

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D 12/80

Board of Review:

S. V. Gittins Q.C., J.P. *Chairman*; Roland K. C. Chow LL.M.; W. T. Grimsdale C.B.E., F.C.A., J.P.; R. S. Huthart, *Members*.

8 December 1980.

Property bought and rented out – building declared dangerous – Appellants decision to redevelop – part of redeveloped property sold off – question whether taxpayer had embarked on business of dealing on property or was merely developing as an investment.

In 1965 the Appellant, a limited company, bought property for \$507,545.24. The property consisted of pre-war buildings and was the Appellant's sole asset. The property was rented out until 1969 when it was declared dangerous. Between 1965 and 1969 expenditure exceeded rental income and the Appellant incurred a loss each year.

The Appellant resolved on the 15 July 1971 to redevelop the plot into a 15 storey, 45 unit building and an occupation permit was issued on the 23 April 1974. Prior to this date the taxpayer has sold off 21 of the 41 units.

The assessor was of the opinion that the Appellant had embarked on a business of property dealing on the 15 July 1971 and assessed accordingly taking the property value as at the 15 July 1971 which was \$1,500,000.00.

The taxpayer objected and the Commissioner determined that the cost of the land to be taken into account was the original cost of \$507,545.24 which was the purchase price in 1965.

The question before the board were –

- (a) Whether the taxpayer traded in land or merely developed the property as an investment;
- (b) If the taxpayer was trading in land, whether such trading commenced on the 26 January 1965 as determined by the Commissioner or on the 15 July 1971 as found by the Assessor.

Held: The Board held on the evidence before them that –

- (i) The property was acquired as a long term investment in 1965.

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- (ii) In resolving to redevelop the property on the 15 July 1971 they embarked on the business of trading in land.

The Appellant was allowed to the extent that assessable profits are to be computed on the cost of the land as at 15 July 1971.

A. K. Gill for the Commissioner of Inland Revenue.

G. Horton instructed by Johnson, Stokes & Master for the Appellant.

Reasons:

1. On 22 November 1965 the Taxpayer bought the property at 35-37 H Road for \$507,545.24. The property consisted of pre-war buildings and was the Taxpayer's sole asset. The property was rented out until 1969 when the buildings were declared dangerous. Between 1965 and 1969 the rental income was insufficient to meet expenses so that the Taxpayer incurred a loss in each year.
2. The Taxpayer redeveloped the property by erecting a 15 storeyed building, with 3 units on each floor making 45 units. The occupation permit of this building was issued on 23 April 1974.
3. Prior to 23 April 1974 the Taxpayer sold 21 of the 27 units located on the 4th to 12th floors for \$3,845,000.
4. The assessor was of the opinion that the Taxpayer had embarked upon a business in dealing with property on 15 July 1971, the date on which it resolved to proceed with the development plans. The Commissioner of Rating & Valuation having valued the site on 15 July 1971 at \$1,500,000, the assessor, after making allowances for depreciation, rebuilding, expenses and losses brought forward, assessed the profits for the year of assessment 1974/75 at \$2,118,916.
5. The Taxpayer objected to the assessment on the ground that the development of the property and the subsequent sales of flats did not amount to a trade or an adventure in the nature of trade in property, and that the profits derived from the sales should not be brought to charge to profits tax.
6. The Commissioner's Determination on the objection was that the cost of land to be taken into account was the original cost of \$507,545.24 and revised the assessable profit for 1974/75 to \$2,156,214 and for 1975/76 to \$25,064.
7. The issues before the Board are:-

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- (a) Whether the Taxpayer traded in land or merely developed the property as an investment;
- (b) If the Taxpayer was trading in land, whether such trading commenced on 26 January 1965 as determined by the Commissioner, or on 15 July 1971 as found by the Assessor.

