INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D14/92

Profits tax – private company – purchase of property and subsequent resale – whether surplus or profit assessable to tax.

Panel: Denis Chang QC (chairman), Ronald Leung Ding Bong and Peter C White.

Dates of hearing: 6, 7 8, 9 and 24 January 1992.
Date of decision: 22 June 1992.

A private company which was a joint venture between two individuals purchased certain property in Hong Kong. The property was stated to be a long term capital investment but was subsequently sold at a substantial profit. The period of ownership of the property was only about 12 months.

The taxpayer submitted that the property had been purchases as a long term capital investment and produced evidence to support this subjective assertion. It was submitted that the reason for the sale was because one of the two owners of the taxpayer was experiencing financial difficulties.

Held:

The subjective intention stated by a taxpayer must be tested against the objective facts. The Board were not satisfied that the taxpayer did intend to hold the property as a long term investment.

Appeal dismissed.

[Editor's note: the taxpayer has filed an appeal against this decision.]

Cases referred to:

Chinachem Investment Co Ltd v CIR 2 HKTC 261
Hillerns & Fowler v Murray 17 TC 77
Simmons v IRC [1980] STC 350
Shadford v H Fairweather & Co Ltd 43 TC 291
Cunliffe v Goodman [1950] 2 KB 237
Marson v Morton [1986] 1 WLR 1348
Beauchamp (Inspector of Taxes) v F W Woolworth [1989] STC 510

Luk Nai Man for the Commissioner of Inland Revenue.

Edward K S Chan QC instructed by Messrs Sit, Fung, Kwong & Shum for the taxpayer.

Decision:

The primary issue in this appeal is whether the profits for which the Taxpayer was assessed to tax under section 14 of the Inland Revenue Ordinance were profits arising from the sale of a capital asset as the Taxpayer contends or were trading profits as the Revenue contends. A subsidiary issue concerns the correct treatment of exchange loss incurred on repayment of a loan. The following facts are agreed:

1. The Taxpayer is a private limited company ('the company') which was incorporated in Hong Kong in early 1987. At all times the company had an authorised capital of $10,000 and a paid-up capital of $2 consisting of two shares of $1 each issued in the name of two nominee companies.

2. By an instrument dated 6 May 1987 each of the two nominee companies separately declared that it held the share registered in its name for a Mr B, [overseas address mentioned].

3. By an agreement for sale and purchase dated 26 May the company agreed to acquire a property ('the property') for $331,537,675. The property was then under development into 2 blocks of domestic apartments and a car park.

4. The said purchase price was payable in the following manner; (1) $66,307,535 being deposit and in part payment of the purchase price to be paid and released to the vendor upon the signing of the agreement to be paid and released to the vendor upon the signing of the agreement (2) $265,230,140 being the balance to be paid on completion.

5. Completion was to take place at the offices of Messrs Woo, Kwan Lee & Lo within 40 days of the purchaser being notified in writing that the Occupation Permit in respect of the building had been issued and that the vendor was in a position to validly assign the property to the purchaser without any encumbrance.

6. The said agreement expressly permitted the purchaser at any time before completion to sub-sell the property or any part or parts thereof as well as to charge mortgage or assign the benefit of the agreement.

7. The deposit paid was financed by an interest-bearing advance form Mr B. The advance carried no specific term of repayment and interest was charged at 2.5 per cent per annum.

8. By an agreement made in mid-1988, the company agreed to sell, in the capacity of a confirmor, the property at a price of $390,000,000.

9. The Occupation Permit of the property was issued 2 months later.

10. In its accounts from the date of incorporation to 31 March 1988 the company showed a 'deposit on acquisition of property held for investment purposes' of $66,307,535 under 'current assets'. The company also showed the following 'current liabilities':

	$
Other unsecured loan	66,456,000
Creditors and accruals	1,471,106
Taxation	12,288
	$67,939,394

11. In its accounts for the year ended 31 March 1989 the company classified as an 'extraordinary item' a profit of $58,462,325 on sale of the property. The company did not offer this profit for assessment in its proposed tax computation for the year of assessment 1988/89.

