

**Case No. D17/14**

**Profits tax** – sale of landed property – rebuilding allowance and deduction of consulting fee and rental expenses – whether profits derived from sale of property capital in nature – whether granting of rebuilding allowance capital in nature – whether consulting fees and rental expenses deductible – sections 16, 17, 36 and 61 of the Inland Revenue Ordinance (Chapter 112) ('IRO').

Panel: Lo Pui Yin (chairman), Corinne Marie D'Almada Remedios and Fong Sui Yi Andrea.

Date of hearing: 17 February 2014.

Date of decision: 10 October 2014.

The Appellant was a private company with principal activity of 'investment in properties for rental purposes'. Mr C and Company D were the shareholders; Mr C and his wife were the directors. In 1997, the Appellant purchased a property ('Property') with existing tenancy at HK\$30.8 million, with completion taking place on 30 May 1997. The Appellant later sold the Property with the existing tenancy at HK\$39.5 million on 10 June 1997, and completion took place on 28 July 1997. The Appellant claimed rebuilding allowance from the sale; the Appellant further claimed deduction of consulting fee and rental expenses paid to Company G (a subsidiary of the Appellant), to which Mr C, his wife and Company D were shareholders.

The Commissioner (who concurred with the Assessor's decision) was of the view that the Property was of the Appellant's trading stock and no rebuilding allowance should be granted; the profits derived therefrom should be chargeable to tax. The Commissioner also increased the net assessable profits (and tax payable thereon), on the ground that the consulting fee and rental expenses should not be allowable for deduction in the relevant years of assessment ('Determination').

The Appellant appealed against the Determination, on the ground that rebuilding allowance should be granted and the assessable profits were excessive. According to the Appellant: (a) the Appellant's original intention was to hold the Property for long-term investment purpose. The Appellant resolved to sell the Property after receiving a generous offer and considering its merits; (b) Company G handled all management of its business, the consulting fee was therefore commercially realistic and deductible; (c) the property ('Property H') was acquired by Company G in 1994, which was used by the Appellant as Mr C's director quarters. The rental payable was determined based on open market rent.

**Held:**

Rebuilding allowance

1. The question of whether a property was trading stock or capital asset was a question of fact and degree to be answered upon a consideration of all the circumstances. The question was one of intention of the appellant at the time of the acquisition of the asset. The stated intention of the appellant could not be decisive. In particular: (a) if the intention was genuinely held, realistic and realizable, and if all the circumstances showed that at the time of the acquisition of the asset, the appellant was investing in it, then such an intention to invest was established; (b) a sale of an investment did not render its disposal a sale in the course of trade unless there had been a change of intention; (c) a single one-off transaction could be an adventure in the nature of trade; (d) matters related to determination included: the nature of the subject matter; the way in which the transaction was carried through; whether the appellant had frequently engaged in similar transactions; whether the item was purchased for personal use or pleasure or income; the source of finance of the transaction; the length of the period in which the item was held; whether the item was resold as it stood or after work had been done on it for the purpose of resale; whether the items was resold in one lot or in several broken down lots; the time, the money or effort expended in selling the item. No single matter was in any way decisive; (e) an asset could not be both trading stock and permanent investment at the same time, nor to possess an indeterminate status of neither trading stock nor permanent asset. (Lionel Simmons Properties Ltd (in liq) & Ors v Commissioner of Inland Revenue 53 TC 461, Marson (Inspector of Taxes) v Morton & Ors 59 TC 381, All Best Wishes Ltd v Commissioner of Inland Revenue 3 HKTC 750, Lee Yee Shing v Commissioner of Inland Revenue [2008] 3 HKLRD 51 and Real Estate Investments (NT) Ltd v Commissioner of Inland Revenue (2008) 11 HKCFAR 433 considered)
2. The Appellant had established that the Property was acquired, held as, and disposed of as capital asset, and the profits arising from the sale were excluded from the charge of profits tax: (a) the Appellant purchased the Property with a sitting tenant at a time when there was protection of the tenure; (b) the purchase of the Property was financed partly by funding from Company D (which in turn borrowed from its directors), partly by personal funding from Mr C, and partly by a 15-year mortgage from Bank E; (c) the terms of mortgage discouraged early repayments of the mortgage loan by imposing monetary charges; (d) the purchase was completed in May 1997 with the Appellant paying all the stamp duties and legal costs; (e) although the Appellant had signed the formal agreement for sale and purchase in February 1997, it had not put the Property in the market by appointing estate agents, publishing advertisements or using other means that would make it known

that the Property was on sale; (f) those in management of the Appellant, including Mr C, were clearly experienced in the buying and selling of properties in Hong Kong both as long term investment and as trading stock. These matters, considered cumulatively, provided objective support to the Appellant's self-declared intention that it acquired the Property as a long-term investment for renting out. Since capital expenditure was incurred by the Appellant in the purchase of the Property, rebuilding allowance should be granted.

3. Although it was true that the duration between completion of the Appellant's purchase and the Appellant's signing of the provisional agreement to sell was 11 days, a fairer description of the event ought to cover at least the duration between the signing of the formal agreement of sale and purchase and completion of the sale and purchase, namely the period of about 3 months between February 1997 and May 1997. The inclusion of that period as the part of the relevant time period also brought into perspective the inaction on the part of the Appellant in disposing of the Property during that time and the astonishingly upward buoyant property market circumstances during that time, namely the early to mid parts of 1997. It supported the Appellant's case that its intention of acquisition for long-term investment for rental purposes was maintained.

Consulting fee/rental expenses

4. Permitted deductions were confined to outgoings and expenses incurred in the production of profits in respect of which tax was chargeable. An expense incurred was at least a sum in respect of which there was an obligation to pay, i.e. an accrued liability which was un-discharged. A deductible expense must have been *bona fide* incurred in the production of profits. All surrounding circumstances must be considered, including the relation between the payer and the payee, the purpose or reason of the payment, and the basis and breakdown of the amount. (Lo & Lo v Commissioner of Inland Revenue 2 HKTC 34, D94/99, IRBRD, vol 14, 603 and So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416 considered)
5. The Board found that the Appellant had failed to show that the consulting fee and rental expenses were expenses *bona fide* incurred in the production of the Appellant's profits: (a) there was no evidence of any contract for the performance of consulting work giving rise to obligation to pay consulting fee; nor evidence of any tenancy agreement in respect of Property H; nor any invoice or receipt to evidence the rendering of consulting work and payment of consulting fee; nor rental receipt in respect of Property H; (b) the Appellant had not demonstrated that, on the assumption that the consulting fee and rental expenses were *bona fide* incurred, the Appellant had incurred them in the production of its chargeable profits.

