Case No. D15/92

Profits tax – purchase and sale of property – whether surplus or profit subject to tax.

Panel: William Turnbull (chairman), Lester Kwok Chi Hang and Winston Lo Yau Lai.

Date of hearing: 23 April 1992.
Date of decision: 23 June 1992.

The taxpayer was a private limited company which purchased a shop in September 1987 and sold the shop in January 1989 at a profit. The taxpayer submitted that the shop had been purchased as a long term capital investment. The reason for the sale was that one of the two shareholders of the taxpayer required money because of the stock market crash in October 1987.

Held:

The Board dismissed the appeal. Immediately after the taxpayer had sold the shop it had purchased a number of residential flats which were subsequently sold at a profit and which were trading transactions. The Board rejected the evidence of the director who said that it was the intention of the company to purchase the shop as a long term capital investment.

Appeal dismissed.

Doris Lee for the Commissioner of Inland Revenue.
Jimmy C H Cheung of Messrs Jimmy C H Cheung & Co for the taxpayer.

Decision:

This is an appeal by a private limited company against a profits tax assessment on the profit arising from the sale of certain property which the Taxpayer claimed was a capital profit and not a trading profit. The facts were as follows:

1. The Taxpayer was incorporated in Hong Kong as a private limited company in early 1987. In September 1987 the Taxpayer acquired a shop in Kowloon at a total price including stamp duty and other expenses of $6,989,210.

2. The Taxpayer was a joint venture between two private individuals who owned the issued shares of the Taxpayer in equal shares. The purchase price of the shop was financed partly by interest free loans made by the two shareholders and partly by a bank loan. The Taxpayer sold the shop in January 1989 at the price of $9,450,000 and after making allowance for certain expenses made a profit or surplus on the sale of $2,440,996.

3. When the shop was purchased it was subject to a tenancy agreement. During the period that the Taxpayer owned the shop the Taxpayer collected rental from the tenant of the shop. In the audited accounts of the Taxpayer the rental income and mortgage interest were shown as income and expenses respectively and the Taxpayer claimed depreciation allowance on the shop.

4. The assessor was of the opinion that the profit which arose on the sale of the shop was a trading profit and accordingly assessed the Taxpayer to profits tax thereon.

5. The Taxpayer objected to the profit on the sale of the shop being assessed to profits tax and argued that the shop had been purchased for long-term rental purposes and that there had been a change of intention. The Deputy Commissioner by his determination dated 6 January 1992 rejected the claim by the Taxpayer but reduced the assessment against which the Taxpayer was objecting to take into account the mortgage loan interest which had not been allowed as a deduction from the tax assessment. The assessable profits were reduced by the Deputy Commissioner from the sum of $2,759,802 with tax payable thereon of $469,166 to profits of $2,440,996 with tax payable thereon of $414,970.

6. The Taxpayer duly appealed to the Board of Review.

At the hearing of the appeal the Taxpayer was represented by its tax representative and one of the directors of the Taxpayer ('the director') who was also one of the two joint venture partners who jointly owned and controlled the Taxpayer was called to give evidence. From his evidence we find the following additional facts:

1. As a result of the stock market crash in October 1987 the director had suffered substantial losses exceeding $10,000,000 on stock exchange margin trading and index futures trading which he had been conducting. The dealer or broker with whom he had been carrying on business agreed that he could make payment of the sum of $6,000,000 by instalments. He sold a flat which he had in Kowloon and a flat which he had in Hong Kong but these were not sufficient to cover the debt which he owed. He also mortgaged his private residence leaving an outstanding balance of more than $1,000,000.

2. The mortgage monthly payments which the Taxpayer had to pay to the bank in respect of the bank loan on the shop was about $60,000 per month which was covered by the rental income of the shop plus financial support which the Taxpayer received from the two joint venture partners. The monthly rental was about $60,000.

