

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D11/02

Profits tax – real property – fail to prove the ‘stated intention’ was in fact held – section 68(4) of the Inland Revenue Ordinance (‘IRO’) – costs – appeal obviously unsustainable – section 68(9) of the IRO.

Panel: Kenneth Kwok Hing Wai SC (chairman), Charles Nicholas Brooke and Thomas Mark Lea.

Dates of hearing: 2 and 3 April 2002.

Date of decision: 7 May 2002.

The appellant, a company incorporated in Hong Kong, was notified that it had been assessed to additional profits tax for the year of assessment 1994/95. The assessor considered that the properties were acquired by the appellant for trading.

The principal grounds of appeal were that:

- (a) the properties, which represented 80% of the flats comprised in a building, were acquired by the appellant as capital assets with a view to redevelopment and long term holding hereafter; and
- (b) the intention to redevelop the properties was subsequently frustrated when it became obvious to the appellant that the outstanding flats in the building could not be acquired and in the event the redevelopment plan had to be abandoned.

Held:

1. D30/01 illustrates some of the difficulties which an appellant faces in establishing that the stated intention was to acquire all the units in one or more blocks of old building, demolish the old building(s), construct new building(s) and hold the new building(s) indefinitely for rental income.
2. One difference between capital and trading cases is that it is not essential for the trader to acquire all the units in the old building(s) but the investor must succeed in acquiring all the units in the old building(s). For the trader, it is a question of acquisition of desired trading stock. For the investor, failure to acquire all the units means that the investment intention is simply and plainly not realisable. The Board had

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not been told about what was thought at the time when the 'stated intention' was said to have been formed to be the prospects of acquiring all the floors of the building. The appellant's case failed at the threshold. Whilst on acquisition, the 'stated intention' was questionable on the appellant's own document. At best it was an 'aim' which was subject to a condition precedent which had never been fulfilled.

3. Another difference between capital and trading cases is that the trader may sell all or some of his trading stock at any time or at any stage of the redevelopment, but the investor must have the financial ability to complete the redevelopment and hold the new building(s), demolish the old buildings, construct the new building(s) and keep the new building(s) indefinitely. For the investment intention to be realistic or realisable, the investor must be able to service the interest element of all long term loans and to repay the principal of all long term loans. The Board had no evidence on the appellant's financial ability to complete the proposed redevelopment and to keep the proposed new building indefinitely. This was another reason why the appeal must and did fail.
4. The third difference between capital and trading cases is that the trader may lease some of the units in the old building(s), but the investor's priority is to evict all occupiers of the old building(s) and will not lease out any unit save in exceptional circumstances and for cogent reasons. The objective facts in this case were that not only was there no evidence of the appellant having taken step to evict any occupier, the appellant granted one lease after another. None of the leases had a redevelopment break clause. Neither the Court nor the Lands Tribunal had any jurisdiction to evict the tenant during the currency of the lease if and so long as the tenant observed all the terms. It made no commercial sense to grant a lease to a tenant and then try to pay the tenant off. This belied the assertion that the appellant intended to redevelop.
5. The appellant has not proved that the 'stated intention' was in fact held, not to mention genuinely held, realistic or realisable. The appellant has not discharged the onus under section 68(4) of the IRO of proving that the assessment appealed against was excessive or incorrect.
6. The Board was of the opinion that this appeal was obviously unsustainable. Pursuant to section 68(9) of the IRO, the appellant was ordered to pay the sum of \$5,000 as costs of the Board.

Appeal dismissed and a cost of \$5,000 charged.

Cases referred to:

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Lionel Simmons Properties Ltd v CIR [1980] 1 WLR 1196
All Best Wishes Ltd v CIR (1992) 3 HKTC 750
Brand Dragon Ltd v CIR, Inland Revenue Appeal No 2 of 2001
D26/00, IRBRD, vol 15, 321
D83/89, IRBRD, vol 6, 300
D76/94, IRBRD, vol 9, 394
D56/93, IRBRD, vol 9, 1
D54/01, IRBRD, vol 16, 465
D30/01, IRBRD, vol 16, 247

Nelson Miu Counsel instructed by Department of Justice for the Commissioner of Inland Revenue.
Albert Yau Counsel instructed by Messrs Woo, Kwan, Lee & Lo for the taxpayer.

Decision:

1. This is an appeal against the determination of the Commissioner of Inland Revenue dated 28 August 2000 whereby the additional profits tax assessment for the year of assessment 1994/95 under charge number 1-5042762-95-5, dated 27 October 1997, showing additional assessable profits of \$119,018,573 with additional tax payable of \$19,638,065 was confirmed.