6. The payment of consulting fee and rental expenses by the Appellant was artificial or fictitious transactions that would reduce the profits of the Appellant and the amount of tax payable, so that they should be regarded under section 61 of IRO. (Seramco Ltd Superannuation Fund Trustees v Income Tax Commissioner [1977] AC 287 and Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 733 considered)

**Appeal allowed in part.**

Cases referred to:

- Lionel Simmons Properties Ltd (in liq) & Ors v Commissioner of Inland Revenue  
53 TC 461  
Marson (Inspector of Taxes) v Morton & Ors 59 TC 381  
All Best Wishes Ltd v Commissioner of Inland Revenue 3 HKTC 750  
Lee Yee Shing v Commissioner of Inland Revenue [2008] 3 HKLRD 51  
Real Estate Investments (NT) Ltd v Commissioner of Inland Revenue (2008) 11  
HKCFAR 433  
Lo & Lo v Commissioner of Inland Revenue 2 HKTC 34  
D94/99, IRBRD, vol 14, 603  
So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416  
Seramco Ltd Superannuation Fund Trustees v Income Tax Commissioner [1977]  
AC 287  
Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 733

Director of the Appellant for the Appellant.  
Yip Chi Chuen for the Commissioner of Inland Revenue.

**Decision:**

**Introduction**

1. This was the appeal by the Taxpayer, Company A, against the Determination of the Deputy Commissioner of Inland Revenue dated 27 September 2013 to reject the Taxpayer's objection to the Profits Tax Assessment for the year of assessment 1998/99, dated 31 March 2005, and to revise the same assessment to increase the net assessable profits to HK\$6,334,972 with Tax Payable thereon of HK\$1,013,595.
2. The Taxpayer's objection, and its main ground of appeal in the appeal before this Board, concerns the question of whether the profits it derived from the sale of a property

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known as Property B, was capital in nature and not chargeable to tax. This appeal is also concerned with two other issues arising out of the revision of the Profits Tax Assessment for the year of assessment 1998/99, namely the granting of a rebuilding allowance claimed in the year of assessment 1997/98 as a consequence to Property B being capital in nature; and the deductibility of the items of consulting fee and rental expenses in the years of assessment 1997/98 and 1998/99.

3. The Taxpayer was represented by its director Mr C at the hearing of this Board of Review. Mr C confirmed at the hearing on behalf of the Taxpayer its agreement to Facts (1) to (12) under paragraph 1 of the Deputy Commissioner's Determination, as well as the first sentence to Fact (13)(a) and the whole of Fact (13)(b) under paragraph 1. This Board finds the above Facts as facts and will summarize these Facts in the next section of this Decision.

4. Although this Board invited Mr C to give evidence for the Taxpayer at the hearing, he declined to do so. On the other hand, Mr C confirmed with this Board that the Taxpayer would rely on the representations made by the Taxpayer's tax representative in response to the Assessor's enquiries, and in support of the Taxpayer's objection to the 1998/99 Profits Tax Assessment.

5. The Revenue, represented by Mr Yip, Senior Assessor of the Inland Revenue Department, did not call any witness to give oral evidence.

**The Facts**

6. The Taxpayer is a private company incorporated in Hong Kong. It was incorporated in January 1997. Its issued share capital (out of an authorized share capital of \$10,000) was \$2, held by Mr C and Company D respectively. Its directors were Mr C and his wife.

7. The Taxpayer was described in its Profits Tax returns to have as its principal activity 'investment in properties for rental purposes'.

8. The Taxpayer purchased Property B with an existing tenancy in 1997 at the consideration of HK\$30.8 million, with completion taking place on 30 May 1997. The Taxpayer sold Property B with the existing tenancy by a provisional sale and purchase agreement dated 10 June 1997 at a consideration of HK\$39.5 million, with completion taking place on 28 July 1997. Subsequent to the sale of Property B, the Taxpayer had become dormant.

9. (a) The Taxpayer's profit and loss accounts for the period from 10 January 1997 to 30 June 1997 showed a net loss of HK1,139,635 and recorded the following two items of expenses: Consulting fee (at HK\$300,000) and Rental expenses (at HK\$720,000).

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- (b) The Taxpayer's profit and loss account for the year ended 30 June 1998 showed a net loss of HK\$1,989,932 and recorded the following two items of expenses: Consulting fee (at HK\$50,000) and Rental expenses (at HK\$1.44 million). The gain derived from the sale of Property B of HK\$7,100,930 was recorded as an exceptional item.
10. (a) In the Taxpayer's 1997/98 Tax Returns, the Taxpayer declared adjusted losses of HK\$1,383,471, which was computed after taking account of a rebuilding allowance in respect of Property B in the sum of HK\$243,836.
- (b) In the Taxpayer's 1998/99 Tax Returns, the Taxpayer declared adjusted losses of HK\$2,136,323. The gain derived from the sale of Property B was not offered for assessment.
11. The Assessor of the Revenue, having issued to the Taxpayer loss computations for the years of assessment 1997/98 and 1998/99 in accordance with the Tax Returns, made enquiries of the Taxpayer. The Taxpayer's tax representative made a number of claims:
- (a) In relation to Property B, it was claimed that:
- (i) The Taxpayer's original intention was to hold the property for investment purposes. The purchase was partly financed by an instalment loan of HK\$18.48 million granted by Bank E. The loan was repayable by 180 monthly instalments. The balance of the purchase cost came from internal funds, including HK\$10 million from the holding company, Company D, which in turn borrowed from its directors; and HK\$3,350,120 advanced by Mr C, one of the directors, from his personal assets. Mr C had no problem providing the loan, as his investment income ran into millions annually. For the two years ended 31 March 1997, Mr C received dividends from Company F in the total amount of HK\$8.221 million. The loans from Company D and Mr C were without any fixed terms of repayment.
- (ii) The property was generating monthly rental income of HK\$90,000 and the tenancy agreement was due to expire on 30 November 1997. The Taxpayer estimated at the time that the monthly rental on a renewal of tenancy or new letting to be between HK\$156,700 and HK\$172,300 (i.e. \$50 and \$55 per square foot on 3,314 square feet). Any shortfall would be financed by Mr C, who was also the guarantor on the bank loan, through his substantial investment and other income. The fact that Bank E, a very reputable lender, was willing to lend the loan of

HK\$18.48 million to the Taxpayer with a repayment term over 15 years spoke for itself as the Taxpayer's repayment ability.

