

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D13/88

Profits tax – sale of block – whether profits were trading gains or realization of capital – evidential factors: inconsistent accounting treatment and statement by managing director – s 14 of the Inland Revenue Ordinance.

Panel: Henry Litton QC (chairman), Norman Leung Nai-pang and Eric Lo King-chiu.

Dates of hearing: 14 March; 2 to 5 May 1988.

Date of decision: 31 May 1988.

The taxpayer company purchased a block of land in 1969. The block was compulsorily acquired by the government in 1981. During that period, the block was let. The Commissioner of Inland Revenue assessed the gains to profits tax.

The taxpayer owned a substantial number of properties, some of which had admittedly been the subject of trading. The property concerned appeared to have been treated as trading stock in the taxpayer's accounts. No depreciation allowances had been claimed with respect to it, although allowances had been claimed with respect to other properties.

Held:

The taxpayer had not established that the property had been acquired as a long-term investment.

- (a) There was no reason to suppose that a mistake had been made in the way the property had been classified in the accounts.
- (b) The accounts, signed by the taxpayer's directors and certified by the auditors to show a true and fair view, provided strong contemporaneous proof of the company's intentions regarding the property.
- (c) A bare declaration by the managing director as to the taxpayer's original intention carries little evidential weight when his statements in the company's accounts are different. The fact that he did not understand English, and therefore could not understand the accounts when he signed them, carries little weight particularly where the company has been represented by professional accountants throughout the years.

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Appeal dismissed.

Case referred to:

Harvey v Caulcott (1952) 33 TC 159

Lee Yun-hung for the Commissioner of Inland Revenue.
A R Suffiad instructed by Lo & Lo for the taxpayer.

Decision:

1. The taxpayer company (the company) was incorporated in June 1966 and has, for a large number of years, been engaged in a variety of business activities: these include pawn-broking, money-lending, and the holding of shares (in both publicly-quoted and private companies) for investment. The company has also been very actively involved in the purchase and re-development of landed properties for re-sale. The company has also purchased a large number of properties which have never been re-developed; some have been re-sold after a short time, others have been held for a considerable length of time. The company has, in the meanwhile, derived rental income from the properties it owned.

2. The company was set up by Mr X who has, since the company's incorporation, made all the decisions concerning its business. There were, at the material time, two other directors of the company: they were Mr X's wife and nephew who, however, took little part in the decision-making process of the company. There were never any formal meetings of the board of directors; accordingly, no minutes of directors' meetings have been produced.

Property A

3. One of the properties owned by the company was Property A. It was a pre-war three-storied building, purchased in 1969 and subsequently surrendered to the Government (under threat of resumption) in 1981. The cost of acquisition was approximately \$42,000, and it was surrendered to the Government for \$1,650,000. The resultant gain of \$1,606,070 was treated as an extraordinary item in the company's accounts for the year ending 31 March 1982 and was not offered for assessment in relation to profits tax.

4. The question for our consideration is whether this profit on disposal of Property A amounting to \$1,606,070 came from the sale of a capital asset, or whether it was the result of the realisation of the company's trading stock.

The evidence

5. Mr X, the managing director of the company, gave evidence before us to the effect that in 1969 he came to know from a friend that Property A (the property) was for sale.

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The person who owned the property had recently died; the family lived on the first floor, but the ground and second floors were let to third parties; if Mr X bought the property, the deceased's family would vacate the first floor and this could be let out as well. After some negotiations, the property was purchased for \$42,000. After the family of the deceased had vacated the first floor (which was about three months after the purchase), a tenant was found for the first floor and the total rental yield of the property, at the time of purchase, was \$6,840 per annum, which gave a yield on the purchase price of over 16%.

6. Mr X gave evidence to the effect that the property was acquired for rental income because of the good yield. The property was far too small in site area for re-development. It was a corner-house (being separated on one side by a scavenging lane from the adjoining property) and he took no steps of any kind, after the purchase, to acquire the adjoining house with a view to re-development. The property was never advertised for sale, and it remained in the company's ownership, deriving rental income, until the surrender to the Government some 12 years later at a profit – a surrender which was forced on the company because, if the property had not been surrendered, the Crown would have exercised its powers of resumption.

7. If the facts, as recited above, had stood alone, then a strong inference would have arisen that the company had acquired the property, and held it ever since, as a long-term investment. The facts would have been consistent with Mr X's declared intention, expressed in his testimony before us, that the purchase of the property was for long-term investment. However, the facts do not stand alone.

The company's property dealings

8. In the course of his evidence, Mr X put before us four schedules of properties, as follows:

Schedule 1

This consisted of 41 properties acquired by the company at different times, and held for different lengths of time, which were said to be properties acquired for long-term investment purposes. Property A was included in this schedule.

Schedule 2

This consisted of three properties, which were said to have been acquired for directors' residence/staff quarters.

