Case No. D112/01

Profits tax – real property – whether the gains arising from the disposal of properties were liable for profits tax – whether expenses should be allowed – sections 2, 14(1), 61, 66(3) and 68(4) of the Inland Revenue Ordinance ('IRO') – costs – frivolous and vexatious and abuse of the process – section 68(9) of the IRO.

Panel: Kenneth Kwok Hing Wai SC (chairman), Robin M Bridge and Daniel Wan Yim Keung.

Date of hearing: 10 October 2001.
Date of decision: 29 November 2001.

The appellant is a private company incorporated in Hong Kong. It purchased a flat in May 1993 at a consideration of $9,200,000 and sold it in November 1994 for $15,700,000.

The appellant contended that it had intended to hold the flat for long term investment and to let it out. The appellant provided certain documents to the Revenue, the authenticity of which was challenged. The appellant failed to provide certain information requested by the assessor.

The appellant also challenged the disallowance of certain expenses.

Held:

1. There was simply no evidence on the appellant's intention at the time of acquisition of the property. There was also no evidence of the appellant's financial ability, with or without the assistance of its shareholders or related companies, to keep the property on a long term basis. The appellant has not proved that at the time of acquisition the intention was to hold the property on a long term basis and that such intention was genuinely held, realistic or realisable. The appellant's case of capital asset failed.

2. The only point raised in the notice of appeal was capital versus trading. By reason of section 66(3) of the IRO, it was not open to the appellant to challenge the disallowance of alleged expenses. In any event, there was no evidence that the appellant had incurred any of the alleged expenses disallowed. Nor was there evidence that the expenses allegedly incurred had been incurred during the basis

period or for the production of profits. The alleged transactions were artificial and should be disregarded.

3. The documents which authenticity was challenged were dated 3 October 1993, 10 March 1994 and 4 December 1994 respectively. They all contained eight-digit telephone numbers. Telephone numbers were not changed from seven-digit to eight-digit until January 1995.

4. The Board was of the opinion that the appeal was frivolous and vexatious and an abuse of the process. The Board deprecated the appellant for putting forward and relying on documents which the Board was not satisfied as to their authenticity. 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:

Marson v Morton [1986] 1 WLR 1343
Simmons v IRC [1980] 1 WLR 1196
All Best Wishes Limited v CIR (1992) 3 HKTC 750
Seramco Trustees v Income Tax Commissioner [1977] AC 287
Commissioner of Inland Revenue v D H Howe [1977] HKLR 436
D42/99, IRBRD, vol 14, 445

Lee Yun Hung for the Commissioner of Inland Revenue.
Leung Ka Wing of A & T Consultants for the taxpayer.

Decision:

1. This is an appeal against the determination of the Commissioner of Inland Revenue dated 1 February 2001 reducing the profits tax assessment for the year of assessment 1994/95 under charge number 1-5015845-95-0, dated 24 July 1996, showing assessable profits of $6,000,000 with tax payable of $990,000 to assessable profits of $4,824,846 (after setting off loss brought forward of $457,168) with tax payable of $796,099.

The background facts

2. The Appellant has not disputed any of the facts stated in 'Facts under which the determination was arrived at' in the determination and we find them as facts.

3. The Appellant, formerly known as Company A, had objected to the profits tax assessment for the year of assessment 1994/95 raised on it. The Appellant claimed that the assessment was excessive.

4. The Appellant is a private company incorporated in Hong Kong on 9 March 1993. At all relevant times, it had an authorised and issued capital of $10,000 and its shareholders and directors were Mr B and Mr C.

5. (a) By a provisional agreement for sale and purchase dated 3 May 1993, the Appellant purchased a flat at Housing Estate D ('the Property') at a consideration of $9,200,000. The Property was assigned to the Appellant on 23 July 1993.

(b) On 23 July 1993, the Appellant used the Property to secure a bank mortgage loan of $5,000,000 repayable by 180 monthly instalments of $49,237 each.

(c) By a provisional agreement for sale and purchase dated 4 October 1994, the Appellant sold the Property for $15,700,000. The sale was made through an estate agent, Company E, and was completed on 14 November 1994.