- (iii) In June 1997, the Taxpayer received an unsolicited offer from a real estate agent for the purchase of the property which was considered to be very generous and worth taking. The estate agent first contacted the Taxpayer by phone with an unsolicited verbal offer and then visited the Taxpayer to follow up. The Taxpayer resolved to sell the property after receiving this unsolicited offer and considering its merits. The Taxpayer did not offer the property for sale either by appointing an estate agent or any other form of advertisement. The Taxpayer had no idea how the purchasers, who had no relationship with the Taxpayer, were solicited. The selling price was determined by the offer submitted by the estate agent to the Taxpayer which was accepted.
  - (iv) The sale proceeds were used to repay the mortgage loan from Bank E and the loan from the Taxpayer's holding company, etc.
  - (v) The Taxpayer did not trade or purchase any property in replacement after the disposal of the property because the Asian financial turmoil of 1997 resulted in unreasonably high interest rate and volatility in the financial market, which made new investments extremely difficult.
  - (vi) The intention of the Taxpayer to purchase the property for long term investment purpose was supported by the fact that the property was purchased with an existing tenancy. The tenant's right of tenancy under residential leases was protected by law in Hong Kong. Tenants could stay for as long as they wish if they paid their rent. Since such properties were not very marketable, it would be foolhardy for the Taxpayer to purchase the property for anything other than long term investment purposes. Furthermore, there was a substantial penalty on the early repayment of the bank loan, which also acted as a deterrent to any quick sale.
- (b) In relation to the consulting fee, it was claimed that:
- (i) The recipient of the consulting fee was Company G, a private company that was incorporated on 12 October 1979. The shareholders of Company G at all relevant times were Mr C (2 shares at HK\$1 each); Mrs C (1 share at HK\$1 each); and Company D (1,997 shares at HK\$1 each), with the total number of issued shares being 2,000. The directors of Company G at all

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relevant times were Mr C and Mrs C. Company G was a fellow subsidiary of the Taxpayer.

- (ii) Company G handled the complete management of the Taxpayer's business on behalf of the Taxpayer. The Taxpayer required its operational and administrative functions to be performed. Such functions encompassed any work, action, deed or representation etc that Company G would do, perform, undertake or carry out on behalf of the Taxpayer. No formal agreement was prepared.
  - (iii) The payments of the consulting fee were effected by crediting Company G's inter-company accounts via the holding company.
  - (iv) No invoice was issued as this was a regular agreed monthly payment. No formal receipts were issued.
  - (v) The consulting fee was a lump sum monthly fee of HK\$50,000. It was never intended to be on a piecemeal basis. The directors of the Taxpayer believed that the consulting fees were commercially realistic and therefore deductible.
  - (vi) The individuals performing the services in Company G were their directors Mr C and Mrs C. They were also the directors of the Taxpayer.
  - (vii) Records of actual expenses incurred by Company G against each of the services rendered were not kept on such basis as all expenses were covered by the monthly fee and not reimbursable.
- (c) In relation to the rental expenses, it was claimed that:
- (i) The recipient of the rental expenses was Company G. The location of the property was a flat in Block 1 of Building H ('Property H'). Company G acquired Property H on 15 March 1994.
  - (ii) The Taxpayer used Property H as Mr C's director quarters. The provision of director quarters to Mr C was pursuant to a shareholders' resolution.
  - (iii) The period of letting of Property H was from 27 January 1997 to 30 June 1998 at HK\$120,000 per month. The monthly rental was determined by an estimate based on the open market rent of a like quality property similarly equipped and decorated. At the time in question in 1997, a nicely decorated flat on high floors in Block 1 of Building H was commanding a per square foot rental at the top



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end of the rental market at around HK\$55 per month. The size of the flat was 2,242 square feet and therefore the then market rental was determined to be HK\$120,000 per month. No written tenancy agreement existed.

- (iv) The rental payments were effected by crediting the inter-company current accounts through the holding company.
  - (v) The provision of director quarters had not been reported in the Employers Return of Remuneration and Pension previously submitted.
- (d) In relation to Company D, it was claimed that:
- (i) The Taxpayer was unable to supply copies of the balance sheets and accounts of Company D for the period from 1 July 1996 to 30 June 1998 as it did not have access to the financial statements of the holding company.
  - (ii) Company D had two other subsidiaries in Hong Kong with their registered offices at the same address in Hong Kong. One of them was Company J, which was a property investment company. The other was Company K, which was a dormant company.

12. The Assessor of the Revenue was of the view that Property B was of the Taxpayer's trading stock and, hence, no rebuilding allowance should be granted in respect of it and the profit derived from its sale should be chargeable to tax. Accordingly the Assessor issued to the Taxpayer the following revised loss computation for the year of assessment 1997/98 and Profits Tax Assessment for the year of assessment 1998/99:

(a) Year of assessment 1997/98

|                                  |                    |
|----------------------------------|--------------------|
|                                  | \$                 |
| Loss per return                  | (1,383,471)        |
| <u>Add: Rebuilding allowance</u> | <u>243,836</u>     |
| Adjusted loss carried forward    | <u>(1,139,635)</u> |

(b) Year of assessment 1998/99

|  |                  |
|--|------------------|
|  | \$               |
| Loss per return                        | (2,136,323)      |
| <u>Add: Gain on sale of Property B</u> | <u>7,100,930</u> |
| Assessable Profits                     | 4,964,607        |
| <u>Less: Loss set-off</u>              | <u>1,139,635</u> |
| Net Assessable Profits                 | <u>3,824,972</u> |
| <br>                                   |                  |
| Tax Payable thereon                    | <u>611,995</u>   |

13. The Taxpayer disagreed with the 1997/98 loss computation and objected to the 1998/98 Profits Tax Assessment on the grounds that the rebuilding allowance should be granted and that the assessable profits were excessive. The Taxpayer's representative put forward the following contentions:

**Year of assessment 1997/98**

- (a) Property B is an investment property and classified under Fixed Assets. At the same time, the property was receiving rent during the period. Rebuilding allowance should be allowed under section 36 of the Inland Revenue Ordinance.