3. The Taxpayer decided to sell the shop in August 1988 and was successful in selling the shop in January 1989. Out of the proceeds of sale the Taxpayer paid to each of its two shareholders something in excess of $1,000,000. The money paid by the Taxpayer to the director was sufficient to enable him to settle the outstanding balance due to the dealer or broker. The balance of the proceeds of sale of the shop after repaying the bank loan and other expenses was retained by the Taxpayer.

4. At some date after the shop was sold in January 1989 and before 31 March 1989 the Taxpayer acquired ten residential flats in a building not yet been completed.

5. To purchase the ten residential flats the Taxpayer used the remaining balance of the proceeds of sale of the shop plus a bank loan. The Taxpayer was required to pay $55,000 per month to the bank in respect of this loan.

6. The Taxpayer sold the ten residential flats in June to September 1990 at a profit which was offered to the Commissioner for profits tax purposes and was duly assessed to profits tax.

The representative for the Taxpayer submitted that to determine whether or not the profit was a capital or trading profit it was necessary to consider two factors. He said the first was the usage of the property. In this case the property had been purchased subject to an existing tenancy and the Taxpayer had received rent.

The second factor was the length of ownership. He said that the Taxpayer had been forced to sell the shop because of the stock market crash in October 1987. The director had suffered a significant loss and this forced the Taxpayer to sell the shop.

The representative for the Commissioner submitted that it was necessary to look at all of the facts and after reviewing the facts said that the shop was a trading asset and not a capital asset. He said that the appeal should be dismissed and the determination of the Deputy Commissioner confirmed subject to a small reduction in the amount of the assessable profits to allow for the amount of depreciation which had been deducted from the cost of the shop and which should be added back. He submitted that the revised assessable profit should be $2,371,104.

When giving evidence the director said that it had been the intention of himself and his partner to acquire the shop as a long-term investment and that likewise the ten residential flats had been acquired as long-term investments. He said that the intention was to let the ten residential flats to employees of his partner. He said that the reason why the shop had been sold was because of the financial pressure put upon him to settle the balance of the debt which he owed to his dealer or broker. He said that the reason for selling the residential flats was because of the June fourth incident in Beijing. As a result the value of the residential flats declined substantially and it was decided to find purchasers for the flats. It was intended to sell the residential flats in 1989 but the actual sales took place between June and September 1990.

We reject these parts of the evidence of the director. It is not credible that the director and his partner would wait until August 1988 before they decided to try to sell the shop. Immediately after the stock market crash the Taxpayer had sold his own properties and mortgaged his own residential apartment. We have been offered to explanation as to why the director and his partner waited until August 1988 before they decided to sell the shop.

The fact that almost immediately after the shop was sold the Taxpayer acquired the residential flats, borrowing money from the bank for this purpose is also significant. It lends no credence to the claim that less than three months earlier the Taxpayer had sold a long-term investment to raise money to support its shareholders.

Another part of the director's evidence which we do not accept is his statement that the ten residential flats were to be long-term investments for rental purposes. He said that the reason for the change of intention and the sale was because the developer had substantially reduced the sale prices following the June fourth incident. There was no evidence or suggestion that the rental which could be obtained for these flats had been reduced. If the director and his partner had made the decision to buy the ten residential flats for long-term rental income purposes then the fact that the value thereof may have substantially declined would have no relevance to the decision to purchase and hold for long-term purposes. It is clear to us that at best it was the intention of the Taxpayer to purchase the shop and subsequently the ten residential apartments with the intention of collecting rental for the time being and to sell the same as soon as a suitable opportunity arose.

As we have rejected the evidence of the director on the crucial question of whether or not it was the intention of the Taxpayer to hold the shop as a long-term capital investment, we dismiss this appeal and confirm the determination of the Deputy Commissioner subject to the amount of the assessable profit being reduced by the amount of the depreciation allowance which should be added back to the cost of the shop. Accordingly the revised assessable profit should be reduced from $2,440,996 to $2,371,104. We remit the assessment back to the Commissioner to reduce the amount thereof accordingly.