12. The company incurred an exchange loss of $45,590 on repayment of the advance referred to in (6) above. The advance was repaid form proceeds of the sale.

13. The company went into creditor's voluntary winding-up in mid-1989.

It is not in dispute that the company had no assets to speak of other than its interest in the property and that it had no staff of its own. It started life as a shelf company of a solicitors' firm before it was purchased on 6 May 1987, Mr B becoming the sole beneficial owner under the declarations of trust mentioned above. The deposit funded by Mr B by way of an interest-bearing loan to the company amounted to 20% of the purchase price; the loan was repaid with interest following the sale of the property. The property was purchased en bloc and sold en bloc in the course of construction after the company had held it for about a year.

Mr B was not called as a witness; the key witness called by the company was Mr A who was at all material times the only resident director of the company. The other director was Mr R, son of Mr B.

We find as a fact that in early February 1987 Mr B telephoned Mr A, whom he had known since 1981/82, to tell him that someone had tried to interest him in the property; Mr B apparently wanted Mr A's opinion because he knew that the prospective vendor was Limited A and that Mr A was a director and shareholder of Limited A. The two then met outside Hong Kong on four separate occasions over a period of three months or so to discuss the matter and eventually Mr B decided to have the property purchases by the company. Mr

A had indicated a price of around $1,300 per square foot; the price that was agreed was worked out on the basis of $1,225 per square foot.

There is no dispute that Mr B then wired in the necessary funds for payment of the deposit. Mr B was not here to tell us the state of his finances but we are prepared to assume that the funds were from his own resources and that he was indeed a man with extensive business connections both in and outside his home country, country J. We cannot assume, however, that he was able and willing to dig into his own pocket to finance the balance of the purchase price; we think we can safely proceed on the basis that there could be no completion of the purchase without obtaining the necessary bank finance – that is assuming there was no re-sale before completion.

It seems that Mr B had never purchases any real property in Hong Kong before. He had once invested US$1,000,000 in the equity of one of Mr A's companies, namely H Ltd and had also participated in a joint investment with Bank A. He did not visit Hong Kong in connection with the acquisition of the property. It was his son who came.

We find as a fact that on 6 May 1987 his son was brought by Mr A to the offices of Messrs Sit, Fung, Kwong & Shum, solicitors where instructions were given to a partner, thereof one Mr C (who was called as a witness and who corroborated Mr B's evidence on the visit) to prepare the necessary documentation for purchasing the company off the shelf; he told Mr C that the directors of the company would be himself and Mr R.

On the same occasion, we find, Mr C was instructed to prepare minutes of a directors' meeting of the company held there and then at the solicitors' office (which was the registered office of the company); he was told to, and he did, include the following resolution in the minutes: 'That the intention of purchasing of the property P is for a long-term investment income of the company and it should be classified in the balance sheet as fixed asset'.

The minutes thus prepared were sent together with the declarations of trust dated 6 May 1987 to the Stamp Duty Office for adjudication. We find that this was done deliberately with the object of getting independent verification of the authenticity of the minutes. 'I wanted to make sure,' Mr A said when cross-examined on the point, 'that nobody can accuse us of producing some document that was not duly signed in front of witnesses on that date.'

Mr A, in passing, explained that he had the 'painful experience' of a case in which certain property was classified by the auditors as 'current assets' despite the fact that it was held for 20 to 30 years. Mr A was determined to see to it that nothing like that would happen this time. Mr A, we find, was quite familiar with both the accounting as well as with the tax aspects.

Neither the accounting treatment nor the minutes, of course, is in any way conclusive of the issue at hand. Common sense dictates that expressions of subjective intent have to be tested against objective facts and circumstances: see, for example, Chinachem

Investment Co Ltd v CIR 2 HKTC 261 at 271 and Hillerns & Fowler v Murray 17 TC 77 at 87.