**Year of assessment 1998/99**

- (b) Property B was purchased as long-term investment with an existing rental agreement. Through numerous previous correspondence with the Revenue, the Taxpayer has affirmed repeatedly that their original intention regarding the purchase of this property was to hold it for long-term rental income.
- (c) Up to the time the unsolicited purchase offer was received, the Taxpayer had no intention of selling this property. Their intention to hold this property for long term was clearly demonstrated by the following facts:
  - (i) They have arranged for long term financing for the property which involved the payment of a hefty early repayment penalty if the loan was repaid within a short period of time;
  - (ii) The subject property, with an existing tenant at the time, was not really a marketable commodity for sale when compared with a property with vacant possession because the tenant's right to renew the tenancy was protected by law. This would be a major deterrent to any potential purchaser who may consider acquiring the property for self use and these are the overwhelming majority of the potential purchasers in the market and
  - (iii) They had not taken any decision to sell this property nor had they taken any steps to market this property.
- (d) If the Taxpayer's intention was otherwise, they could reasonably be expected to have taken the following steps:
  - (i) They should have arranged for some financing arrangement with minimal repayment penalty on early repayment,

- (ii) They should have purchased a property with vacant possession which would have a much greater marketability and
- (iii) They should have taken active steps to market their property such as advertising and appointing sales agent etc to increase the property's exposure to the market in order to enhance the chance of selling the property quickly and obtaining a good selling price.

The Taxpayer did none of the above because they did not have any intention of selling their property at the time.

- (e) Between the time the Taxpayer purchased Property B and the time they received the unsolicited purchase offer in June 1997 the property market in Hong Kong had gone through a period of explosive and unusual activities and this explained why such a generous unsolicited offer was received. This unsolicited offer was the REASON that persuaded the Taxpayer to change their intention regarding this property because the offer was simply too generous to be passed over. As a result, the property was only held for a relatively short period of time but this was not intended.
- (f) Whether a business project is commercially viable would be best left to the judgments of the enterprise involved and its bankers. ... The Taxpayer's judgment was obviously agreed to by their lender, Bank E, one of the most respectable financial institutions in Hong Kong, as it was satisfied with the repayment ability and the staying power of the Taxpayer and was willing to lend to the Taxpayer more than HK\$18 million over a term of fifteen years. We believe this attested to the 'long term' viability of the project.

14. The Assessor of the Revenue had also ascertained that Company G had an accumulated tax loss of HK\$988,998 as at 31 March 1996. In its 1996/97, 1997/98 and 1998/99 Profits Tax return, Company G declared adjusted loss of HK\$241,518, assessable profits of HK\$89,396 (before loss set-off) and adjusted loss of HK\$1,164,721 respectively.

#### **The Deputy Commissioner's Determination**

15. The Deputy Commissioner rejected the Taxpayer's objection and decided to revise the Profits Tax Assessment for the year of assessment 1998/99 to increase to net assessable profits of HK\$6,334,972 and tax payable thereon of HK\$1,013,595, accepting the consideration of the Assessor that the consulting fee and rental expenses should not be allowable for deduction in the year of assessment of 1997/98 and the year of assessment of 1998/99.

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16. The Deputy Commissioner, in his determination dated 27 September 2013, disagreed with the Taxpayer's claim that Property B was purchased as a long-term investment for rental purpose and considered that Property B was the Taxpayer's trading asset. In this regard, the Deputy Commissioner was of the view that the 'extremely short period of ownership' the Taxpayer had of Property B was 'clearly inconsistent with the [Taxpayer's] claim that it purchased Property B as an investment. Quite the contrary, the quick sale clearly indicated that the [Taxpayer] purchased Property B for trading purpose'. The Deputy Commissioner also disagreed with the Taxpayer's contention that Property B, acquired with an existing tenancy, would not be marketable. The Deputy Commissioner further questioned that if the Taxpayer had intended to hold Property B for rental purpose, it would not have promptly accepted the offer from the estate agent. The Deputy Commissioner furthermore considered the substantial shortfall between the monthly instalment of the mortgage loan and the monthly rental income of the existing tenancy, which had to be met by the Taxpayer and noted that the Taxpayer had not provided any feasibility study or other documentary evidence to show that it had the financial ability to hold Property B on a long term basis. The Deputy Commissioner lastly did not find the argument based on the early repayment penalty clause of the loan agreement convincing; the willingness of the Taxpayer to pay the early repayment penalty of HK\$277,200 'showed the [Taxpayer's] readiness to sell Property B for a profit rather than holding it for rental income'.

17. The Deputy Commissioner, having determined that Property B was the Taxpayer's trading stock, proceeded to hold that it was not entitled to any rebuilding allowance since it had not incurred any capital expenditure in purchasing Property B.

18. The Deputy Commissioner did not accept the Taxpayer's claim of deductibility of the consulting fee and rental expenses allegedly paid to Company G. The Deputy Commissioner was in serious doubt as to whether the Taxpayer had actually incurred the alleged consulting fee and rental expenses. Also it was doubtful, in the light of the activities of the Taxpayer at the material time of receiving rental income, whether there was a commercial reason for it to pay substantial amounts of consulting fee or rental expenses for generating the rental income. There was no sufficient evidence produced to justify the payment of consulting fee to Company G for the services of the Taxpayer's own directors. Rather there was evidence that suggested that Mr C had resided in Property H before it was allegedly rented as Mr C's quarters by the Taxpayer from 27 January 1997. With reference to market rent assessed by the Commissioner of Rating and Valuation, it was questionable why the Taxpayer should pay rent grossly in excess of the market rent to Company G for the use of Property H as Mr C's residence.

19. The Deputy Commissioner also invoked section 61 of the Inland Revenue Ordinance (Chapter 112) to hold that the purported payments of the consulting fee and rental expenses to Company G were artificial or fictitious and should be disregarded.