8. The Commissioner arrived at his Determination on facts set out in paragraphs, 1, 2 and 3 above and on other facts which included the following:-

- (a) When the buildings on the Property were declared dangerous in 1969, the Directors resolved to demolish it and erect on the site a four storeyed building. The plans for this redevelopment were not approved by the P.W.D.
- (b) On 15 July 1971 the directors amended their decision and resolved to erect a 14 storey building and to sell the flats on the 4th to 11th floors and to retain the balance to earn rental income.
- (c) On 17 September 1971 the directors amended their decision and resolved to erect a 15 storey building and to sell the flats on the 4th to 12th floors “in order to finance costs of construction and repayment of loan”.
- (d) On 29 December 1971, the Taxpayer placed an order with Model Art Advertising Agency for the printing of 2000 copies of brochures and price lists for the redeveloped property.
- (e) At a meeting of the directors held on 5 June 1972, it was resolved to mortgage the Property to Hong Nin Savings Bank Ltd. For a principal sum of \$1,100,000 with interest payable at the rate of 1.05% per month.
- (f) During the period from February 1972 to January 1973, the Taxpayer placed advertisements in local newspapers for the sale and for letting of flats at the building then to be erected.
- (g) Although the nature of the Taxpayer’s business is described as “investment” in its Business Registration Certificate and all its Profits Tax Returns, its memorandum includes powers to deal in land properties.

9. All the above facts, which are set out in the Commissioner’s Determination, are admitted by the Taxpayer save the last clause in (g), that its memorandum includes powers to deal in land properties. We find that the memorandum does include such powers, but we do not consider this a material fact in the determination of the issues before us.

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10. On these facts which give the history of the property, the way its development was financed, the way the units were disposed, the Commissioner came to the conclusion that they were all consistent with an adventure in the nature of a trade.

11. Before the Board evidence was led for the Taxpayer by affidavits and oral evidence from Madam L, her husband Mr. L, and Mr. Y and an affidavit by Mr. R. This evidence dealt with matters including the following:-

- (a) Nos. 32 to 37 H Road, comprising 6 houses, were acquired in about December 1961 by W H Land Investment Co. Ltd. The shares of this company were held by Mr. L, and two of his sons, in equal shares. W H received a small rental for these properties.
- (b) The sons wanted the properties sold whereas the father wanted them retained for long term investment. The sons forced a liquidation of the company and an arrangement was reached whereby W H was to sell Nos. 35, 36 and 37 to a new company to be formed by Mr. L and Nos. 32, 33 and 34 and other property to B H Land Investment Co. Ltd, a company owned by the 2 sons.
- (c) The Taxpayer company was expressly formed by Mr. L and Madam L for the purpose of acquiring Nos. 35, 36 and 37 H Road from W H. The shareholders of the Taxpayer were Mr. L, his wife Madam L and 2 of Mr. L's other children. These 4 persons were also directors of the Taxpayer. The business of the Taxpayer was at all times almost completely managed by Madam L.
- (d) Madam L gave instructions for the incorporation of the Taxpayer to Mr. Y, then of Messrs. Lowe, Bingham and Matthews and told him: "The Company is to acquire 35-37 H Road from W H as a long term investment for leasing out".
- (e) The purpose of the Taxpayer in acquiring 35-37 H Road was to hold the property as a long term investment.
- (f) Madam L had a firm policy that it was better to retain properties as long term investments rather than dealing in them or developing them for sale. She had convinced Mr. L of this long term investment before the Taxpayer was incorporated. The subject property was always treated as a capital asset in the Taxpayer's accounts.
- (g) By the time the Taxpayer acquired Nos. 35-37 H Road from W H there had been a regrant of Nos. 32-37 (6 houses) which contained a building covenant of \$250,000 and required the payment by instalments of a premium of \$478,566.
- (h) Nos. 35-37 H Road were demolished in about October 1969 after the issue of the demolition order on 12 August 1969.