It is the Revenue's case that the objective facts and circumstances all point to the conclusion that when the property was acquired Mr B had not in fact made up his mind that it would be held for long-term rental income; that he did not have the material to enable him so to decide; that he kept his options open, intending to turn the property to profitable account either by sale or by letting; that the purchase and subsequent sale of the property was an adventure in the nature of trade; that in any event the company has not discharged its onus of showing that the assessment appealed against was incorrect.

'It is not possible for an asset to be both trading stock and permanent investment at the same time, nor for it to possess an indeterminate status, neither trading stock nor permanent asset. It must be one or the other, even though … the company, in whatever character it acquires the asset, may reserve an intention to change its character. To do so would, in fact, amount to little more than making explicit what is necessarily implicit in all commercial operations, namely that situations are open to review' per Lord Wilberforce in Simmons v IRC [1980] STC 350 at 352.

Thus, property is not acquired as a permanent investment if the intention at the time of acquisition is to turn the asset to profitable account either by selling it or letting it: see Shadford v H Fairweather & Co Ltd 43 TC 291 at 299. Furthermore a piece of property does not have the character of a permanent investment merely because it is within the contemplation of the taxpayer to let out the property; something may well be within the taxpayer's contemplation before he has definitely made up his mind, before it can be said in any realistic sense that the requisite 'intention' exists.

'Not merely is the term "intention" unsatisfied if the person professing it has too many hurdles to overcome, or too little control of events: it is equally inappropriate if at the material date that person is in effect not deciding to proceed but feeling his way and reserving his decision; until he shall be in possession of financial data sufficient to enable him to determine whether the project will be commercially worthwhile': Asquith L J in Cunliffe v Goodman [1950] 2 KB 237 at 254 and see also 253.

In the present case, the matter clearly went well beyond mere 'contemplation' in at least one respect; it actually went past the point of 'decision' to that of an accomplished fact, namely the acquisition by the company of the property (albeit with 80% of the purchase price still to be paid upon completion). Mr B had already shown the colour of his money by coming up with the funds for the deposit. In doing this had he also made up his mind, and did the company truly intend, to have the property acquired as a permanent investment? To answer this question it is necessary to look at the total picture.

It is also important to remember that the so-called 'badges of trade' are in no sense a comprehensive list of all relevant matters nor is any one of them decisive in all cases; the most they can do is to provide common sense guidance to the conclusion which is appropriate; the question whether or not there has been an adventure in the nature of trade

depends on all the facts and circumstances of each particular case and depends on the interaction between the various factors that are present in any given case: per Sir Nicolas Browne-Wilkinson V-C in Marson v Morton [1986] 1 WLR 1348.

In the present case an important factor is the level of rental yields compared with other options. Mr A acknowledged that the market rental for unfurnished flats was then around $10 per square foot per month and that this would work out to something like 8% per annum return which Mr A said 'was not really sufficient to cover interest charges because the interest charges in those times were more or less 10.5% or 11%'. It must have been clear to Mr B, and indeed Mr A said he told Mr B this, that if the units were let out unfurnished, the company would be faced with a negative cash-flow and that the situation was unlikely to improve before the expiry of the initial lettings: this meant at least three years down the line from the date of Mr B's outlay of $66,300,000 for the payment of the deposit.

It is clear that Mr A was not expecting that the rental market for the type of domestic property with which we are concerned would improve by the time the building was completed; in fact, as it turned out, and the figure came from Mr A himself, the market rental for unfurnished flats was still around $10 per square foot in about May 1988. We think this gives a better and more relevant indication of the generally slow rental market at all relevant times than what Mr D (an expert called on behalf of the company) was able to extract from the Government Property Reviews.