### **The Submissions of the Parties**

20. Apart from adopting the representations made on behalf of the Taxpayer in correspondence with the Revenue, Mr C for the Taxpayer drew this Board's attention to the Notice of Appeal where the following points were made:

- (a) Property B was purchased by a provisional agreement dated 23 January 1997. The assignment was taken up on 30 May 1997. The property was held until late July 1997. It was misleading to say that the Taxpayer held the property for only 11 days.
- (b) The Taxpayer did not take any steps to market and sell Property B between 23 January 1997 and 30 May 1997. The Taxpayer negotiated and took out a 15 year mortgage loan from Bank E (which included a hefty early repayment penalty for the first few years), paid all the stamp duties, legal costs and took up assignment of the property. The Taxpayer did all those exactly because it had the intention to acquire the property for investment and rental purposes throughout that period and not as trading stock. A different property, one with vacant possession, would have been chosen had the Taxpayer had the intention to purchase a property as trading stock at the time of acquisition.
- (c) The unsolicited offer from a real estate agent in the first week of June 1997 was so good and generous and the fact that it would have taken the Taxpayer a great number of years to achieve the same result if it decided to turn down the offer finally persuaded it to change its mind and decided to accept the offer.
- (d) The Revenue has no reason or ground to doubt the Taxpayer's long term financial ability to hold its investment property.
- (e) The Taxpayer disagrees with the Revenue's view that no change of intention should be made regardless of any change in circumstances.
- (f) The deductions of consulting fee and rental expenses were shown as expenses in the Taxpayer's financial statements in the relevant years and reported in the tax returns for those years. Company G had also reported the same as income in its financial statements and tax returns for the relevant years. The Revenue has had all the record and information for over 10 years and issued the Profits Tax Assessments for the years of assessment of 1997/98 and 1998/99 to the Taxpayer in March 2005 based on and accepted these deductions. The Revenue should not have waited more than 8 years to bring up the issue of these deductions.

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21. Mr C reiterated in his oral submissions the following points:
- (a) The Revenue has been very unreasonable and disregarded all the objective evidence. The Taxpayer's case should be judged on its individual merits. Otherwise, there is no need to specify that the intention was crucial, rather than what happened subsequently.
  - (b) Property B came with a sitting tenant at a time when Hong Kong still had rent control.
  - (c) The Taxpayer was unaware in January 1997 how much the property market could change in the next six months. It was surprised by the offer in June 1997, which was so high and so unexpected. But it had to look at the changed situation and the offer on the table, and decided at the time that it would not be commercially correct to turn down the offer. The intention of the Taxpayer changed and the property was sold. The circumstances changed and the Taxpayer changed with the circumstances.
22. Mr C also clarified in relation to the rental expenses. He stated that Property H was very recently renovated at the time and fully furnished. The rental was all inclusive of car park, management fees and rates. The Property H came with one car parking space. Towards the second part of 1997, Company G acquired another car parking space at Building H.
23. Mr Yip for the Revenue relied on his written submission of 26 pages prepared before the hearing of this Appeal. He also underlined the following points in respect of the purchase of Property B:
- (a) The taking out of a mortgage loan, the payment of stamp duties and the taking up of assignment of Property B were just incidental to the acquisition of a property; they were just neutral factors.
  - (b) Acquiring a property with an existing tenancy was not conclusive of an intention to hold the property as a long term investment for rental purpose. The tenancy in the case of Property B would expire by the end of November 1997.
  - (c) The property was not for the own use of the Taxpayer. It made no difference to the Taxpayer so long as there was a tenancy there.
  - (d) Whether a property with a sitting tenancy was saleable or not was not conclusive. It was a rather neutral point.

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- (e) The Taxpayer's action of selling the property quickly refuted its claim that it purchased the property for long term rental purpose. There were only 11 days between the completion of the purchase of the property and the contract to sell.
- (f) The Taxpayer's declared intention to hold the property for long term was not realistic. The property was partly financed by loans from the shareholders and partly by a bank loan, repayable by monthly instalments of HK\$192,000. The rental income under the then existing tenancy was just HK\$90,000. The Taxpayer had to make up the shortfall of over HK\$100,000 each month. Although the Taxpayer asserted that Mr C would support the shortfall in the long run, it was hollow to speak of financial ability without considering liabilities and other commitments at the same time. There was insufficient evidence to show Mr C had the ability to commit to the financial shortfall in the long run.
- (g) Reference was made to the Rating and Valuation Department's overview of the Hong Kong property market, and also review of large units of the private domestic sector. The upward trend of the price index from the last quarter of 1996 to the first quarter of 1997 was far greater than the rental index. It was stated that the residential market continued its upward trend at the beginning of 1997. Prices rocketed some 30 per cent during the first half of the year. Although the rental market followed the sales market, the movements were more moderate. Although by the end of the year prices were falling faster than rents, the yields were at about 3.8 per cent at the end of the year. Bearing in mind of the above trends of the property market during late 1996 and late 1997, which was around the time that the Taxpayer purchased the property, it was more likely that it purchased the property for trading rather than for long term rental purposes.

24. Mr Yip accepted that it may be relevant to look at how a subsidiary company with the Taxpayer had been holding property. Company D, the holding company, had a number of subsidiaries apart from the Taxpayer. Company G held two or three properties. Another company, called Company J, was a property investment company. Yet another company, called Company K, bought a property, treated it as trading stock, and reported the gain in the tax return. Mr Yip noted all these matters and made the submission that one should focus on what the Taxpayer did. There was no direct relationship between the way a taxpayer bought one property for rental purpose and bought another property for trading purpose.

25. Mr Yip, when concluding his submissions on the purchase of Property B, emphasized that the Taxpayer had merely asserted a self-declared and therefore subjective intention. The intention that the Taxpayer must establish by evidence was an objective one.

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All the surrounding circumstances must be looked at to determine the Taxpayer's intention. The Taxpayer was not to benefit from the scarcity of evidence.

26. Regarding the deduction of rebuilding allowance, Mr Yip referred this Board to section 36 of the Inland Revenue Ordinance which applies to 'commercial building or structure' as defined in section 40 of the Ordinance. He emphasized the point that the Taxpayer must show that there was a relevant interest in relation to the capital expenditure incurred on the commercial building. If the building or the property involved was not a capital asset, but a trading stock, then the rebuilding allowance should be denied.