6. The Appellant became dormant after the disposal of the Property.

7. On divers dates, the assessor issued to the Appellant for completion profits tax returns for the years of assessment 1993/94 and 1994/95. The Appellant did not file the returns within the stipulated periods. The assessor raised on the Appellant the following estimated profits tax assessments in the absence of returns:

	1993/94	**1994/95**
	$	$
Assessable profits	100,000	6,000,000
Tax payable	17,500	990,000

8. Messrs Y T Lo & Co, on behalf of the Appellant, objected against the assessments for the years of assessment 1993/94 and 1994/95 on the ground that they were excessive.

9. (a) The Appellant filed profits tax returns for the years of assessment 1993/94 and 1994/95 and declared its principal business activity as ' commission agent' .

(b) The profit and loss accounts of the Appellant showed the following particulars:

	1993/94	**1994/95**
Period covered	9-3-1993 (Date of incorporation) – 31-3-1994	1-4-1994 – 31-3-1995
	$	$
Commission income	32,439	--
Less: Expenses		
Audit fee	8,000	9,500
Bank charges	6,250	140
Bank overdraft interest	184,350.42	316,925.93
Building management fee	--	215,808.15
Business registration fee	1,250	2,250
Cleaning and sanitary	--	1,300
Depreciation	240,226.19	--
Insurance	6,000	21,587
Legal fee	2,471	--
Management fee	--	4,263,840.48
Mortgage loan interest	281,285.53	298,458.63
Preliminary expenses written off	8,076	--
Rent and rates	--	1,389,207
Secretarial fee	--	1,140
Sundry expenses	--	680

Water and electricity	--	447
Total expenses	737,909.14	6,521,284.19
Loss before exceptional item	(705,470.14)	(6,521,284.19)
Exceptional item		
Gain on disposal of the Property	--	6,212,978.59
Loss for the period/year	(705,470.14)	(308,305.60)

(c) In its tax computations, the Appellant claimed losses of $549,168 and $6,521,284 for the years of assessment 1993/94 and 1994/95 respectively. It did not offer for assessment the gain on the disposal of the Property.

10. In replies to enquiries raised by the assessor, the Appellant provided the following information relating to the disposal of the Property:

(a) The Appellant intended to hold the Property for long term investment and to let it out.

(b) Apart from the bank mortgage loan [paragraph 5(b)], the balance of the purchase money for the Property was from a bank overdraft of $4,000,000 and a loan from a related company, Company F. The loan from Company F was interest free and there was no loan agreement. Both the bank overdraft and the loan from Company F were repayable on demand. The Appellant provided copies of the following documents to support its claims:

(i) A copy of the **purported** minutes of Company F dated 13 May 1993.

(ii) Copies of the financial statements (for management purpose only) of Company F for the years ended 31 March 1994 and 31 March 1995.

(iii) A copy of the Appellant's bank statement showing that overdraft of $4,000,000 was drawn on 1 November 1993.

(c) Company F was controlled by the directors of the Appellant.

(d) The Property was purchased with vacant possession and it remained vacant during the Appellant's period of ownership.

(e) The Appellant appointed Company G to lease the Property. As the Appellant did not want to have a bad tenant, it instructed Company G to find tenant through business friends and companies only. Company G had a good relationship with business friends in Mainland China and they had a demand for residential places

in Hong Kong. A copy of the **purported** letter dated 3 October 1993 from the Appellant to Company G was provided by the Appellant.

(f) Company G was controlled by the directors of the Appellant.

(g) The Appellant could not give the monthly rental it demanded in respect of the Property and the expected rate of rental return because it ' could not find a suitable tenant' .

(h) The Appellant resolved to sell the Property because it could not find a suitable tenant and appointed Company G to offer the Property for sale.

(i) The Appellant wanted to put confidence on the buyer and thus Company G appointed an estate agent [paragraph 5(c)] to deal with the sale process.

11. The Appellant provided the following information relating to the various expenses charged to the profit and loss accounts:

Building management fee (1994/95 $215,808)
Rent and rates (1994/95 $1,389,207)

(a) The details were:

Location	**Building management fee**	**Rent**	**Rates**
	$	$	$
The Property	22,026	--	16,284
Property 1	193,782	1,303,425	69,498
Total	215,808	1,303,425	85,782
			$1,389,207

(b) The recipient of the charges in respect of Property 1 was Company H.