Schedule 3

This consisted of 23 properties, acquired at different times, which were said to be properties for re-development for sale.

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Schedule 4

This consisted of 17 properties, held for varying lengths of time (and only one for more than about 2 or 3 years) which were said to have been acquired for re-sale.

9. The four schedules were prepared for the purposes of this tax appeal. The way in which the properties of the company has been classified in the four schedules is not reflected in the financial statements of the company over the years. The landed properties of the company were classified in the financial statements as follows:

(i) In the year in which Property A was purchased (year ending 31 March 1970), the property was classified in the balance sheet under the general heading 'properties' with the sub-heading 'Land and Building'. The addition to 'Land and Building' during that year was \$1,002,191.30 and, in a 'list of additional land and building' accompanying the accounts, which included Property A, there were other properties which undoubtedly formed part of the trading stock of the company. These were Property B, Property C and Property D (which are included in schedule 3, tendered by Mr X as the schedule of properties acquired for re-development for sale). There is also included in the same list of additional properties Property E, the upper floors of which were re-developed for sale.

(ii) In the balance sheet for 31 March 1971, the classification of the company's landed properties was as follows:

'PROPERTIES, at cost (per schedule attached)

Land and building
Unsold flats
Properties under re-development
Properties under joint development.'

Property A was classified under the sub-heading of 'Land and Building'.

None of the company's landed properties was classified as FIXED ASSETS (within which classification there was only a motor car and furniture and fixtures).

(iii) In the balance sheet as at 31 March 1972 there appeared, under the heading of FIXED ASSETS, a reference to staff quarters. No other properties were included as fixed assets. All the other properties of the company (including Property A) appeared under the general classification of PROPERTIES.

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- (iv) During the year ending 31 March 1978, three out of the nine properties the company purchased were classified as FIXED ASSETS, the rest appearing in the accounts under the general heading of OTHER INVESTMENTS. In the notes to the accounts, the same four sub-groups for the landed properties appeared as before, namely:

Land and Buildings
Unsold flats
Properties under re-development
Properties under joint development.

- (v) During the year ending 31 March 1980, Property F which was under joint development was transferred to FIXED ASSETS upon the completion of the construction. Property A remained under the same property classification as in previous years.

10. A close scrutiny of the four schedules produced by Mr X in his evidence shows that, plainly, his attempted re-grouping of the company's properties is unsound. Schedule 1 is claimed by Mr X as 'properties acquired for long-term investment purpose' but, when one looks more closely at some of the properties in schedule 1, the claim appears very dubious. For example, there is a Property G acquired in the same year as Property A, with a rental yield even better than that of Property A, 18.15%; and yet, Property G was sold in the year ending 31 March 1973 and the resulting profit was offered by the company for assessment as a trading profit.

11. As we have stated above, in the year in which Property A was purchased, there was an addition of a total of nine properties to the company's portfolio. Property G was one of them. As to the remaining seven, every one was re-developed for sale, and the subsequent profits were offered for assessment as trading profits – the only slight exception was Property E, where the property was also re-developed for sale, except that the ground floor car park was retained by the company for rental income and remains to this day in the company's ownership.

12. Not only did Property A appear in the company's financial statements, in the year of purchase, in the same list as undoubted trading stock, the subsequent treatment of the property was consistent only with the management of the company regarding Property A as trading stock. From the year ending 31 March 1972 onwards, a distinction was drawn in the accounts between properties for which a re-building allowance was claimed, and properties for which there was no such claim. It was only in relation to 'staff quarters' under the classification of FIXED ASSETS that a re-building allowance was claimed.

13. Furthermore, no depreciation was charged in the company's accounts in respect of Property A. However, depreciation was charged in respect of capital assets including staff quarters.

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14. In the year ending 31 March 1975, the profit and loss account of the company shows two significant items:

- (i) Landed properties at a cost of \$1,453,903 were disposed of, and the profit on these sales was reflected as 'gross profit from sale of properties' in the profit and loss account.
- (ii) There was also a profit of \$2,781 from 'disposal of fixed assets', being sale of the staff quarters.

Plainly, the company's management distinguished between profits from sale of trading stock (landed properties) and sale of fixed assets (staff quarters). If, for example, Property A had been sold in the year ending 31 March 1975, there seems no doubt whatever that it would have come within the figure of 'gross profit from sale of properties'; it could never have been treated as 'profit on disposal of fixed assets'.