Mr A said that Mr B was 'hesitating quite a bit' over whether to go ahead and that he was 'very concerned' about such things as whether it was possible to obtain the necessary finance for the balance of the purchase price and who would look after the matter for him. Mr A told Mr B that he had checked with a number of banker friends about the prospect of obtaining finance on 75% of the value of the property and that 'the response was that for a person of Mr B's standing it should not be an unduly difficult loan to arrange.'.

But it is clear to us that, even if Mr A was able to give to Mr B some comfort (unsupported by any subsequent concrete approach to any bank for confirmation of the facilities likely to be available on completion) on all other matters, the concern over the projected yield remained. 'He was asking me,' said Mr A, 'if I can see any way of making the project more interesting for him. So I put it to Mr B that it might be possible after the Occupation Permit to furnish the building as service flats and apartments and lease them out at a higher rate because at that time the market rate for service apartments was in the region of at least $16 per square foot per month.'

It was Mr A who emphasised the tentative nature of the suggestion because, as he told Mr B, although he was very experienced in the property field (having been, to use his own words, 'in this game for many years') he possessed no particular expertise in the service-flat rental business and did not have reliable information to give to Mr B on such matters as the probable cost of converting unfurnished units into service apartments.

No study on the feasibility of service apartments was caused to be done by Mr A until early March 1988. The building was then expected to be completed by around July or August 1988. The written feasibility report was not finalised until 20 April 1988 although it was probable that Mr A did, as he suggested, had some advance notice of its contents. Mr A concluded that conversion would cost some $10,000,000 and in the face of competition against better-located properties would not be viable.

However, in March 1988 even before the report was anywhere near completion Mr B began to make noises about the financial pressure he said he was experiencing and his desire to get immediate cash from the property to help service what he said was an increasingly heavy loan service bill. Mr A said that Mr B was not in any sense desperate; simply that he appeared to be under pressure. Without the benefit of Mr B's direct evidence, we are not prepared to accept that this pressure, if it existed, was due to any sudden turn of events that had become apparent to Mr B only since March 1988.

We find that by late April 1988 Mr A was telling Mr B that he could get together a group to take over the property. This he did in a matter of a few days, in what he described as 'a back-of-an-envelope deal': the group which purchased the property using a corporate vehicle was formed by his wife and some friends who were all experienced in these matters. Mr A said they bought at market price with reasonable expectation of making a profit down the line.

The decision to sell was recorded in a minute of a directors' resolution dated 6 May 1988. Mr A signed the minute and had it sent by DHL courier service to country J; Mr R signed and returned it. After referring to the offer as 'unsolicited' the minute stated, inter alia: 'Preliminary budgets were prepared and tabled at the meeting demonstrating that sale of the property at the above price would be more beneficial to the shareholders than to hold the flats and other parts of the property for rental. The directors anticipated that the proceeds of sale of the property would be able to be reinvested into other projects with a much higher yield'.

The minute further stated: 'The shareholders of the company are advised of all prospects of reinvestment at a greater yield and accordingly the shareholders have given their consent to sell the property'. Then followed the resolution to sell and authorisation to Mr A to sign the agreement.

Mr A admitted that the reference to the offer as 'unsolicited' was not quite correct; further, that no budgets were presented; and that in fact the company never thought of reinvesting. He said he signed the minute because he wanted something for his own protection. We think this is only partly true. It is quite plain to us that the minute was drafted also with tax implications in mind. We think Mr A wanted a document on file which would, apart from giving him the necessary authority, also support a case of continuing intention to invest. In so doing he was prepared to and did take a few liberties with the truth.

Mr A made it clear this was not a case in which the sale came about because of some totally unexpected and dramatic rise in property prices. By the end of the first quarter

of 1988 property prices were, to use Mr A's words, 'comfortably up'; he also said the trend could be described as 'solidly slow up'. Mr D's picture was somewhat more optimistic based on the property review figures pertaining to sales of flats in completed buildings: an actual rise of between 18% and 25% over the previous 12 months. The upwards movement appeared to have begun slowly and gently during the first quarter of 1987, that is around about the time of acquisition of the property by the company.