(c) Company H was controlled by the directors of the Appellant.

(d) The Appellant used Property 1 as office.

Management fee (1994/95 $4,263,840)

(e) The recipient was Company G.

(f) The services provided by Company G included the finding of tenant and purchaser for the Property and the keeping of the Appellant's records and documents.

(g) The total management fee of $4,263,840 was made up of monthly management fee of $250,000, that is, $250,000 x 12, and the fee for selling the Property of $1,263,840. Copies of the **purported** management contract dated 10 March 1994 and the **purported** debit note dated 4 December 1994 were provided by the Appellant.

(h) The Appellant paid the management fee 'by transfer' and 'by the usual way between related companies' (given in response to the assessor's request for the date and mode of each payment to Company G).

12. The Appellant did not provide the following information requested by the assessor:

(a) the date and mode of each payment to Company H [paragraph 11(b)] and

(b) the nature of its commission income for the year of assessment 1993/94 [paragraph 9(b)].

13. The Appellant provided a copy of the financial statement (for management purpose only) of Company G for the year ended 31 March 1995. The financial statement showed that Company G sustained a loss of $26,542,191 for the year.

14. The Appellant provided a copy of the financial statement of Company H for the year ended 31 March 1995. The statement showed that Company H did not have any rental income and its loss for the year was $4,049,310.

15. The tenancy agreement dated 29 April 1992 between Company H and the landlord of Property 1 showed that Company H leased the premises for a term of three years commencing on 1 May 1992 at a monthly rental of $144,825 and the tenant's share of service, management and air-conditioning charges was $15,931 per month.

16. The assessor had ascertained that Property 1 was the registered address of the Appellant, Company G and Company H in the years of assessment 1993/94 and 1994/95.

17. A & T Consultants in a subsequent letter filed on behalf of the Appellant, stated that the Property was occupied by a business partner of the Appellant, Mr I, rent free while the Appellant tried to find a tenant.

18. The assessor revised the profits tax assessment for the year of assessment 1993/94 to ' Nil' assessable profits with a note stating that the loss for the year was to be agreed on settlement of the objection against the assessment for the year of assessment 1994/95.

19. The assessor then proposed to revise the profits tax assessment for the year of assessment 1994/95 as follows:

	$	$
Loss per computation [paragraph 9(c)]		(6,521,284)
Add:		
Property 1 [paragraph 11(a)]		
Building management fee	193,782	
Rent	1,303,425	
Rates	69,498	
Management fee [paragraph 11(g)]	4,263,840	
Profit on disposal of the Property ($6,212,979 - $240,226)	5,972,753	11,803,298
Profit for the year		5,282,014
Less:		
Loss for 1993/94 brought forward and set-off [Note below]		457,168
Assessable profits		4,824,846
Tax payable		796,099

Note:

Year of assessment 1993/94	$
Loss per computation [paragraph 9(c)]	(549,168)
Add: Rebuilding allowance on the Property	92,000
Loss for the year and carried forward	(457,168)

The appeal

20. By her determination, the Commissioner reduced the profits tax assessment for the year of assessment 1994/95 to assessable profits of $4,824,846 (after setting off loss brought forward of $457,168) with tax payable of $796,099.

21. By letter dated 28 February 2001, A & T Consultants gave notice of appeal on behalf of the Appellant to the Clerk to the Board of Review in these terms:

> ' With reference to your Notice of Objection against profits tax assessment dated 1 February 2001, we would like to appeal against this assessment on behalf of our captioned client as the following reasons. The commissioner has not consider the point (15) of the facts upon which the determination was arrived at of the notice. Attached please find the secretarial record that can prove Mr I has occupied the property. We can' t find any payment receipt of electricity or club membership as he paid by himself and our client has lost the contact of Mr I. Besides, the financial controller, Mr J died suddenly in May 2000. He managed the whole group of the company. This make the finding of record very difficult. Fortunately, we find out some secretarial record in the last minute and make this appeal. It is because our client' s opinion is that if they treated the property as a trading stock, they would not let their business partner occupied the property.
>
> Under these circumstances, we should been most grateful if you will please reconsider our case.
>
> We are the tax representative of [the Appellant] and are pleased to inform you that our office address has been changed from [Address K] to [Address L] as we discover your department has the old record only.'

