

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D11/99

Profits Tax – deduction in assessable profit in preceding year on the basis of loss on securities found to be missing – all the lost shares recovered – whether gains on disposal of recovered shares should be charged to tax.

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, a stock broker, in the preceding year of assessment reported and the assessor accepted an exceptional item of \$12,188,880 as loss on securities found to be missing on 29 January 1993 and professional fees incurred thereon less insurance claims and compensation received and receivable. During the year ended 30 September 1994, the taxpayer recovered nearly all the lost shares. The assessor determined that the gains on disposal of the recovered shares, which were described by the taxpayer as ‘gain on disposal of shares previously acquired for replacement of shares stolen which were disposed of upon recovery’ and ‘gain on disposal of bonus shares’ in the sum of \$2,438,985 and \$252,593 respectively, should be charged to tax.

The taxpayer appealed against the assessor’s determination on the ground that the shares were not purchased for trading purpose and that the profits did not arise ‘from such trade, profession or business.’

Held:

1. To succeed, the taxpayer had to establish that the shares sold during the relevant year of assessment were shares purchased by the taxpayer in the preceding year of assessment, and not the shares by the taxpayer during the relevant year of assessment.
2. On the evidence, the words ‘profit on selling the said securities recovered’ in note 13 to the audited financial statements for the year ended 30 September 1994 made it clear beyond preadventure that the shares sold were the shares recovered, not the purchased shares.

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3. Equally unequivocal is the statement in the letter dated 30 November 1995 that the 'shares recovered were disposed of ... given that the relevant claims on the individual securities had been settled.'
4. In any event, the taxpayer provided for a loss of \$12,188,880 in its accounts for the preceding year of assessment, without making any allowance for recovery of shares. During the relevant year of assessment, the taxpayer recovered and sold some of them of \$6,889,812. The whole recovery of \$6,889,812 is subject to tax. To split the amount, as the taxpayer did, into \$4,450,827 as the 'cost' of shares 'recovered' and \$2,438,985 as the 'gain' on disposal of shares 'acquired for replacement' is artificial.

Appeal dismissed.

Chan Wong Yee Hing for the Commissioner of Inland Revenue.
Chau Sau Ming of Global Tax Consulting Company for the taxpayer.

Decision:

1. This is an appeal against the determination dated 10 November 1997 by the Commissioner of Inland Revenue, rejecting the Taxpayer's objection against the profits tax assessment for the year of assessment 1994/95 dated 26 June 1995 showing assessable profits of \$4,111,261 with tax payable thereon of \$678,358, and reducing the assessable profits to \$3,915,871 with tax payable thereon of \$646,118.

The facts

2. 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.

3. The Taxpayer was incorporated on 31 December 1985 and was at all material times a stock broker.

The preceding year of assessment

4. The Taxpayer's profit and loss account for the year ended 30 September 1993 dated 28 January 1994, showed an exceptional item of \$12,188,880. According to the supporting schedules, \$12,188,880 comprised 'loss arised (sic) from securities stolen' of \$10,701,990; 'dividend claimed in respect of securities stolen' of \$195,390; 'legal and professional fees' of \$10,000, \$951,000, and \$30,000; and 'accounting fee' of \$300,500. According to Note 14, this exceptional item represented 'loss on securities found to be missing on 29 January 1993 and professional fees incurred thereon less insurance claims and compensation received and receivable'.

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5. According to Note 14, 'compensation ... receivable' was to be deducted. However, it was stated in Note 23, under the heading of 'contingent gain' that as 'at the balance sheet date, the Company had entered into an agreement with a third party for the return of certain missing securities as explained in Note 14 to the accounts. For the purpose of returning the missing securities to the Company's clients, the Company had already purchased those missing securities from the stock market with an aggregate cost of \$12,585,820. The Company agrees to contribute to the loss of that third party a sum of \$2,500,000 upon receipt of the said missing securities. Market values of the said missing securities at 30 September 1993 and 27 January 1994 were \$16,025,914 and \$24,670,460 respectively. Up to the date of approval of the audited accounts, the abovementioned missing securities have not been received by the Company. The directors are of the opinion that the gain should not be accounted for in the accounts for the year ended 30 September 1993 in view of conservatism'.

6. In its profits tax return for the year of assessment 1993/94, the Taxpayer claimed deduction in respect of the exceptional item of \$12,188,880 and reported a loss of \$10,478,510.

7. At the request of the assessor, the then auditors and tax representatives of the Taxpayer stated that the loss on securities stolen in the amount of \$10,701,990 was computed by deducting insurance claim received of \$8,000,000 and compensation from transferee of stolen shares of \$3,097,338 from the purchase cost of shares of \$21,799,328.

8. The assessor accepted that the exceptional item of \$12,188,880 arose in the ordinary course of the Taxpayer's business and issued the loss computation for the year of assessment 1993/94 to the Taxpayer showing loss per return of \$10,478,510, loss brought forward of \$481,237, and loss carried forward of \$10,959,747.