27. Regarding the deductibility of the consulting fee and rental expense, Mr Yip submitted that section 16 of the Inland Revenue Ordinance focused on the expenses themselves, whether they had been incurred and whether they were incurred in the production of the profits. 'Incurred' means there is a definite commitment and accrued liability which is undischarged. Whether or not the recipient of the sums had declared the sums chargeable to tax or not was irrelevant. Mr Yip pointed to the replies of the Taxpayer's representative to the enquiries of the Revenue, indicating that no formal agreement was prepared in respect of the consulting fees and no tenancy agreement was in existence in respect of Property H. There was also no invoice and receipt in respect of the consulting fees and no rental receipt in respect of the payment of the rental expenses. The reply only stated that payments of the consulting fee and the rent were effected by crediting inter-company current accounts but it was not known whether routine monthly payments and indeed any payments were made. Thus Mr Yip submitted that the Taxpayer had not proved that it had a definite commitment to pay consulting fee or rent to Company G.

28. Mr Yip also submitted that the Taxpayer had not discharged its burden to show that the consulting fee and rental expense were incurred in the production of the profits. It was unreasonable and commercially unrealistic for a company to incur a great amount of expenses to derive the small amount of rental income. Given the rental income was from a sitting tenant, it could not be shown how the work of Company G was required to derive the rental income. The transactions involving the Taxpayer during the time when consulting fees were charged all involved the Taxpayer and/or its directors as directors of the Taxpayer; there was no mention of Company G. There was a lack of commercial reality for the Taxpayer to pay consulting fee to a related party when its own directors were performing services for it.

29. Mr Yip further referred to two pieces of documentary evidence. He first noted that Company G acquired Property H in March 1994. A telephone bill suggested that Mr C was residing in Property H in late 1996 to early 1997, well before the Taxpayer paid any rent to Company G. Thus Mr Yip submitted that there was no commercial reason for the Taxpayer to pay rent for the quarters that Mr C was already residing in, except for shifting part of the trading profits of the Taxpayer to a related company. There was also no commercial reason to continue to pay rent to the related company after the Taxpayer became dormant following the sale of Property B.



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30. Regarding the amount of the consulting fee and the rental expenses, Mr Yip submitted no rational basis had been given to their determination. There was no explanation as to the determination of the consulting fee as a monthly lump sum of HK\$50,000. The monthly rent paid in respect of Property H of HK\$120,000 was in excess of the market rent of HK\$77,000 that the Rating and Valuation Department had assessed. While the assessment was exclusive of management charges, rates and car parking space, the Taxpayer had not furnished information of those items. On the other hand, the profit and loss account of the Taxpayer included items of rates and staff quarters expenses without any breakdown, note or explanation.

31. Mr Yip lastly submitted that the charging of the consulting fee and the rental expenses constituted an artificial or fictitious transaction that would reduce the Taxpayer's profits within the meaning of section 61 of the Inland Revenue Ordinance. These two items should therefore be disregarded.

32. In reply, Mr C stressed that everything the Taxpayer had provided with the Revenue should have demonstrated that its intention was to hold Property B as an investment property and the Revenue ought not to have regarded the matters as neutral. He also asked this Board to compare the approach taken by the Taxpayer and that by Company K. He highlighted the facts that in relation to the property purchased by Company K, there was no arrangement for financing, the property was marketed immediately and it was sold before assignment since this would save a lot of money and there was no intention of taking up the assignment. The sale of the property by Company K was regarded as trading and reported to the Revenue as such, leading to an assessment for tax and payment of tax. The Taxpayer's purchase of Property B was completely different. He further considered that it was erroneous to refer to the Rating and Valuation Department's overview of the property market in support of the submission that the intention at the beginning must be to trade the property for profit because the luxury property market went up by 30 per cent in the first quarter of 1997. The Taxpayer had no control of the property market and things would not happen in such a way. In the business world, one had to look at all the factors and information available at the time to make decisions. Intention may change in the light of the circumstances. The Taxpayer did not have the luxury of the Revenue of looking back.

33. Mr C submitted that the consulting fee and rental expenses were reasonable expenses. Directors' quarters had to be provided by one or other of the group's companies. How this was decided was an internal matter. As to the level of the rental expenses, the Revenue had accepted that the Rating and Valuation Department's valuation had not taken account of furnishing, car parking, etc., but the Revenue had not asked for further information about those items. He also criticized the highhandedness of the Revenue in raising the issue of consulting fee years after the information was submitted.

### Discussion and Findings

34. This appeal is concerned principally with the intention of the Taxpayer in the purchase of Property B. If the intention of the Taxpayer in the purchase of Property B was to invest in a capital asset, then the Taxpayer is not liable to be taxed on the profits from the sale of Property B and also entitled to the rebuilding allowance. If the intention of the Taxpayer in the purchase of Property B was to acquire a property for the purpose of trade, then the Taxpayer is liable to be taxed on the profits from the sale of Property B and also not entitled to the rebuilding allowance.

35. The other aspect of this appeal is the deductibility of the items of consulting fee and of rental expense as an expense of the Taxpayer under section 16 of the Inland Revenue Ordinance. Also, the Revenue has sought to invoke section 61 of the Ordinance to ask this Board to disregard the transactions of the payment of consulting fee and of rental expense on the ground that they were fictitious or artificial transactions.

36. Although this Board has not heard oral evidence from Mr C or anyone else of the Taxpayer, it is clear from the representations made by the Taxpayer's tax representative (which Mr C adopted and relied on in support of the Taxpayer's case before this Board) that the Taxpayer claims that its intention in the purchase of Property B in January 1997 was to invest in a capital asset and that it was the changes in the circumstances of the property market that followed, including the unsolicited and very generous offer to purchase received in June 1997, that had led to the decision to sell Property B.

