

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D117/97

Profits tax –whether profits realized from sale of property is merely a capital gain or liable to profit tax assessment – whether assessment excessive or otherwise incorrect.

Panel: Terence Tai Chun To (chairman), David A Morris and Kenneth Ting Woo Shou.

Date of hearing: 13 January 1998.

Date of decision: 3 March 1998.

On 27 February 1992, the taxpayer as a company incorporated in Hong Kong, entered into a provisional agreement for the purchase of the Subject Property together with car parking space and open yard terrace at the price of \$8,500,000 subject to existing tenancy. On 13 July 1992, the taxpayer signed a formal agreement for the sale of the Subject Property at the price of \$11,650,000 subject to and with the benefit of the said Tenancy Agreement. On 8 October 1992, the taxpayer purchased another property.

The Commissioner of the Inland Revenue upheld the assessor of the Inland Revenue Department that the purchase and subsequent sale by the taxpayer of the Subject Property was in the nature of trade, thereby the profit from the sale after various deduction amounting to \$2,622,770 was taxable.

The taxpayer appealed against the determination of the Commissioner.

Held:

- (1) The Board was of the view that taking into account the following circumstances, the taxpayer's purchase of the Subject Property was for short term trading purpose rather than long term investment, namely,
 - (a) The short term of ownership;
 - (b) When the taxpayer obtained a bank loan of \$4,000,000 and interest free loans from Mr E's (the taxpayer's director) related companies in order to finance the purchase of the Subject Property, the taxpayer did not have any projection study of its long term commitment;
 - (c) The bank loan was to be repaid by 120 monthly instalments of \$52,308.4 and the interest free loan to be repaid on demand. The

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monthly rental of the Subject Property of \$46,500 was insufficient to cover the monthly instalment of \$52,308.4 payable to the bank; and

- (d) As for the interest free loans and advances, the taxpayer did not show how it was going to pay it back if and when demanded by Mr E's related companies. There was no evidence to show that Mr E's related companies were financially able to make and extend these interest free loans indefinitely.
- (2) The taxpayer's claim that the Subject Property was sold in exchange of another property representing a change of investment was unfounded. The Board found that it was obvious that on 13 July 1992, Mr E had no inkling of the other property and the taxpayer's decision to sell the Subject Property was made in isolation and in ignorance of the existence of the other property.
- (3) The Board further found that Mr E's submission that he disposed the Subject Property because he would find it strenuous to drive along a long and winding road after his mahjong games late at night incredible as this problem would have been apparent to Mr E prior to the purchase of the Subject Property.

Appeal dismissed.

J R Smith for the Commissioner of Inland Revenue.

T C Foo of Messrs T C Foo & Company for the taxpayer.

Decision:

The Taxpayer Company (the Company) appeals against the determination of the Commissioner of Inland Revenue dated the 4 April 1997 assessing the Company to profits tax upon its sale of property.

The grounds of appeal are set out in full as follows:

1. That the assessment under appeal is excessive or otherwise incorrect;
2. That the Taxpayer maintains that the Taxpayer did not carry on a trade or business or in the nature of an adventure of trade in respect of a property-dealing in Hong Kong as alleged by the assessor of Inland Revenue Department, Hong Kong and therefore, the Taxpayer is not liable to profits tax assessment for the year of assessment 1992/93 levied upon him by the Commissioner of Inland Revenue although the Taxpayer has obtained a gain derived from the disposal of its investment in landed property at the premises at District A and two car parking spaces ('Subject Property') as a result of change of its

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investment and the profit derived therefrom is merely a capital gain not liable to profits tax assessment for the relevant year of assessment or at all;

3. That the Commissioner thus took an erroneous view leading himself to reach a wrong conclusion in his determination dated 4 April 1997; and

4. That entirely without prejudice to the generality of the foregoing, the Taxpayer alternatively maintains that if, which is denied, the disposal of the Subject Property which is its capital investment in landed property be held as liable to profits tax assessment for the year of assessment 1992/93, then and in such event, the deduction of cost of the Subject Property for profits tax purpose should not be restricted to the original amount of its cost paid by the Taxpayer but to the extent of its market value of the Subject Property at the time when a change of his intention was made by the Taxpayer for converting it from investment into trading stock.

Mr J R Smith represented the Revenue and Mr T C Foo appeared for the Company.

Before the Board, there were 3 bundles of documents:

1. the Board's bundle or the original bundle,
2. the Company's list of documents,
3. the Company's list of authorities.