22. By letter dated 17 September 2001, Mr Lee Yun-hung, chief assessor who represented the Respondent at the hearing of this appeal, gave written notice to the Appellant that he intended to challenge the authenticity of the following documents and to submit that they were not contemporaneous documents:

(a) **purported** letter from the Appellant dated 3 October 1993 [paragraph 10(e)];

(b) **purported** management contract dated 10 March 1994 [paragraph 11(g)]; and

(c) **purported** debit note dated 4 December 1994 [paragraph 11(g)].

23. By letter dated 20 September 2001, A & T Consultants wrote to the Clerk to the Board of Review in these terms:

> ' We refer to the appeal against the above assessment to be heard on 10 October 2001 and would advise our position. Our client emphasize that they do not try to evade profit tax. They just want to explain the fact. Our client have not treat the property as trading stock. The fact is the property was free occupied by business friend [Mr I]. Unfortunately, our client can' t find [Mr I] to prove the evidence. Moreover, they have no right to get back the payment receipts of club membership fee and building management fee. Furthermore, their staff [Mr J] died last year

unlucky. He knew the whole case. Under these circumstances, our client would like the Board of Review to consider the above mitigating circumstances and reconsider the tax amount.

Thank you for your understanding and consideration.'

24. None of the directors of the Appellant attended the hearing of the appeal to 'explain the facts'. Only a 'staff' attended and the Appellant was represented by Mr Leung Ka-wing of A & T Consultants.

25. Neither party called any witness.

26. At the end of the submission of Mr Leung Ka-wing, we invited him to address us on costs. After his submission on costs, we told the parties that we were not calling on the Respondent and that our decision would be given in writing which we now do.

Our decision

27. Section 68(4) of the IRO provides that the onus of proving that the assessment appealed against is excessive or incorrect is on the Appellant. 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 Property

28. We remind ourselves of what Sir Nicholas Browne-Wilkinson VC said in Marson v Morton [1986] 1 WLR 1343 at pages 1347 to 1349 and [1986] STC 463 at pages 470 to 471; what Lord Wilberforce authoritatively stated in Simmons v IRC [1980] 1 WLR 1196 at page 1199 and (1980) 53 Tax Cases 461 at pages 491 to 492; and the statement of the law by Orr LJ at pages 488 and 489 of the report in Tax Cases, which was approved by Lord Wilberforce as a generally correct statement (WLR at page 1202 and Tax Cases at page 495).

29. We also remind ourselves of what Mortimer J, as he then was, said in All Best Wishes Limited v CIR (1992) 3 HKTC 750 at page 770 and page 771.

30. There is simply no evidence on the Appellant's intention at the time of acquisition of the Property.

31. The copy return of allotments sent by A & T Consultants with the notice of appeal is not evidence of the Appellant's intention at all.

(a) It merely shows that the Property was given as the ' Address' of Mr I in that **purported** return dated 1 December 1993 in respect of the allotment of shares in a company called Company M.

(b) It does not prove that Mr I occupied the Property at any time.

(c) The allegation that Mr I occupied the Property is contradicted by the statement in the Appellant's letter dated 19 December 1998 that the ' property was vacant during the whole period owned by the company' and no attempt has been made to explain the discrepancy.

(d) Mr I's alleged occupation at the Property, even if proved, is at best a neutral factor. We do not see how his occupation, alleged by A & T Consultants in their letter dated 30 June 2000 to be ' free of charge till they can let out the property', is inconsistent with trading intention. The case put forward was that Mr I would vacate the Property on request. Mr I's alleged occupation is no more inconsistent with trading intention than with intention to lease for rental income.

32. There is also no evidence of the Appellant's financial ability, with or without the assistance of its shareholders or related companies, to keep the Property on a long term basis. There is no evidence on the Appellant's financial ability to service the bank mortgage loan repayments of $49,237 each month. There is no evidence on the Appellant's financial ability to repay the balance of the purchase price ($9,200,000 - $5,000,000 = $4,200,000). We do not see the relevance of the bank overdraft of $4,000,000 on 1 November 1993 [paragraph 10(b)] when the acquisition had already been completed on 23 July 1993. The financial statements of Company F [paragraph 10(b)] as at 31 March 1994 showed that Company F had net current liability of $53,476,161 and net liability of $717,170.

