

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D10/88

Profits tax – sale of flat – anticipated loss of harbour view – whether profits were trading gains or realization of capital – s 14 of the Inland Revenue Ordinance.

Panel: Howard F G Hobson (chairman), Raymond J Faulkner and Hwang King-hung.

Dates of hearing: 16 and 17 March 1988.

Date of decision: 19 May 1988.

The taxpayer company bought a flat ‘off the plan’ in 1980. Having heard that another block was to be built in front of the site, thereby blocking harbour views and reducing the value of the flat, the taxpayer sold it while still uncompleted.

The original intention had been to hold the property as a long-term investment. The purchase had been financed by shareholders’ loans. The shareholders owned other property investment companies. The proceeds from sale were reinvested in another flat and some shares, which were still held by the taxpayer.

The taxpayer was assessed to profits tax on the gains from the resale of the flat. He appealed against the assessment.

Held:

The gains were of a capital nature.

Appeal allowed.

D J Gaskin for the Commissioner of Inland Revenue.

Baldwin K L Wong of W S Wong & Co for the taxpayer.

Decision:

This appeal is concerned with whether or not a profit on the sale of a Hong Kong property by the taxpayer company (‘the company’) during the basis period for the year of assessment 1981/82 is chargeable to profits tax. Central to that question is the company’s original intention at the time of acquisition.

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### Background

The following facts were either agreed or adduced in evidence and accepted by us as primary facts:

1. The company was incorporated as a private company in June 1975. In 1980 it bought a flat ('the Property') from X Company, the latter acting, effectively, as a confirmor. At that time the flat did not exist because the block of which it was to form a part was simply a site, rendered vacant on the demolition of the former building.
2. The purchase price payable to the developer by X Company was payable by instalments. On top of that, the company agreed to pay a large premium to X Company. On signing the agreement the company placed \$1,000,000 in escrow pending a formal transfer of X Company's rights to the company. The company, having only two dollars of paid-up capital, borrowed the necessary funds from its two beneficial equal Singaporean shareholders, Mr A (actually the money was borrowed from Mr A's wife) and Mr B. Their beneficial holdings were derived through two nominee companies. However, Mr A and Mr B were directors of the company.
3. In May 1981, the company resold the Property, still in its uncompleted state, paying commissions to Y Company (\$45,519) and Mr C (\$10,000).

Notwithstanding certain documents and information presented to the Commissioner, he upheld (with a variation allowing certain expenses) the assessment of the aforementioned profits to tax because he did not accept the explanations given to him by the company's tax representative.

### The company's submissions

The company bought the Property with the intention of renting it out as a long term investment. However, a few months after entering into the Agreement for Purchase with X Company, Mr A learnt of the probability of a block being built in front of the Property which would obstruct the harbour view which the Property would otherwise have. This knowledge and the expectation that its rental value would be substantially reduced induced the company to sell the Property. The proceeds of sale were then invested mostly in an apartment (the 'Apartment') then under construction but also in shares in the Hong Kong stock market. Both these substitute assets were bought as long term investments in 1981 and both are still held by the company, the Apartment having been let out since its completion.

### Evidence

Mr A appeared and his evidence in general supported the foregoing submissions. The following are relevant specific parts of his testimony:

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1. After working for many years with a bank in Singapore, he became a director and shareholder of G Company, a tug and barge company, and in 1976 formed H Company, a holding company, for his own investments in Singaporean and Malaysian properties. That company holds both residential and commercial properties, is not used for trading and rents the properties out and none of them have been disposed of since their respective purchases. The only other property (the company's Hong Kong interests excluded) in which he has held an interest is his own residence in Singapore (now in his wife's name) which has been held for 10 years. Mr B is a childhood friend and was a shareholder and director of G Company until about 1977 when Mr A and others bought him out whereupon Mr B formed his own company which acquired properties and operates in the same fashion as H Company.
2. Mr A and Mr B decided to invest about US\$1,000,000 in Hong Kong where Mr B was then living and which Mr A visited regularly because he had an interest in J Company (a company operating in Hong Kong).
3. Mr A's philosophy is to buy properties which show a rental yield approximating the rate of interest to be obtained from bank deposits. The Property was suggested to him in 1979 by a friend, Mr D, an estate agent. He went to the site and noticed that even at that level there was an unobstructed harbour view. Mr B and friends who know Hong Kong estate agents gave him their views as to the potential rental (\$348,000 per annum) when the building was completed and J Company gave him information on the going rates for deposits. Beyond that no feasibility study was undertaken. On 7 September 1980, at a meeting in Singapore, Mr A and Mr B resolved to buy the Property 'for rental purposes'. By a letter dated 7 January 1980, Mr D sent Mr A the developer's sale brochure (including artist's impression, floor plans etc): we are unsure whether this is a type for 1981 or whether indeed the Property had been suggested as early as January 1980 because it is unclear from Mr A's evidence precisely when the Property was recommended to Mr A.
4. Mr A also said that all the properties H Company had bought in Singapore and Malaysia were in the course of construction at the time of purchase. He did not wish to buy after occupation because he would be paying a premium or alternatively there would be something wrong with the property to cause the owner to sell.
5. On learning from Mr C that a new building would be put up in front of the Property and the harbour view obstructed, he and Mr B decided to sell because they were told that the lack of a view could reduce the rental potential by 30%. They looked for an alternative property. The proceeds of sale were used to buy the Apartment referred to above and the balance was invested in quoted shares in Hong Kong. Both lots of purchase are still held by the company.
6. Mr A was cross-examined but nothing adverse to his earlier testimony was elicited. It was put to Mr A that L Company was owned or associated with X Company; it is unclear to us however whether Mr A was aware of that fact at that time or at all or

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even whether it was correct. Although it is clear from the documentation that X Company made a profit as confirmor, we do not know whether L Company received brokerage. Beyond that we have no idea what was implied by this line of questioning.

7. On the Apartment being completed it was let (on the recommendation of the sister of Mr B, who looks after lettings on behalf of the company). Mr A believed there have been about four separate lettings to date.
8. Mr A acknowledged that the company had passed a large sum of money to M Investment Company to 'invest' in the Hong Kong stock market and that, as M Company had traded the portfolio, the company had been assessed to profits tax on profits made. However, Mr A said that money had nothing to do with the proceeds from the sale of the Property.
9. Mr C testified that at the material time he was employed as an accountant by J Company and that he had known Mr A for many years. Mr C has never had any personal interest in the company but, as it did not have an active office, his colleague, Mr E of J Company, helped out and consequently Mr C got to know of the company's purchase of the Property. J Company's office was next door to Mr D's office and Mr C learned from them that a 29 storey block would be built in front of the Property. Within a couple of days of learning of this, Mr C phoned Mr A in Singapore. Mr A asked if it would affect the rental value and Mr C said that it would. However he could not remember whether he mentioned a percentage though he thought it likely that he would have discussed that aspect with the estate agents and have passed it on to Mr A.
10. Mr A then asked him to find out if it was possible to sell the Property. So Mr C approached Mr D to see if they could find a buyer which they eventually did. Although Mr C had no normal business relationship with Mr A, he confirmed he received \$10,000 for his part in the sale of the Property – Mr A and Mr B having resolved at a meeting in Singapore on 5 March 1981 to authorize Mr C to negotiate a sale.
11. He said that he thought Mr E was the person who provided Mr A with original rental estimates for the Property.

### Conclusion

We found Mr A and Mr C to be credible witnesses and straight forward and accept their evidence, which in several instances is backed up by documentation, without qualification. We therefore find as a matter of fact that the Property was indeed bought with the intention of holding it as a long term investment.

This appeal is therefore allowed.