The agreed facts

2. The following facts are agreed and we find them as facts.

3. The Appellant has objected to the additional profits tax assessment for the year of assessment 1994/95 raised on it. The Appellant claimed that the profits it derived from the sale of properties should not be charged to profits tax.

4. The Appellant was incorporated as a private company in Hong Kong on 6 October 1989. It commenced business on 25 June 1990. At all relevant times, the issued and paid up share capital of the Appellant was \$10,000, divided into 10,000 shares of \$1 each, and the shareholders of the Appellant were:

Name	Occupation	Number of shares held	Note
Mr A	Merchant	1,000	
Mr B	Lawyer	1,000	
Mr C	Architect	500	originally held 1,000 shares, transferred 500

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				shares to Madam D on 25-2-1991
Company E	-	6,500		originally held 7,000 shares, transferred 500 shares to Madam D on 25-2-1991
Madam D	Merchant	<u>1,000</u>		
		<u>10,000</u>		

5. At all relevant times, the directors of the Appellant were Mr A, Mr B, Mr C and Mr F. The directors of the Appellant considered that the ultimate holding company of the Appellant was Company E, a private company incorporated in Hong Kong. Company E is and was at all relevant times owned by Mr F and his wife Madam G who are also directors of that company.

6. According to the audited financial statements of the Appellant for the period ended 31 March 1991 and for the years ended 31 March 1992, 31 March 1993 and 31 March 1994, the principal activity of the Appellant was stated to be property investment. And according to the audited financial statements of the Appellant for the year ended 31 March 1995, it was stated that 'The Company carried on the business of property investment until 24 August 1994, the date of disposal of all its investment properties. The Company has been dormant since that date.'

7. The Appellant acquired the following properties within a block of five-storey building (G/F to 4/F) situated at Numbers 1 and 2 Road H (collectively 'the Properties') during the years 1991 to 1993:

Location	Vendor	Date of sale and purchase agreement	Date of assignment	Purchase price \$
G/F, 1/F and 4/F, 1 Road H and G/F, 2 Road H	Company I	-	5-2-1991	22,500,000
2/F, 1 Road H	Company J	18-9-1991	18-11-1991	2,500,000
3/F, 1 Road H	Mr K through the attorney Mr L	-	8-2-1991	1,450,000
1/F, 2 Road H	Mr M	-	5-2-1991	1,000,000
2/F, 2 Road H	Mr N	16-12-1992	5-11-1993	4,000,000
				<u>31,450,000</u>

At the relevant time, Mr A's brother was a director of Company J.

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8. (a) The acquisition of G/F, 1/F and 4/F, Number 1 Road H and G/F and 1/F, Number 2 Road H was financed by a bank loan of \$14,000,000 from Bank O. The loan was to be repaid by 96 monthly instalments each in the sum of \$216,160.23 (subject to interest rate fluctuation).
- (b) The acquisition of 2/F, Number 1 Road H was financed by a bank loan of \$1,470,000 from Bank O. The loan was to be repaid by 96 monthly instalments each in the sum of \$22,306.02 (subject to interest rate fluctuation).
- (c) The acquisition of 3/F, Number 1 Road H was financed by a bank loan of \$900,000 from Bank O. The loan was to be repaid by 96 monthly instalments each in the sum of \$13,896.01 (subject to interest rate fluctuation).
- (d) The acquisition of 2/F, Number 2 Road H was financed by a bank loan of \$2,000,000 from Bank O. The loan was to be repaid by 60 monthly instalments each in the sum of \$41,516.71 (subject to interest rate fluctuation).

9. By an agreement for sale and purchase dated 30 April 1993, Company P acquired the property known as Address Q for \$3,538,000. The acquisition was completed on 31 May 1993. At the time of completion, Company P and the Appellant were related companies in that they had the same holding company – Company E.

10. Before the Properties were disposed of by the Appellant (as mentioned in paragraph 11 below), the Appellant had acquired all but two units at Numbers 1 and 2 Road H. The two units were 3/F and 4/F, Number 2 Road H.

11. By an agreement for sale and purchase dated 25 April 1994, the Appellant sold the Properties with existing tenancies to Company R at a total consideration of 156,000,000. The sale was completed on 24 August 1994.

12. The following are extracts from the Appellant's profit and loss account for the years ended 31 March 1992, 31 March 1993 and 31 March 1994:

Year ended	31-3-1992	31-3-1993	31-3-1994
	\$	\$	\$
Income			
Rental income	2,153,022	3,295,025	3,155,274
Expenses			
Bank loan and overdraft interest	1,504,660	1,159,987	1,074,188
Net profit/(loss) for the year	(329,815)	1,278,956	828,179

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The Appellant filed its profits tax return for the year of assessment 1994/95 showing assessable profits of \$1,660,489. Profits of \$119,018,573 derived by the Appellant from the sale of the Properties were not offered for assessment.

