INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D10/99

Profits Tax – whether gain on disposal of properties was of capital or trade in nature.

Panel: Kenneth Kwok Hing Wai SC (chairman), Charles Hui Chun Ping and Kenneth Ku Shu Kay.

Date of hearing: 2 April 1998.
Date of decision: 13 May 1999.

The taxpayer company purchased the 2 subject properties on 12 February 1992. The subject properties were resold on 13 March 1992. In reply to the assessor's enquiries, the taxpayer stated that the taxpayer and a named person acquired the subject properties with the intention of carrying on a plastics products manufacturing business. When they found out after the agreements for sale and purchase that the subject properties were not allowed to be used as a plastics factory, they disposed of the subject properties and made a gain.

The assessor was of the view that the gain on disposal of the subject properties should be subject to subject to profits tax and the taxpayer appealed.

Held:

The Board found that it is inherently improbable that the taxpayer had not been advised by its lawyers that the deed of mutual covenant of the subject properties prohibited user as a plastics manufacturing factory. Besides, the taxpayer had been dealt with properties in the same industrial building before and its directors had been working there for about 10 months before purchasing the subject properties. The taxpayer thus failed to discharge the onus of proving that the subject properties were acquired as capital assets.

Obiter

The taxpayer also claimed for industrial building allowance in respect of another unit. The Board found the taxpayer failed to discharge the onus of proof. Furthermore, the taxpayer's case was that this unit was used as an office. User as office is not a qualifying user under section 40(1) of the IRO.

Appeal dismissed.

Chan Wong Yee Hing for the Commissioner of Inland Revenue.
Taxpayer represented by its director.

Decision:

1. This is an appeal against the determination dated 7 November 1997 by the Commissioner of Inland Revenue, rejecting the Taxpayer's objection against the profits tax assessment for the year of assessment 1992/93 dated 17 November 1994 showing assessable profits of $767,962 with tax payable thereon of $134,393, and increasing the assessable profits to $847,202 with tax payable thereon of $148,260. The gain arose from the sale of 2 units of an industrial building ('the Subject Properties').

2. The Taxpayer appealed on the ground that the gain was of capital nature. It also complained about the disallowance of industrial building allowance in respect of another unit of the same industrial building.

The facts

3. On the statement of facts in the determination, the documents produced and the oral evidence given at the hearing of the appeal, we make the following findings of facts.

4. The Taxpayer was incorporated on 27 January 1989. Its authorised and issued share capital was $10,000. At all relevant times, its nature of business was stated as property investment. Its directors were also the shareholders.

5. By two agreements dated 12 March 1991, the Taxpayer agreed to purchase Units 1 and 2 of the same industrial building for $5,500,000.

6. The purchases of Units 1 and 2 were completed by two assignments dated 22 March 1991.

7. By an agreement dated 27 December 1991, a company associated with the Taxpayer in that 70% of its shares were held by the shareholders of the Taxpayer ('the Associated Company') agreed to purchase Unit 3 for $2,782,000.

8. By another agreement also dated 27 December 1991, the Taxpayer agreed to purchase Unit 4 for $2,782,000.

9. By a nomination dated 28 January 1992, the Associated Company nominated the Taxpayer to take up the purchase of Unit 3.

10. By two agreements dated 12 February 1992, the Taxpayer agreed to purchase Units 5 and 6, that is, the Subject Properties, for $2,782,000 each.

11. By an agreement dated 13 February 1992, the Taxpayer agreed to sub-sell Unit 4 for $3,004,560.

12. By two agreement dated 13 March 1992, the Taxpayer agreed to sub-sell Units 5 and 6,that is, the Subject Properties, for $3,338,400 each.

13. By an agreement dated 13 March 1992, the Taxpayer agreed to purchase Unit 7 for $2,720,000.

14. Unit 3 was assigned to the Taxpayer by an assignment dated 26 April 1992.

15. Unit 7 was assigned to the Taxpayer by an assignment dated 30 April 1992.

16. The Taxpayer completed the confirmor sale of Unit 4 by an assignment dated 22 May 1992.

17. The Taxpayer completed the confirmor sales of Units 5 and 6, that is, the Subject Properties, by two assignments dated 27 May 1992.

18. In its profits tax return for the year of assessment 1991/92 dated 24 September 1992, the Taxpayer offered the gain of $145,060 on sale of Unit 4 for assessment and the profit was duly assessed.

19. In its profits tax return for the year of assessment 1992/93, the Taxpayer declared assessable profits of $198,581, after excluding the gain of $486,381 on sale of the Subject Properties.

20. In reply to the assessor's enquiries, the Taxpayer, through its former auditors and tax representatives, stated that the Taxpayer and a named person acquired the Subject Properties with the intention of carrying on a plastics products manufacturing business. When they found out after signing the agreements for sale and purchase that the Subject Properties were not allowed to be used as a plastics factory, they disposed of the Subject Properties.

21. In support of its claim, the Taxpayer supplied copies of what purported to be an agreement dated 27 January 1992 between the Taxpayer and the named person; what purported to be an amendment dated 13 February 1992 between the Taxpayer and the named person; and an extract of the Deed of Mutual Covenant dated 18 December 1978.