33. For the reasons we have given, the Appellant has not proved any of the following and its case of capital asset fails:

(a) that at the time of acquisition in May 1993, the intention of the Appellant was to hold the Property on a long term basis, whether for rental income or at all;

(b) that such intention was genuinely held, realistic or realisable.

Documents challenged by the Respondent

34. We are not satisfied as to the authenticity of any of the three documents referred to in paragraph 22, the authenticity of which the Respondent intended to challenge, and we attach no weight to any of them. These documents are dated 3 October 1993, 10 March 1994 and 4

December 1994 respectively. They all contain eight-digit telephone numbers. Telephone numbers were not changed from seven-digit to eight-digit until January 1995.

Expenses disallowed

35. The only point raised in the notice of appeal is capital versus trading. By reason of section 66(3) of the IRO, it is not open to the Appellant to challenge the disallowance of alleged expenses.

36. In any event, there is no evidence that the Appellant has incurred any of the alleged expenses disallowed.

37. There is also no evidence that any of the expenses allegedly incurred was incurred during the basis period or that any of expenses allegedly incurred was incurred in the production of profits.

38. Section 61 of the IRO provides that:

> *' Where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessable accordingly.'*

39. We remind ourselves of the observations made by Lord Diplock, delivering the advice of the Privy Council in Seramco Trustees v Income Tax Commissioner [1977] AC 287 at pages 297 to 298:

> *' It is only when the method used for dividend stripping involves a transaction which can properly be described as "artificial" or "fictitious" that it comes within the ambit of section 10(1). Whether it can properly be so described depends upon the terms of the particular transaction that is impugned and the circumstances in which it was made and carried out.*
>
> *"Artificial" is an adjective which is in general use in the English language. It is not a term of legal art; it is capable of bearing a variety of meanings according to the context in which it is used. In common with all three members of the Court of Appeal their Lordships reject the trustees' first contention that its use by the draftsman of the subsection is pleonastic, that is, a mere synonym for "fictitious". A fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. "Artificial" as descriptive of a transaction is, in their Lordships' view a word of wider import. Where in a*

> *provision of a statute an ordinary English word is used, it is neither necessary nor wise for a court of construction to attempt to lay down in substitution for it, some paraphrase which would be of general application to all cases arising under the provision to be construed. Judicial exegesis should be confined to what is necessary for the decision of the particular case. Their Lordships will accordingly limit themselves to an examination of the shares agreement and the circumstances in which it was made and carried out, in order to see whether that particular transaction is properly described as "artificial" within the ordinary meaning of that word.'*

40. Lord Diplock considered whether the impugned transaction was ' unrealistic from a business point of view' (at page 294).

41. In Commissioner of Inland Revenue v D H Howe [1977] HKLR 436 at 441, Cons J (as he then was) considered whether the impugned transaction was ' commercially unrealistic' .

42. Applying those principles, the alleged transactions with Company H and the alleged transactions with Company G were both artificial and both should be disregarded.

(a) Company H: Property 1 was the address of at least three companies. There is no evidence of any business activity on the part of the Appellant and the Appellant has also allegedly incurred ' management fee' . It is commercially unrealistic for the Appellant to bear 75% of the rental and to pay building management fee higher than the amount payable by Company H under its tenancy agreement.

(b) Company G: There is no evidence of any business activity on the part of the Appellant. The Appellant' s income in the year of assessment 1993/94 amounted to $32,439 and its income in the year of assessment 1994/95 was nil. Under the **purported** letter dated 3 October 1993, the Appellant had to pay Company G the ' reward of twice of the monthly income' . It is commercially unrealistic for the Appellant to pay $250,000 each month from April 1994 to March 1995 to Company G as management fee. It is also commercially unrealistic for the Appellant to pay Company G ' 20% extra fee of the gain on sale of property' .

Disposition

43. The Appellant has failed to discharge 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 reduced by the Commissioner.

Costs order

44. We are of the opinion that this appeal is frivolous and vexatious and an abuse of the process. We also deprecate the Appellant for putting forward and relying on documents which we are not satisfied as to their authenticity, see also D42/99, IRBRD, vol 14, 445. 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.