The facts of the case have been agreed between Mr Smith and Mr Foo as follows:

1. The Taxpayer was a company incorporated in Hong Kong on 28 January 1992 pursuant to the Companies Ordinance Chapter 32 with registered capital of \$10,000 divided into 10,000 shares of \$1 each, of which 10,000 shares were fully paid up and issued.

2. On 27 February 1992 the Taxpayer entered into a provisional agreement for the purchase of a property together with car parking space and open yard garden terrace at District A (Subject Property) at the price of \$8,500,000 subject to existing tenancy, and paid the initial deposit of \$100,000.

3. On 16 March 1992 the Taxpayer signed a formal agreement for sale and purchase in respect of the purchase of the Subject Property and paid the further deposit of \$1,175,000. The said Agreement was duly registered with the Land Registry.

4. To facilitate the purchase of the Subject Property the Taxpayer on 8 May 1992 obtained from Bank B a mortgage loan of \$4,000,000 to be repaid by 120 consecutive monthly instalments of \$52,308.40 each.

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5. The Taxpayer completed the purchase of the Subject Property on 11 May 1992 by executing an assignment and paid the balance of the purchase price in the sum of \$7,225,000. At the same time the Taxpayer executed a legal charge in favour of Bank B as security for the repayment of the mortgage loan. The said Assignment was duly registered with the Land Registry.
6. The tenancy referred to in respect of the Subject Property was for a fixed term of two years from 1 May 1991 to 30 April 1993 at the monthly rent of \$46,500 exclusive of rates and other outgoings and subject to the terms and conditions as contained in a written tenancy agreement dated 29 April 1991.
7. On 13 July 1992 the Taxpayer signed a formal agreement for the sale of the Subject Property at the price of \$11,650,000 subject to and with the benefit of the said Tenancy Agreement dated 29 April 1991 when the Taxpayer received a deposit of \$2,330,000. By the Agreement for Sale and Purchase duly registered with the Land Registry, completion shall take place on or before 14 September 1992.
8. The Taxpayer completed the sale of the Subject Property on 11 September 1992 by executing an assignment in favour of the purchaser, which said assignment was duly registered with the Land Registry. After deduction of the redemption money of \$4,010,896.56 paid to Bank B for the release and discharge of the Subject Property and other expenses incurred in connection with the sale, the Taxpayer received the sum of \$5,208,891 as balance of the purchase price.
9. On 8 October 1992 (some 26 days after completion of sale of the Subject Property) the Taxpayer signed a provisional agreement for the purchase of a property, and a car parking space at District C (Property D) at the price of \$12,700,000 subject to existing tenancy and paid the initial deposit of \$400,000.
10. Pursuant to the Provisional Agreement, the Taxpayer signed a formal agreement for sale and purchase in respect of the purchase of Property D on 21 October 1992 and paid the further deposit of \$870,000. By the Agreement for Sale and Purchase, completion shall take place on or before 19 January 1993, and the Agreement was duly registered with the Land Registry.
11. To facilitate the purchase of the Property D the Taxpayer obtained from Bank B on 4 December 1992 a mortgage loan of \$8,890,000 repayable by 120 monthly instalments of \$109,038.32 each.
12. The Taxpayer completed the purchase of Property D by executing an assignment subject to existing tenancy and paid the balance of the purchase price in the sum of \$11,430,000 on 19 January 1993 when the Taxpayer also executed a legal charge in favour of Bank B as security for repayment of the mortgage loan. The Assignment was duly registered with the Land Registry.

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13. The tenancy referred to in respect of Property D was created under a tenancy agreement in writing dated 10 September 1991 for a fixed term of two years from 15 August 1991 to 14 August 1993 at the monthly rent of \$58,000 exclusive of rates and management fees.
14. Upon the expiration of the said term the tenant moved out and delivered vacant possession of Property D to the Taxpayer in December 1993. The Property D has been used and occupied by the Taxpayer as residence since May 1994.
15. The assessor of the Inland Revenue Department was of the opinion that the purchase and subsequent sale by the Taxpayer of the Subject Property was in the nature of trade, thereby the profit from the sale after various deduction amounting to \$2,622,770 was taxable. Accordingly a Notice of Assessment and Demand for profit tax for the year of assessment 1992/93 was served on the Taxpayer on 23 May 1994 requiring the Taxpayer to pay profits tax of \$458,984.
16. Through its representatives on 26 May 1994 the Taxpayer filed its objection to this assessment.
17. The matter was then considered by the Commissioner of Inland Revenue. In his determination dated 4 April 1997 he upheld the assessment.
18. On 1 May 1997 through its Representatives the Taxpayer gave notice of appeal to the Board of Review against the determination of the Commissioner.