13. The assessor raised on the Appellant the following profits tax assessment for the year of assessment 1994/95:

	\$
Profits per return	1,660,489
Tax payable thereon	<u>273,980</u>

Assessor's notes: 'This assessment based on the returned profits has been raised subject to the acceptance of the accounts submitted which are being examined.'

The Appellant did not object to the assessment for the year of assessment 1994/95 raised.

14. The assessor considered that the Properties were acquired by the Appellant for trading and raised on the company the following additional assessment:

	\$
Additional assessable profits	<u>119,018,573</u>
Additional tax payable	<u>19,638,065</u>

15. For the years prior to the year of assessment 1994/95, the computation of the loss position and profits tax assessments of the Appellant were as follows:

Year of assessment 1990/91	\$
Loss per return and carried forward	894,459
Assessed profit	<u>Nil</u>
Tax payable thereon	<u>Nil</u>

According to the Appellant's profit and loss account for the period 6 October 1989 (date of incorporation) to 31 March 1991, the total income was \$179,217 all of which was rental income.

Year of assessment 1991/92	\$
Loss per return	514,658
Assessed profit	<u>Nil</u>
Tax payable thereon	<u>Nil</u>
Statement of loss	
Loss brought forward	894,459

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<u>Add: Loss for the year</u>	<u>514,658</u>
Loss carried forward	<u>1,409,117</u>

According to the Appellant's profit and loss account for the year ended 31 March 1992, the total income was \$2,155,614.14 of which \$2,153,022 was rental income.

Year of assessment 1992/93	\$
Profit per return	1,081,495
<u>Less: Loss set off</u>	<u>1,081,495</u>
Assessed profit	<u>Nil</u>
Tax payable thereon	<u>Nil</u>
Statement of loss	
Loss brought forward	1,409,117
<u>Add: Loss for the year</u>	<u>1,081,495</u>
Loss carried forward	<u>327,622</u>

According to the Appellant's profit and loss account for the year ended 31 March 1993, the total income was \$3,310,287.38 of which \$3,295,025.27 was rental income.

Year of assessment 1993/94	\$
Profit per return	679,525
<u>Less: Loss set off</u>	<u>327,622</u>
Assessed profit	<u>351,903</u>
Tax payable thereon	<u>61,583</u>

According to the Appellant's profit and loss account for the year ended 31 March 1994, the total income was \$3,163,928.86 of which \$3,155,274 was rental income.

16. By letter dated 24 November 1997, the Appellant, through Messrs Woo, Kwan, Lee & Lo, solicitors, objected to the additional assessment claiming that the Properties were the Appellant's capital assets.

17. By a determination dated 28 August 2000, the Commissioner confirmed the additional profits tax assessment for the year of assessment 1994/95 under charge number 1-5042762-95-5 dated 27 October 1997 showing additional assessable profits of \$119,018,573 with additional tax payable of \$19,638,065.

18. On 22 September 2000, the Appellant, through its solicitors, gave notice of appeal to the Board of Review against the Commissioner's determination.

The appeal hearing

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19. The Appellant's principal grounds of appeal are that:

- '1. The properties known as Ground Floor, 1st Floor, 2nd Floor, 3rd Floor and 4th Floor of [Number 1 Road H] and Ground Floor, 1st Floor and 2nd Floor of [Number 2 Road H] (collectively "the Properties"), which represent 80% of the flats comprised in the building situate at [Numbers 1 and 2 Road H] ("the Building"), were acquired by the Taxpayer as capital assets with a view to redevelopment and long term holding thereafter.
2. The intention to redevelop the Properties was subsequently frustrated when it became obvious to the Taxpayer that the outstanding flats in the Building (i.e. 3rd Floor and 4th Floor of [Number 2 Road H]) could not be acquired and in that event the redevelopment plan had to be abandoned.'

20. The Appellant was represented by Mr Albert Yau, counsel, instructed by Messrs Woo, Kwan, Lee & Lo, solicitors, and assisted by a firm of certified public accountants. The Respondent was represented by Mr Nelson Miu, counsel, instructed by the Department of Justice, and Mr Herbert Li, senior Government counsel, and assisted by Miss Tse Yuk-yip, senior assessor, and Miss Tsui Nin-mei, assessor.

21. Mr Albert Yau called Mr F, Mr A and Mr C who gave evidence along the lines of their respective witness statements. Mr Nelson Miu did not adduce any oral evidence.