The relevant year of assessment

9. During the year ended 30 September 1994, the Taxpayer recovered nearly all the lost shares.

10. The Taxpayer's profit and loss account for the year ended 30 September 1994 showed an exceptional item of \$12,480,399. According to Note 13, this exceptional item represented 'the cost of stolen securities previously recorded which had been recovered during the year, the cash compensation in lieu of physical script of stolen securities received and the profit on selling of the said securities recovered less all related professional fees incurred for the year' (emphasis added).

11. However, according to the supporting schedules, \$12,480,399 comprised 'cost of physical shares recovered and on hand as at 30 September 1994 of \$7,839,006; 'cost of physical shares recovered and disposed of during the year' (emphasis added) of \$4,450,827; 'compensation received for stolen warrants which was expired' of \$346,742; after deducting

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‘compensation paid for claiming the stolen securities’ of \$2,700,000; deducting ‘handling and service charges for claiming stolen securities’ of \$17,000; and deducting ‘legal and professional fee’ of \$516,308; and adding ‘dividend income’ of \$385,554; adding ‘gain on disposal of shares previously acquired for replacement’ of shares stolen which were disposed of upon recovery’ (emphasis added) of \$2,438,985; and adding ‘gain on disposal of bonus shares’ of \$252,593.

12. It was expressly stated in the supporting schedules that the last 3 items (that is \$385,554, \$2,438,985 and \$252,593) were ‘non-taxable item for capital nature’. In its profits tax computation for the year of assessment 1994/95, the Taxpayer offered all \$12,480,399, less these 3 items, for taxation.

13. The assessor considered that dividend income recovered in the amount of \$195,390 and the gains on disposal of shares should be charged to tax. The assessor thus added \$2,438,985, \$252,593 and \$195,390 to the profit per return of \$12,184,040 to arrive at assessable profits of \$15,071,008. After setting off loss brought forward of \$10,959,747, the net assessable profits were \$4,111,261 with tax payable thereon of \$678,358.

14. The then tax representatives lodged an objection against the assessment.

15. By letter dated 30 November 1995, the then tax representatives stated, inter alia, that ‘Shares recovered were disposed of according to the sound knowledge and expertise of the directors of [the Taxpayer] in the securities market given that the relevant claims on the individual securities had been settled’ (emphasis added).

16. The assessor conceded that dividend income in the sum of \$195,390 should not be charged to tax and that the profits tax assessment for the year of assessment 1994/95 should be reduced accordingly to show a net assessable profits of \$3,915,871, with tax payable thereon of \$646,118.

17. The Commissioner rejected the Taxpayer’s objection and reduced the assessment to net assessable profits of \$3,915,871, with tax payable thereon of \$646,118.

18. By letter dated 6 December 1997, the Taxpayer gave notice of appeal.

The Taxpayer’s case

19. The Taxpayer’s case in its notice of appeal was that the shares were not purchased for trading purpose and that the profits did not arise ‘from such trade, profession or business’.

Our decision

20. Two items are in issue on this appeal, \$2,438,985 and \$252,593. Both parties agreed that the latter should stand or fall with the former.

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21. The Taxpayer's case on \$2,438,985 was that it was the 'gain on disposal of shares previously acquired for replacement of shares stolen which were disposed of upon recovery'.
22. To succeed, the Taxpayer had to establish that the shares sold during the relevant year of assessment were shares purchased by the Taxpayer in the preceding year of assessment, and not the shares recovered by the Taxpayer during the relevant year of assessment.
23. The words 'profit on selling of the said securities recovered' in Note 13 to the audited financial statements for the year end 30 September 1994 made it clear beyond peradventure that the shares sold were the shares recovered, not the purchased shares.
24. Equally unequivocal is the statement in the letter dated 30 November 1995 that the 'shares recovered were disposed of ... given that the relevant claims on the individual securities had been settled'.
25. It appears from the supporting schedules that shares were sold during the relevant year of assessment for \$6,889,812 (\$4,450,827 + \$2,438,985). What the Taxpayer did by the supporting schedules was to split it into 2 items. The first, \$4,450,827, was said to be 'the cost of physical shares recovered and disposed of during the year'. In other words, the shares sold were the recovered shares, not the purchased shares.
26. In contrast with Note 13, the gain or profits is said in the supporting schedules to be in respect of the purchased shares – 'gain on disposal of shares previously acquired for replacement of shares'. The new assertion made in the supporting schedules was that the shares sold were the purchased shares, not the recovered shares. We reject this assertion.
27. In our decision, the Taxpayer has failed to establish the factual basis for its case on \$2,438,985. Its appeal must fail.
28. In any event, the Taxpayer provided for a loss of \$12,188,880 in its accounts for the preceding year of assessment, without making any allowance for recovery of shares. During the relevant year of assessment, the Taxpayer recovered shares and sold some of them for \$6,889,812. The whole recovery of \$6,889,812 is in our decision subject to tax. To split the amount into \$4,450,827 as the 'cost' of shares 'recovered' and \$2,438,985 as the 'gain' on disposal of shares 'acquired for replacement' is artificial.
29. We dismiss the appeal and confirm the assessment as reduced by the Commissioner by his determination.
30. Lastly, we would like to record our thanks to Mrs Chan for her helpful assistance.