Much of the activity which followed the re-sale by the company related to the disposal of the proceeds and the eventual winding-up of the company. On 24 August, 2 and 9 September 1988 Mr B was, by way of three payments, repaid the entirety of the principal sum lent by him to the company. On 3 October 1988 he was paid the interest on the loan.

The surplus proceeds which could have been distributed to Mr B by way of dividend if no provision was made for tax liability amounted to some $56,000,000. Mr A said tax liability was estimated to be around $9,500,000 should the contention that the property was a capital asset be rejected. On 2 December 1988, however, the whole sum of $56,000,000 was, at least according to the books of the company and Mr A's evidence, paid over to Mr B, with $9,500,000 thereof being booked as a loan to Mr B (by reason of the tax liability contingency) and the rest paid to him outright as dividend.

When asked why, if Mr B was indeed a man of means, Mr A should have thought fit in the statement of affairs of the company to certify (which he did) that the recovery value of the $9,500,000 loan was 'Nil'. Mr A said he had forgotten the reason but, after reflection, said that although he was '80% to 90% sure' about its recovery he thought he should still put down 'Nil' because he was not Mr B and therefore could be wrong. We do not accept the explanation.

The simple truth, we think, is that whatever the chances of recovery of the $9,500,000 loan were, Mr A was not inclined to encourage the Revenue to think there would be any money in the kitty. He did the opposite. Indeed he also caused or permitted a creditors' voluntary winding-up to take place, the creditor being an accountant of H ltd whose book debt of $10,000 for services rendered to the company was then left outstanding so that he could, upon request, wind up the company (which he did in July 1989).

Mr A produced a Chinese-language document dated 4 April 1988 which, on its face, appointed one of Mr A's companies, namely T Ltd as sole rental agent for the company with authority to lease the property at a monthly rent of not less than $12 per square foot. The appointment letter was expressed to be valid for three months starting from the date of the Occupation Permit. Ms E, one of Mr A's staff, signed the letter on behalf of the company.

The said letter was produced to the Revenue along with correspondence generated by various staff members of Mr A acting in one capacity or another: one such letter dated 6 May 1988 stated that 'due to unforeseen events' the directors had resolved not to rent out the property; another letter was a response from T Ltd claiming damages of around $5,200,000 for alleged breach of the appointment letter.

There is, we find, an air of unreality about these documents, including the appointment letter. Mr A testified that the expected rental for unfurnished flats was around $10 per square foot per month; when asked why $12 per square foot was specified as the minimum he said words to the effect that it was just an instance of someone wanting to shoot 'for the moon'. One would have thought that T Ltd would not have accepted appointment on an unrealistic basis; that Mr A, if only for his own protection, would have sought confirmation of agreement at Board level instead of getting one of his staff to act on behalf of the company to contract with his own company.

We do not believe that the appointment letter dated 4 April 1988 was a product of any real discussion between Mr A and Mr B. According to Mr A's own evidence, Mr B had by then already been telling him about his increasing financial pressure. We think the appointment letter, like the correspondence referred to earlier, was just one of those documents produced in-house which Mr A found it convenient to have on file. The $12 per square foot, incidentally, was the figure upon which the $5,200,000 damages claim was calculated. The claim itself was simply left lying on file, Mr A happily allowing Mr B to take out what was in the kitty following the sale.

Even if the appointment letter is taken at its face value it does not prove that at the date of acquisition a decision had been made that the property should be held and rented out as a long-term investment. The letter on its face represented at best a decision, made some eleven months after the company's acquisition, to appoint a rental agent for a trial period of three months to test the market to see if lettings could be obtained at a rate which Mr A accepted was unrealistic.