22. Mr Albert Yau put the following cases on his list of authorities:

- (a) an extract from Lionel Simmons Properties Ltd v CIR [1980] 1 WLR 1196
- (b) an extract from All Best Wishes Ltd v CIR (1992) 3 HKTC 750
- (c) Brand Dragon Ltd v CIR, Inland Revenue Appeal No 2 of 2001 (Chu J)
- (d) D26/00, IRBRD, vol 15, 32
- (e) D83/89, IRBRD, vol 6, 300
- (f) D76/94, IRBRD, vol 9, 394
- (g) D56/93, IRBRD, vol 9, 1
- (h) D54/01, IRBRD, vol 16, 465

23. The Respondent put two cases on his list of authorities:

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- (a) Lionel Simmons Properties Ltd v CIR [1980] 1 WLR 1196
- (b) All Best Wishes Ltd v CIR (1992) 3 HKTC 750

24. On the first day of the hearing, the Chairman drew the parties' attention to D30/01, IRBRD, vol 16, 247.

25. After Mr Albert Yau had said everything which could be said on behalf of the Appellant, we invited him to address us on costs. After his submission on costs, we told the parties that we were not calling on Mr Nelson Miu and that we would give our decision in writing which we now do.

Our decision

26. The law is well-known, see paragraphs 34 to 36 in D30/01.

27. D30/01 illustrates some of the difficulties which an appellant faces in establishing that the stated intention was to acquire all the units in one or more blocks of old building, demolish the old building(s), construct new building(s) and hold the new building(s) indefinitely for rental income.

28. One difference between capital and trading cases is that it is not essential for the trader to acquire all the units in the old building(s) but the investor must succeed in acquiring all the units in the old building(s). For the trader, it is a question of acquisition of desired trading stock. For the investor, failure to acquire all the units means that the investment intention is simply and plainly not realisable.

29. As in D30/01, we have not been told about what was thought at the time when the 'stated intention' was said to have been formed to be the prospects of acquiring all the floors at Numbers 1 and 2 Road H. The Appellant's case fails at the threshold.

30. Whilst on acquisition, we note that the 'stated intention' is questionable on the Appellant's own document. At best it was an 'aim' which was subject to a condition precedent which had never been fulfilled. The record of the 10 June 1990 meeting stated that:

‘ [Mr F] proposed, if all the units could be successfully acquired, our aim would be long term investment, because the area had very attractive rental return, the increase in value of office premises would be great, and profits better.’

31. Another difference between capital and trading cases is that the trader may sell all or some of his trading stock at any time or at any stage of the redevelopment, but the investor must have the financial ability to complete the redevelopment and hold the new building(s) indefinitely. In

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other words, the investor must have the financial ability to complete the acquisition of all the old units, pay all expenses in vacating all occupiers at the old building(s), demolish the old buildings, construct the new building(s) and keep the new building(s) indefinitely. All borrowed funds have to be repaid at some stage. For the investment intention to be realistic or realisable, the investor must be able to service the interest element of all long term loans and to repay the principal of all long term loans.

32. As in D30/01, we have no evidence on the Appellant's financial ability, with or without its shareholders and directors, to complete the proposed redevelopment and to keep the proposed new building indefinitely. This is another reason why the appeal must and does fail.

33. Mr F had 70% or 65% interest in the project. His assessable profits were \$2,666,363 (1989/90), \$2,780,152 (1990/91) and \$2,892,216 (1991/92). This is not the sort of income for a redevelopment project where the total acquisition cost of the eight units alone was \$31,450,000.

34. We have no evidence on the financial worth of any of the other shareholders. What we do have is the following statement in the record of the 12 May 1993 meeting:

‘ [Mr A] be responsible to contact [Mrs S], hope to have a reply as early as possible since [the property at Address Q intended to be used in exchange for Mrs S's unit] had already been purchased, had to make payment to bank each month.’

35. We attach no weight to the financial appraisal on page 53 of bundle A.

- (a) It omitted the premium of \$6,111,610 payable by 21 equal annual instalments of \$642,410 each (including interest at the rate of 10% per annum) payable under the Government lease dated 4 January 1988 in respect of Number 1 Road H and also omitted the premium of \$6,056,019 payable by 21 equal annual instalments of \$636,567 each (including interest at the rate of 10% per annum) payable under the Government lease dated 4 January 1988 in respect of Number 2 Road H. In other words, it omitted annual premium totalling \$1,278,977 for about 18 years.
- (b) The interest rate of 10% is unrealistic. The prime rate had been no less than 10% for nearly two years.
- (c) The ‘spread’ of two years for interest is clearly wrong. The period from 1990 to 1995 (the assumed completion date) is five years. More importantly, the loans for land cost and construction cost will not be paid off immediately on completion of construction of the new building. At best the loans will be restructured and interest will still be payable.