22. The assessor was of the view that the gain on disposal of the Subject Properties should be subject to profits tax and raised on the Taxpayer the profits tax assessment for the year of assessment 1992/93 with assessable profits of $767,962 (by adding the gain of $486,381 on sale of the Subject Properties and adding overstatement of industrial building allowance of $83,000 to the profits per return of $198,581) with tax payable thereon of $134,393.

23. The Taxpayer, through its former tax representatives objected to the assessment on the ground that 'the purchase intention of [the Subject Properties] was not for short-term profit making, but for long-term investment'.

24. The assessor was of the view that the profits tax assessment for the year of assessment 1992/93 should be revised by adding the gain of $486,381 on sale of the Subject Properties, and adding overstatement of industrial building allowance of $162,240 to the profits per return of $198,581, to arrive at an assessable profits of $847,202, with tax payable thereon of $148,260.

25. The Commissioner rejected the Taxpayer's objection and increased the assessment to $847,202, with tax payable thereon of $148,260.

26. By letter dated 5 December 1997, the Taxpayer gave notice of appeal.

The Taxpayer's case

27. The Taxpayer's case in its notice of appeal was that the gain on sale of the Subject Properties was of capital nature. It also complained that 'the Commissioner, without giving any reasons, disallowed the industrial building allowance in respect of the company's property at Unit 7'.

Relevant provisions

28. Section 68(4) of the Inland Revenue Ordinance, Chapter 112, ('the IRO') provides that the onus of proving that the assessment appealed against is excessive or incorrect is on the Taxpayer. Section 2 defines 'trade' as including 'every trade and manufacture, and every adventure and concern in the nature of trade'. Section 14(1) excludes profits arising from the sale of capital assets.

The issues

29. The issues are whether the Taxpayer has discharged the onus of proving that the assessment appealed against is incorrect in that the gain arising from the sale of the Subject Properties is not assessable to profits tax in accordance with section 14(1) on the ground that the Subject Properties were acquired as capital assets; and whether the Taxpayer has discharged the onus of proving that the assessment appealed against is excessive in that the Taxpayer was entitled to industrial building allowance in respect of Unit 7.

Our decision

30. At the hearing of the appeal, the Taxpayer was represented by one of its directors who gave evidence along the lines of a prepared statement in Chinese. She told us that they wished to start a plastic products manufacturing business; that because the costs of setting up the machinery and the costs of decoration of the factory were very high, they had to

safeguard their interests by purchasing their own factory; that on 27 January 1992, they signed the agreement with the named person; that on 10 February 1992, they signed the agreement (or agreements) for the purchase of the Subject Properties; that on 11 February 1992, they were told by the management office of the industrial building that the Subject Properties could not be used for their purposes; and that on 13 February 1992, they and the named person agreed to amend their agreement.

31. We were not impressed by the evidence of the director and we reject her evidence.

32. We categorically reject the director's assertion that they acquired the Subject Properties for use as a plastic products manufacturing factory.

33. By 27 January 1992, that is, the date of the purported agreement with the named person, the directors of the Taxpayer had entered into the two agreements to purchase Units 1 and 2 (12 March 1991); had executed the assignments whereby Units 1 and 2 had been assigned to them (22 March 1991); had been working at the industrial building for about 10 months (22 March 1991 to 27 January 1992); and had entered into the two agreements to purchase Units 3 and 4 (27 December 1991).

34. It is inherently improbable that on none of the occasions when the four agreements in respect of Units 1, 2, 3 and 4 and the two assignments in respect of Units 1 and 2 were signed, the lawyers had advised the directors of the Taxpayer that the Deed of Mutual Covenant prohibited user as a plastics manufacturing factory.

35. It is also inherently improbable that the directors of the Taxpayer had never asked their lawyers about the restrictions, if any, on user. Restrictions on user are not uncommon. On the one hand, the restrictions may prohibit the intended user of an intended purchaser. On the other hand, the restrictions may prohibit obnoxious businesses and are welcomed by an intended purchaser who does not intend to operate any such business.

36. The directors had been working at the industrial building for about 10 months. We do not find it probable that the question of user only came up in a discussion with the management office on 11 February 1992, one day after allegedly signing the agreement (or agreements) for purchase on 10 February 1992. Furthermore, 10 February 1992 was not the date when the formal agreements in respect of the Subject Properties were signed. The director had given no intelligible reason why the formal agreements were signed on 12 February 1992, despite having allegedly been told about the prohibition the day before.

37. The reason put forward by the director for acquiring the Subject Properties as factory premises was to safeguard their very high costs of setting up the machinery and the factory. If this were so, it is inconceivable that the directors had not safeguarded their costs of acquisition ($5,564,000) of the 'factory premises' by asking the vendor, the management office or their own lawyers about the alleged intended user of the Subject Properties before contracting the purchase the Subject Properties.

38. We turn now to the claim for industrial building allowance in respect of Unit 7. Nothing has been said on behalf of the Taxpayer in support of this claim. The Taxpayer has thus failed to discharge the onus of proving that the assessment appealed against is excessive.

39. Furthermore, the Taxpayer's case was that Unit 7 was used as an office. User as an office is not a qualifying user under section 40(1) of the IRO.

40. For the reasons given above, the Taxpayer has failed on both issues.

41. We dismiss the appeal and confirm the assessment as increased by the Commissioner by his determination.