directors' advances amounted to \$1,224,500 of which \$650,000 represented the Taxpayer's own contribution to the purchase price (See 1.2). The after tax funds of Y Company were insufficient to meet this shortfall (See 1.11). Moreover as regards Mr A though by 31 March 1988 he had made advances of \$524,000 the figures given in his personal assessment would not justify an otherwise unsupported inference that he would be able to sustain even his own share (50%) of the shortfall. The personal returns of other shareholders were equally unconvincing. The inability to retain the Premises on a long-term basis must have been apparent to the shareholders at the time of acquisition.

4.5 Mr Yim drew our attention to evidence inconsistent with the explanation that Mr C's intention to emigrate had triggered the cessation of Y Company and consequently the sale of the Premises. This evidence comprised a copy of a Business Registration Application under the name of Z Company established in 1984 of which the Sole Proprietor was the same Mr C. Unlike Y Company there is no evidence of cessation of that business due to the alleged intention to emigrate. Again on the matter of Mr C being important to the

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continuation of Y Company's business (See 1.9.3), Mr Yim pointed out that according to Y Company's own tax returns Mr C did not take any salary out of Y Company: from this it can be inferred – in the absence of evidence to the contrary – that Mr C did not take an active role in Y Company's business.

### 5. Conclusions

Bearing in mind the submissions of Mr Yim and that the onus is upon the Taxpayer to convince us on the balance of probabilities that the assessment under appeal is excessive or incorrect (S68(4) of the Inland Revenue Ordinance) we now set out our findings

As no witnesses were called our findings necessarily depend upon our view of the agreed Statement of Facts. It is abundantly clear that at the time of purchase the income from the Premises would be substantially short of the monthly mortgage payments. Although the shareholders made advances to the Taxpayer there was no evidence to suggest that they could continue their financial support throughout the 5 year mortgage pay back period. On the contrary judged by the personal assessment returns of the Taxpayer's shareholders and the net profit of Y Company (the sole evidence before us on this aspect) there could have been no real belief in the expectation of holding the Premises as a long-term investment. Accordingly, we infer and so find that the Premises were bought with the intention of reselling at a profit when a favourable opportunity presented itself. Having reached that conclusion (and no suggestion of change of intention having been mooted) it is irrelevant whether it was the prospect of a very substantial profit or the alleged intention of Mr C to emigrate which led to the sale, or even a combination of those and perhaps other considerations. Accordingly we dismiss this appeal.