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- (d) The rental income figures is another reason why the financial appraisal is wholly unreliable. The monthly rental for the ground floor shops at the time of acquisition in February 1991 was \$83,000 + \$85,000 = \$168,000 per month. There is no evidence to explain how the monthly rental for the ground floor shops in the 'medium grade' proposed new building could possibly jump 3.6 times to \$604,000 in 1995. More importantly, the Appellant has not begun to justify 100% occupation of the shops, commercial and office premises in 1995. Road H was not known to be an area for offices.

36. The third difference between capital and trading cases is that the trader may lease some of the units in the old building(s), but the investor's priority is to evict all occupiers of the old building(s) and will not lease out any unit save in exceptional circumstances and for cogent reasons.

37. The objective facts in this case are that not only is there no evidence of the Appellant having taken any step to evict any occupier, the Appellant granted one lease after another. None of the leases had a redevelopment break clause. Neither the Court nor the Lands Tribunal had any jurisdiction to evict the tenant during the currency of the lease if and so long as the tenant observed all the terms. It makes no commercial sense to grant a lease to a tenant and then try to pay the tenant off. This belied the assertion that the Appellant intended to redevelop.

- (a) By a tenancy agreement dated 29 May 1991, the Appellant granted a three-year lease of G/F, Number 2 Road H from 15 July 1991 to 14 July 1994.
- (b) By a tenancy agreement dated 23 July 1992, the Appellant granted a lease of G/F, 1/F and 3/F of Number 1 Road H for a fixed term of three years (from 1 August 1992 to 31 July 1995) with an option to renew for two years at fair market rental.
- (c) By a Chinese agreement dated 1 November 1993, the Appellant granted a two-year lease of 2/F, Number 2 Road H for two years from 1 November 1993 to 31 October 1995.

38. Further and in any event, we do not believe the witnesses' assertion on intention to redevelop for rental income.

- (a) Mr F applied in December 1989 to emigrate to Country T. According to him, his sons (then over 20 years of age) were afraid after June 1989 and told him to apply to emigrate. We do not believe that he, having applied in December 1989 to emigrate, would embark in mid-1990 and early 1991 on a multi-million capital investment which according to him would take six to eight years before

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completion of the construction of the proposed new building and before rental income from the proposed new building could accrue.

- (b) Both Government leases for Numbers 1 and 2 Road H were subject to an express restriction on redevelopment [clause 4(33)(b)]:

‘ in the event of re-development ... the Lessee will observe and comply with the following conditions ... the said piece or parcel of ground ... or any building erected or to be erected thereon ... shall not be used for any purpose other than for such purposes as shall be in conformity with the land use zoning designated on the plan now or at any time hereafter prevailing approved under the Town Planning Ordinance and governing the area in which the said piece or parcel of ground is situate’.

- (c) Numbers 1 and 2 Road H were situated in an area zoned ‘Other Specified Use (Comprehensive Redevelopment Area)’. By 1991, Mr C had no experience in comprehensive redevelopment area and had almost no town planning experience. In the absence of any plausible explanation, we reject the Appellant’s assertion of intention to redevelop on land subject to an express restriction which its own expert had no relevant experience.

39. Mr Albert Yau placed heavy reliance on the Appellant’s efforts to acquire the remaining units, that is, 3/F and 4/F, Number 2 Road H. We are not persuaded that this was more consistent with capital as opposed to trading intention and regard this as a neutral factor.

40. For the reasons given, the Appellant has not proved any of the following:

- (a) that at the time of the respective acquisitions of the eight units, the intention of the Appellant was to hold any of them or any proposed new building on a long term basis, whether for rental income or at all;
- (b) its financial ability, with or without its shareholders and directors, to demolish the old buildings, to construct the proposed new building and to keep the proposed new building indefinitely.

41. The Appellant has not proved that the ‘stated intention’ was in fact held, not to mention genuinely held, realistic or realisable.

42. The Appellant has not discharged the onus under section 68(4) of the IRO of proving that the assessment appealed against is excessive or incorrect. We dismiss the appeal and confirm the assessment as confirmed by the Commissioner.

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Costs

43. We are of the opinion that this appeal is obviously unsustainable. Pursuant to section 68(9) of the IRO, we order the Appellant to pay the sum of \$5,000 as costs of the Board, which \$5,000 shall be added to the tax charged and recovered therewith.