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- (i) To comply with the building covenant Madam L gave instructions to the Taxpayer's architect to draw up plans for a 4 storey building on the Taxpayer's site. The cost of this building was estimated at not exceeding \$600,000 and could be met by the resources of the Taxpayer and other resources available to Madam L and Mr. L without recourse to outside borrowings.
- (j) Madam L estimated the annual return from letting out the 4 storey building at \$364,800 which would give a return of 33% per annum on a building cost of \$600,000 plus land cost of \$500,000 plus the total of premium instalments. This was regarded by Madam L and her husband as a satisfactory return having regard to their desire to retain the building as a long term investment and the fact that they did not wish to be burdened with the repayment of money borrowed by way of mortgage for a larger building.
- (k) Madam L and her husband had previous experience with 2 other properties purchased in 1957 and 1960 or 1961. Both properties were redeveloped with mortgage finance and let out. During the 1967 riots it became difficult to collect rent from tenants and the mortgagee in each case pressed for repayment. Both properties had to be sold in a depressed market to repay the mortgages.
- (l) Madam L was told by the P.W.D. at some time between April and June 1971 that the plans for the 4 storey building would not be approved because such a small building was incompatible with Government's plans for the area.
- (m) Neither Madam L nor her husband had the resources to finance the much higher building required by the P.W.D., so that substantial outside finance was required. This had not been foreseen by Madam L and her husband when the Taxpayer acquired the property; there had been no indication of such a requirement until after the plans for the 4 storey building had been lodged. The project could not be delayed because of the time limit for complying with the building covenant.
- (n) The Taxpayer's minuted resolution of 15 July 1971 to erect a 14 storey building in place of the 4 storey with the 4th to 11th floors for sale was the first contemplated sale of any part of the building. In October 1971 this was amended to a 15 storey building with the "4th to 12th floors for sale in order to finance cost of construction and repayment of loan".
- (o) As pre-completion sales would only bring in 30% of the purchase price prior to the issue of the occupation permit it was necessary to obtain bridging finance of \$1.1 million by a building mortgage.
- (p) It was always Madam L's intention not to sell any more flats than were necessary to finance construction costs and repay the mortgage debt. In fact the 4th and 6th floors were not sold because the Taxpayer's cash flow was

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sufficient to meet its commitments. This was in line with her intention for the Taxpayer to retain as much as possible of the building for letting out.

12. In answer to questions in cross examination Madam L agreed that Nos. 35-37 H Road consisted of old pre-war buildings partly built of timber, which were rent controlled; that in the years following their acquisition the rent received was less than expenses and that the Taxpayer was not prepared to allow this annual loss to continue indefinitely; that redevelopment was not then considered because circumstances were unsuitable for redevelopment; that redevelopment was to wait until circumstances were favourable.

13. We accept the submission of the Commissioner that Madam L is a shrewd business woman and as such we find that it was her intention, and therefore that of the Taxpayer, that Nos. 35-37 H Road eventually would be redeveloped.

14. Mr. Gill's submission on behalf of the Commissioner is that the erection of the building and the sales of flats had all the hallmarks of a typical Hong Kong business of development of property for sale. For this submission he relied on the facts:-

- (a) that the Taxpayer had admitted that the flats sold were always intended to be sold;
- (b) that flats were advertised for sale and printed price lists were issued;
- (c) that contract for the sale and purchase of flats were entered into before the new building was completed.

15. As to (a) in paragraph 14 above we note that the Taxpayer's intention to sell some of the flats was first evinced in a resolution of the directors dated 15 July 1971.

16. In addition to the facts on which the Commissioner made his Determination and which are admitted by the Taxpayer or found by this Board, viz. paragraph 1, 2, 3, 8(a) to (g), we find as facts the evidence of the Taxpayer set out in paragraph 11 except the following:-

- (a) We accept 11 (e) and 11 (f) but qualified by our findings set out in paragraph 13.
- (b) As to 11 (k) we find this to be just as consistent with Madam L's desire to avoid a forced sale in a depressed market as an intention not to sell at all.
- (c) As to 11(m) we find that when the Taxpayer acquired the property, with the inevitability of future redevelopment, outside financing could have been a possibility.
- (d) As to 11(n), this is accepted subject to our findings in paragraph 13.

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17. We have come to the conclusion that the property was acquired by the Taxpayer as a long term investment when it was incorporated in 1965.

18. But that when the Taxpayer's directors resolved on 15 July 1971 to redevelop by a 14 storey building and to sell units to pay for this redevelopment and then implemented this resolution by advertisements and sales brochures followed by actual sales before completion of the building, these activities constitute badges of trade. We find that the Taxpayer embarked on the business of trading in land on 15 July 1971.

19. The appeal is allowed to the extent that assessable profits are to be computed on the cost of land being at the agreed value of \$1.7 million on 15 July 1971 and the proportion of this amount attributable to the units sold being allowed as part of the cost thereof.