37. The case law on the determination of whether an asset is a trading or capital asset is well known. This Board has been referred to the following cases, namely, Lionel Simmons Properties Ltd (in liq) & Ors v Commissioner of Inland Revenue 53 TC 461, Eng CA and HL; Marson (Inspector of Taxes) v Morton & Ors 59 TC 381, Ch D; All Best Wishes Ltd v Commissioner of Inland Revenue 3 HKTC 750, HC; Lee Yee Shing v Commissioner of Inland Revenue [2008] 3 HKLRD 51, CFA; and Real Estate Investments (NT) Ltd v Commissioner of Inland Revenue (2008) 11 HKCFAR 433, CFA. It is not necessary for the purpose of determining this appeal to set out at length the relevant portions of the judgments in these cases. Highlighting the following points will suffice:

- (a) The question of whether property is trading stock or a capital asset is always to be answered upon a holistic consideration of the circumstances of each particular case. It is a question of fact and degree to be answered by the fact-finding body upon a consideration of all the circumstances.
- (b) The question is one of the intention of the Taxpayer at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit or was it acquired as a permanent investment?
- (c) The stated intention of the Taxpayer cannot be decisive and the actual intention can only be determined upon the whole of the evidence.

Intention can only be judged by considering the whole of the surrounding circumstances including things said and things done. Things said at the time, before and after, and things done at the time, before and after. If the intention is on the evidence, genuinely held, realistic and realizable, and if all the circumstances show that at the time of the acquisition of the asset, the Taxpayer was investing in it, then such an intention to invest is established.

- (d) A sale of an investment does not render its disposal a sale in the course of trade unless there has been a change of intention.
- (e) A single, one-off transaction can be an adventure in the nature of trade.
- (f) Matters of enquiry related to the determination of the question include the nature of the subject matter, the way in which the transaction was carried through, whether the Taxpayer has frequently engaged in similar transactions, whether the item was purchased for personal use or pleasure or income, the source of finance of the transaction, the length of the period in which the item was held, whether the item was resold as it stood or after work had been done on it or relating to it for the purposes of resale, and whether the item was resold in one lot or in several broken down lots, the time, money or effort expended in selling the item. No single matter is in any way decisive and it is always necessary to look at the whole picture.
- (g) An asset cannot be both trading stock and permanent investment at the same time, nor to possess an indeterminate status of neither trading stock nor permanent asset.

38. This Board, having examined the evidence before it according to the approach set out in the preceding paragraph, finds that the Taxpayer has discharged its burden of proof to establish that its intention in purchasing Property B was to hold it as an investment; that there was no change in that intention; and that the sale of Property B was a disposal of an investment the profits arising out of which were not liable to taxation.

39. The examination of the evidence by this Board requires it to have regard to the whole picture presented by all the circumstances of the purchase of Property B by the Taxpayer and its subsequent sale by the Taxpayer. The Taxpayer purchased a property with a sitting tenant at a time when there was protection of the tenure of tenancy subject to the payment of market rent. The purchase of the property was financed partly by funding from Company D (which in turn borrowed from its directors), partly by personal funding from Mr C, and partly by a 15 year mortgage from Bank E. The terms of the mortgage discouraged early repayments of the mortgage loan by imposing monetary charges. The purchase was completed in May 1997 with the Taxpayer paying all the stamp duties and legal costs. Although the Taxpayer had signed the formal agreement for sale and purchase

on 5 February 1997, it had not put the property in the market by appointing estate agents, publishing advertisements or using other means that would make it known that the property was on sale. Those in the management of the Taxpayer, including Mr C, were clearly experienced in the buying and selling of properties in Hong Kong both as long term investment and as trading stock. This is illustrated by the portfolio of properties held by Company D and its subsidiary companies, including the Taxpayer and Company K, and the different approach taken by those in control of Company K to actively market the purchased property before the taking of the assignment, resulting in a confirmor sale, and to book the gain as a trading profit subject to taxation. These matters, considered together and cumulatively, do provide objective support to the self-declared intention on the part of the Taxpayer that it acquired Property B as a long term investment for renting out.

40. The Revenue submits that the Taxpayer's intention was neither realistic nor feasible by reference to its HK\$2 paid up capital, the monthly instalment of HK\$192,972.80 payable under the 15 year mortgage, and the rental income of HK\$90,000 of the existing tenancy. The Revenue considers that the Taxpayer has not provided sufficient evidence to show that it or its directors were well capable of meeting the shortfall between the monthly instalment repayment and the monthly rental income, which may range from HK\$20,000 to HK\$90,000 depending on the true valuation of the rental of Property B. This Board notes on the other hand not only the representations of the Taxpayer's tax representative that Mr C was the personal guarantor of the mortgage loan, that the shareholder's and director's advances to the Taxpayer in the total amount of HK\$4.3 million had no fixed terms of repayment, and that Mr C had substantial annual income from his investments in the order of millions, but also the fact that the existing tenant was an established telecommunications corporation that was likely to afford to pay market rental for the continued or renewed tenancy. This Board considers that there is a good and sufficient evidential basis to sustain the Taxpayer's case that the shortfall between the monthly instalment repayment and the monthly rental income could and would be met by funding from its shareholders and directors, even though in this Board's opinion, the shortfall was likely to be closer to the HK\$90,000 end of the range.

41. The Revenue also submits that the sale of Property B was a quick sale which speaks for itself in refuting the Taxpayer's claim of its intention of acquiring the property for long term investment as a rented property. Since the Taxpayer was ready to sell following the receipt of an unsolicited, albeit very generous, offer, it could not therefore be demonstrated that it had the intention to hold the property for rental purposes. If the Taxpayer's intention were to hold the property for rental purposes, it would not have considered and accepted that offer. This Board considers that, although it is true that the duration between completion of the Taxpayer's purchase and the Taxpayer's signing of the provisional agreement to sell was 11 days, a fairer description of the event ought to cover at least the duration between the signing of the formal agreement of sale and purchase and completion of the sale and purchase, namely the period of about 3 months between February 1997 and May 1997. The inclusion of this period as the part of the relevant time period also brings into perspective the inaction on the part of the Taxpayer in disposing of its property during that time and the astonishingly upward buoyant property market circumstances

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during that time, namely the early to mid parts of 1997. It supports the Taxpayer's case that its intention of acquisition for long term investment for rental purposes was maintained.