After considering the total picture, including such evidence there was of market trends and perceptions, we think the probabilities are that at the date of acquisition Mr B had not made up his mind that the property would be let out at all by the company furnished or unfurnished; and we so find. We are unable to accept Mr A's evidence insofar as he asserted or suggested otherwise. In particular, we do not accept that the only thing that was left to be decided was whether the lettings should be of unfurnished flats or of service apartments.

We find that the true intention of Mr B, which was also the true intention to be attributed to the company, was to turn the property to profitable account either by sale or by letting. We think Mr B did not find the letting option attractive because of the then projected low rental yield; he was probably shrewd enough to appreciate, even without the benefit of any feasibility report, that conversion into service flats would require additional cost and organisational back-up. It is unlikely however that he should have ruled out at the start the possibility of letting out the property in a form that would bring in the best return.

The flexibility that he required was facilitated by the terms of the sale and purchase agreement insofar as it contained standard provisions expressly allowing sub-sale of the property prior to completion and a clause providing for a longer than usual period for completion after notification of Occupation Permit, 40 days instead of 14 for

run-of-the-mill sale of flats. The vendor was happy to allow 40 days after Mr C, the solicitor handling the transaction for the company, had told the vendor's solicitors that there was a possibility of his client wanting to let out the flats and therefore needed more time to cater for such things as inspection of flats after completion, marketing and preparation of leases.

We should make it clear that we accept Mr C's explanation that when he used the word 'possibility' he did not mean to throw doubt on his client's instructions, already expressed in the minute of 6 May 1987 which he had been asked to and did prepare, that the company's intention was to hold the property for long-term rental income. However, we do not accept that the minute reflected the company's true intention in this regard.

A striking feature of this case was the apparent ease with which the property, purchased in bulk, was re-sold in bulk at a handsome profit when it was still in the course of construction. Mr A told us that Mr B was a foreigner who was alien to the idea of sub-selling individual units, that if he was thinking of buying to sell at a profit he would buy whole and sell whole. Of course the mere fact that, in Mr A's words, Mr B 'bought whole and sold whole' does not mean that he intended right from the beginning to resell. What it does demonstrate, however, along with other evidence is that there was a market for bulk sales which Mr A was eminently in a position to exploit whether for his own benefit or the benefit of friends such as Mr B. Mr A not only had his pulse on the market, he <u>was</u> part of that market.

It was not at all surprising therefore that Mr A should have been able to find a purchaser for the property <u>en bloc</u> without the assistance of property agents, advertising or the like; or that Mr B was apparently content with the profitable offer procured by Mr A, who, after all, had been keeping a careful eye on matters affecting the property and had been in regular contact with him since the company's acquisition of the property.

The fact that there was no sale or attempted sale of individual units of the property was also fully explicable without the need to postulate any intention to hold for rental income; sale by subdivision into individual units might in the end bring in more revenue but would, among other things, require more time and organisation. Selling <u>en bloc</u> must have appeared to someone like Mr B to be neater, less complicated, and given Mr A's well-placed position, likely to be much quicker and in the end bring in a surer profit and make for an easier exit from Hong Kong. The whole structure of this $2 dollar company facilitated easy exit when the market was right. This was precisely what happened.

We find that the company did not acquire the property as a permanent investment. What it embarked upon was a trading or an adventure in the nature of trade. The appeal against the Commissioner on this part of the case is therefore dismissed.

The subsidiary issue, the exchange loss, can be disposed of shortly. The matter has not been fully argued before us but the position seems to be this: a loan was a revenue transaction if it was temporary and fluctuating and was incurred in meeting the ordinary running expenses of the business: <u>Beauchamp (Inspector of Taxes) v F W Woolworth</u>

[1989] STC 510. Despite the fact that the asset purchased has been held by us to be non-capital in nature, it does not follow that the loan was incurred in meeting the ordinary running expenses of the business and it cannot be described as 'temporary and fluctuating'.

We therefore hold that the exchange loss incurred on repayment of the loan was not an allowable deduction. The appeal is therefore dismissed in its entirety and we confirm the relevant assessment.