Reasons for decision

Mr E, director and virtual owner of all the shares of the Company, gave evidence at the hearing.

In his written statement which he confirmed to be correct, he said that he was advised by professionals that flats/houses in high class residential areas would be good investment. As a result, he caused the Company to be incorporated with the main object of carrying on the business of property investment.

Shortly after the formation of the Company, the Company entered into a provisional agreement for the purchase of the Subject Property subject to existing tenancy for \$8,500,000.

The monthly rent was \$46,500 giving a yield of about 6.5%.

According to Mr E, a yield over 6% would be a good deal.

The Company's resolution approving the purchase stated that the purchase was for long term and rental income purpose. The resolution, however, was self-serving and had limited evidential value.

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The purchase was completed on 11 May 1992 with a mortgage loan of \$4,000,000, the balance of the purchase price being made up by interest free loans from Mr E's related companies.

In giving evidence under cross-examination, Mr E said that he would have been prepared to renew the existing tenancy of the Subject Property upon its expiry as the Company purchased the Subject Property for long term investment and for rental purposes. In another breath, Mr E said that he wanted to occupy the Subject Property at the expiration of the existing tenancy to comply with the wishes of his girl friend although in his own admission, Mr E found the Subject Property most inconvenient. Mr E's conflicting evidence cast doubt on the real intention of the Company which must come up with more cogent evidence to support its claim that the Subject Property was purchased for long term and rental purposes. Indeed, the Company sold the Subject Property within about four months after acquisition. This short term of ownership was more indicative of a short term trading purpose than a long term investment.

In his written statement, Mr E stated that early in July 1992 he was persuaded by estate agents to purchase a flat in District F and District G or District H in Hong Kong Island. As a result, he decided that the Company should change the location of its investment (the Subject Property) so that he could use the newly acquired property in one of these areas as his eventual matrimonial home.

The Company entered into an agreement to sell the Subject Property on the 13 July 1992.

Mr E claimed that the completion date for the sale of the Subject Property was deliberately fixed for September 1992 so as to allow him more time to look for a suitable flat in District F, District G or District H in exchange of the Subject Property.

Mr E went on to say that after the signing of the Agreement on the 13 July 1992, he began to look for suitable flats in the aforesaid areas.

It was obvious that on the 13 July 1992, Mr E had no inkling of Property D and the Company's decision to sell the Subject Property was made in isolation and in ignorance of the existence of Property D.

It was only on 1 September 1992 that the Company resolved to authorise Mr E to negotiate the purchase of Property D.

The Company's claim that the Subject Property was sold in exchange of Property D representing a change of investment was unfounded.

Mr E further said in effect that he disposed of the Subject Property because he would find it strenuous to drive along a long and winding road after his mahjong games late at night. We would have thought that the long and winding road would have been apparent

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to Mr E prior to the purchase of the Subject Property and the factor of inconvenience was merely put up by Mr E as an excuse to support the Company's claim of a change of intention leading to the sale of the Subject Property.

When the Company obtained a bank loan of \$4,000,000 and interest free loans from Mr E's related companies in order to finance the purchase of the Subject Property, the Company did not have any projection study of its long term commitment.

The bank loan was to be repaid by 120 monthly instalments of \$52,308.4 and the interest free loan to be repaid on demand.

The monthly rental of \$46,500 was insufficient to cover the monthly instalment of \$52,308.40 payable to the bank. The deficiency was said to be covered by advances made by a related company of Mr E's.

The Company did not show how it was going to pay back the interest free loans and advances if and when demanded by Mr E's related companies.

There was no evidence to show that Mr E's related companies were financially able to make and extend these interest free loans indefinitely.

From the evidence adduced before us, we cannot see how the Company was financially capable of holding the Subject Property long term.

Having regard to all the circumstances of this case, we are satisfied that the Company acquired the Subject Property with the intention of selling it at a profit and was liable for profits tax. We dismiss the Company's appeal and confirm the determination of the Commissioner dated 4 April 1997.

It is almost superfluous to mention that it is not necessary for us to rule on the alternative ground (4) of the grounds of appeal in view of our finding that the Company acquired the Subject Property with the intention of selling it at a profit.

There remains for us to record our appreciation of the precise but thorough manner in which both Mr Smith and Mr Foo handled this appeal which shortened the hearing considerably.