15. The accounting treatment of Property A in the accounts of the company is consistent with only one thing: that the management of the company regarded Property A as trading stock. This is not surprising. The company was heavily engaged in the business of buying property for re-sale and re-development. There was plainly no firm policy of the company (or of the managing director, Mr X) of holding properties for rental income as such. Although Mr X gave detailed evidence regarding the circumstances of the purchase of Property A, he told the Board nothing concerning any system which the company might have set up regarding rent collection: how many persons were employed, or how the rent from the wide diversity of properties was actually collected. Many of the properties yielded, individually, a very low rent: a few hundred dollars here, a few hundred dollars there. If the company had a systematic business of property ownership for long-term investment, encompassing the 41 properties set out in schedule 1, there would have been some sort of rent collection system set up. We do not go so far as to infer that the company had no properties held for long-term investment – each individual transaction would have to be examined with care before such a conclusion could be drawn – but we doubt very much whether the claim is as wide as asserted by Mr X in schedule 1.

16. As regards the circumstances of disposal of the property, it was submitted to us that, but for the threatened Crown resumption in 1981, the company might well be holding the property still to this day. This may very well be so but, if the property was held throughout as trading stock, the fact that it was not sold within a short time of purchase is not relevant. Two other properties of the company, classified in the accounts as 'Land and Buildings', were also resumed by the Government. The profit on the compensation received from the Government was offered for assessment to profits tax in the years concerned.

17. Initially, the company's notice of appeal included a ground to the effect that (without prejudice to the main contention) the property was required for dealing purposes but the company later changed its intention to hold the property for long-term investment.

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This ground of appeal was however abandoned, and we are left thus with this proposition: if the property was trading stock in the earlier years, it remained trading stock when the Crown resumed the property in 1981.

Expert evidence

18. At the hearing before us, the company called a senior lecturer in the Department of Accountancy of one of the Hong Kong polytechnics as an expert witness. This witness was a Fellow of the Institute of Chartered Accountants of a Commonwealth country. She drew attention to the four sub-heads under which the company's properties were classified in the financial statements (as set out in paragraph 9(ii) above), and expressed the view that 'unsold flats' and 'properties under re-development', which would normally be trading stock, should not be classified under the same general head as 'Land and Buildings'. She also said that where 'Land and Buildings' were acquired with the intention of use in business for generating income, these should be classified as fixed assets.

19. In our judgment, this witness' testimony added little to the case as presented before us by the company. The classification of assets in a company's accounts would, generally speaking, be an expression of the company's intentions regarding those assets; the expert witness cannot, for obvious reasons, tell the Board what those intentions might be. All she can do is to give the Board the benefit of her knowledge with regard to the vocabulary generally used by accountants. Here, the expression 'Land and Buildings' has no particular flavour, not having been classified either under fixed assets or current assets.

The taxpayer's submissions

20. It was submitted on behalf of the company that the case cannot be decided by the way the property was treated in the company's accounts. It was urged upon us by Counsel that the facts and circumstances surrounding the acquisition and disposal of the property, coupled with the length of ownership and the fact that no attempts were ever made to either re-develop or sell the property, showed that the property was intended all along as a long-term investment, held for rental income. As for the company's long history of extensive property dealings, the case of Harvey v Caulcott (1952) 33 TC 159 was cited to us by Counsel for the company to illustrate the fact that a builder, putting up shops and houses for sale, could nevertheless hold such properties as investments. We take these points into account. What we do not accept in the submission made on behalf of the company is the suggestion that the classification of the assets in the company's accounts is a mere matter of 'labelling'. What we consider to be of significance is the consistency of accounting treatment as regards Property A, as we have summarised above, which has throughout been treated together with many other properties as trading stock. The accounts, signed by the directors and certified by the auditors to show a true and fair view as at the various accounting dates, provide strong contemporaneous proof of the company's intentions regarding the properties. Error in classification is sometimes made by directors and by professional accountants, but there is no reason to think that any mistake has been made in this case.

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21. The reality of the situation is that, in many instances (we do not say all), a property was acquired by the company because the price was judged by the managing director to be right. Later on, if an offer to purchase was attractive, the property was sold – irrespective of what the rental yield might have been. Property G is a good example. In many such instances, the subsequent profit was offered for assessment as a trading profit.

Conclusion

22. Ultimately, the burden falls on the company to satisfy us by evidence that the assessment was erroneous. A bare declaration by the managing director in the witness box that he (or the company) did not intend to acquire Property A for re-development or re-sale, and intended it as a long-term investment, carries little weight when his own statements as a director of the company appearing in the company's accounts suggest something quite different. We attach little weight to Mr X's testimony that, being ignorant as to English, he could not understand the accounts which he signed. The fact is that the company has, throughout the years, been professionally represented by professional accountants; the information which finally went into the company's accounts could only have come from the management of the company.

23. In our judgment, this appeal fails and must be dismissed. However, there is a small error in the Commissioner's determination which we take this opportunity to correct: a re-building allowance in respect of the property has been claimed only for one year of assessment, 1970/71; therefore the profits tax assessment for the year in question, 1981/82, should be reduced by the sum of \$157. We therefore dismiss the appeal and direct that the assessable profit be amended to \$4,954,951, taking into account the miscalculation in respect of the re-building allowance.