42. The unsolicited and very generous offer, which was eventually accepted, was in the amount of HK\$39,500,000. The gain from the sale, after deducting the purchase cost, agency commission on purchase, legal fee on purchase, stamp duty, finance charge on early loan termination, legal expenses on sale and the agency commission on sale, was HK\$7,100,930. This was equivalent to 6.5 years of the rental income at the level of HK\$90,000, or nearly 5 years of rental income at the level of HK\$120,000, or nearly 4 years of rental income at the level of HK\$150,000. The amount of gain illustrates the generosity of the offer. The early return of such an amount of gain also lends support to the decision to sell. The Taxpayer's case that Property B was acquired as a long term investment for rental purposes has not been undermined by these matters. This Board is of the view that the sale was consistent with the disposal of an investment.

43. Accordingly, for the reasons stated above, this Board concludes that Property B was acquired, held as, and eventually disposed of as a capital asset and that the profits arising from the sale of Property B were excluded from the charge of profits tax.

44. Consequently, rebuilding allowance should be granted in respect of Property B, since capital expenditure was incurred by the Taxpayer in the purchase of this property.

45. This Board turns to the last topic of the deductibility of the consulting fee and rental expenses.

46. Sections 16 and 17 of the Inland Revenue Ordinance govern the deductibility of expenses for the determination of profits tax. Permitted deductions are confined to the outgoings and expenses incurred in the production of profits in respect of which tax is chargeable. An expense incurred is at least a sum in respect of which there is an obligation to pay, that is, an accrued liability which is undischarged. A deductible expense must have been bona fide incurred in the production of profits. All surrounding circumstances must be considered, including the relation between the payer and the payee, the purpose or reason of the payment, and the basis and the breakdown of the amount; see Lo & Lo v Commissioner of Inland Revenue 2 HKTC 34, PC; D94/99, IRBRD, vol 14, 603; and So Kai Tong v Commissioner of Inland Revenue [2004] 2 HKLRD 416, CFI.

47. This Board, having examined the evidence before it, finds that the Taxpayer has failed to discharge its burden of proof to show that the consulting fee and rental expenses were expenses bona fide incurred in the production of profits of the Taxpayer. The Revenue does have strong grounds in questioning whether these two claimed items of expense were *bona fide* incurred and in questioning whether they were incurred in the production of profits of the Taxpayer.

48. This Board agrees with the Revenue's submission that there was no evidence before this Board of any contract between the Taxpayer and Company G in respect of the

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performance of consulting work, which would give rise to the obligation to pay the consulting fee; and that there was no evidence before this Board of any tenancy agreement between the Taxpayer and Company G in respect of Property H. There was no invoice and no receipt to evidence the rendering of consulting work and payment of consulting fee. There was no rent receipt in respect of Property H.

49. This Board also agrees with the Revenue's submission that the Taxpayer has not demonstrated on the evidence before this Board that on the assumption that the consulting fee and rental expenses were expenses *bona fide* incurred, the Taxpayer had incurred them in the production of its chargeable profits. There was no evidence of Company G performing administrative and operational functions on behalf of the Taxpayer in respect of the Taxpayer's business, which appeared to be completing the purchase of Property B, the receipt of rental from the tenant, and the disposal of Property B by sale. All these business activities of the Taxpayer were performed by Mr C in his capacity of a director of the Taxpayer. Also, there was a lack of commercial reality for the Taxpayer to pay consulting fees for 7 months and rental expenses for 18 months to Company G for services of its own directors. Further, the amounts of consulting fee and rental expense said to have been paid by intercompany current accounts bear little rational correlation with the work that could possibly be involved and the likely rental of Property H. Even if the factors of full furnishing, the availability of car parking space, and the inclusion of management fees had been included into likely rental of Property H, the monthly rent of HK\$120,000 claimed by the Taxpayer may still be excessive by a margin exceeding HK\$20,000.

50. This Board considers that the items of consulting fee and rental expense were likely to have been payments that the Taxpayer gave away to a related party. As Mr C had said, he regarded the provision of directors' quarters an internal matter within the group of companies; it was simply a facility that one or other of the group's companies had to provide. This may well be justified as a matter of internal management of a group of companies, so long as the relevant credits and debits had been recognized in the audited accounts. However, the question that this Board needs to determine and the Taxpayer needs to meet is that of deductibility in accordance with the provisions of sections 16 and 17 of the Inland Revenue Ordinance. The Taxpayer has failed to persuade this Board in this regard.

51. Last, but not least, this Board accepts the submission of the Revenue that the transactions of the payment of the consulting fee and rental expense by the Taxpayer to Company G were artificial or fictitious transactions that would reduce the profits of the Taxpayer and the amount of tax payable, so that they should be disregarded pursuant to section 61 of the Inland Revenue Ordinance; see Seramco Ltd Superannuation Fund Trustees v Income Tax Commissioner [1977] AC 287, PC; and Cheung Wah Keung v Commissioner of Inland Revenue [2002] 3 HKLRD 773, CA. The absence of any legally binding agreement, payment record, invoices and receipts and any rational basis for the items themselves and the amounts said to have been charged, taken together, show that the transactions were fictitious. They were also artificial in the sense that they were unrealistic from a business point of view. The Revenue's suggestion that they were simply appropriations of the Taxpayer's profits may well be true.

**Conclusion**

52. The Taxpayer's appeal is allowed in part. The loss computation for the year of assessment 1997/98 should be revised to allow the deduction of the rebuilding allowance, so that the adjusted loss carried forward becomes HK\$363,471. The Profits Tax Assessment for the year of assessment 1998/99 should be revised to exclude the gain on the sale of Property B, so that the computation becomes as follows:

| <u>Year of assessment 1998/99</u> | \$                 |
|-----------------------------------|--------------------|
| Loss per return                   | (2,136,323)        |
| <u>Add:</u> Consulting fee        | 50,000             |
| Rental expenses                   | <u>1,440,000</u>   |
| Adjusted loss                     | (646,323)          |
| <u>Less:</u> Loss brought forward | <u>(363,471)</u>   |
| Adjusted loss carried forward     | <u>(1,009,794)</u> |

Accordingly, this Board annuls the Profits Tax Assessment for the year of assessment 1998/99 under Charge Number X-XXXXXXX-XX-X, dated 31 March 2005, that the Deputy Commissioner of Inland Revenue, by his Determination dated 27 September 2013, had increased the net assessable profits to HK\$6,334,972 with Tax Payable thereon of HK\$1,013,595.