INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D16/88

Profits tax – sale of premises – change of intention – whether profits were trading gains or realization of capital – s 14 of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Benjamin C Kwok and Richard Lee.

Dates of hearing: 17 and 18 May 1988.
Date of decision: 15 June 1988.

The taxpayer company carried on a business of dealing in properties. The properties in question had been owned by it since at least 1972. Although it claimed to hold some properties as investments, its accounts did not distinguish between trading stock and investments. It had claimed capital allowance with respect to some of its properties.

In 1977, the taxpayer's board of directors resolved that henceforth all but one of the properties would be held as long-term investments. No changes were made by the taxpayer to its accounts as a result of this. Between 1980 and 1982, it sold all the properties except its own offices. Each decision to sell was made ad hoc without any firm principle being applied. The IRD assessed the gains to profits tax and rejected the taxpayer's argument that, by passing the 1977 resolution, there had been a change of intention sufficient to convert the trading stock into long-term investments. The taxpayer appealed.

Held:

Except for the taxpayer's own premises, the properties remained trading stock throughout. The profits were therefore assessable.

There must be clear and unequivocal evidence of an alleged change of intention. The mere holding of trading stock for a long time, or the renting out of trading stock, does not of itself show a change of intention. A self-serving statement of intention by the taxpayer is necessary but, by itself, is not sufficient. One must look at other facts. Although it would have been sufficient if the taxpayer had continued to hold the properties for a lengthy period, this was not done. Furthermore, it appeared that the taxpayer was merely attempting to secure a tax advantage by such resolution. The board resolutions would therefore be disregarded.

Appeal allowed in part.

Cases referred to:

James Hobson & Sons Ltd v CIR (1957) 37 TC 609
Sharkey v Wernher [1956] AC 58

Anthony Wu for the Commissioner of Inland Revenue.
A director of the taxpayer appeared for it.

Decision:

The question which the parties asked the Board of Review to decide was whether or not the Taxpayer converted part of its trading stock of properties into long term investments consequent upon a resolution passed by the Board of Directors on 30 September 1977. The relevant facts were as follows:

1. The Taxpayer was at all material times the subsidiary of a public company ('the Public Company').

2. The Public Company was owned and controlled by the X Family prior to it becoming a quoted public company in Hong Kong in 1972. Thereafter it remained under the control of the X Family.

3. The Taxpayer carried on the business of property development and trading. This appeal relates to six properties owned by the Taxpayer ('the First to the Sixth Properties').

4. When the Public Company became public in 1972, a prospectus was issued. Particulars of the properties were included in the prospectus as being owned by the Taxpayer at that time. There was no clear indication in the prospectus as to the nature of the Taxpayer's investment in the properties. Different expressions were used, namely 'held for investment' and 'with the intention to hold the same either for rental income or resale'. Where expressions such as 'Fixed Assets' and 'Properties' were used, it was clear from the evidence given before us by Mr Y that such expressions did not denote capital and trading assets but rather denoted the difference between completed buildings and buildings in the course of development.

5. All of the buildings of which the properties formed part had been developed by the Taxpayer either alone or in joint venture, and the properties comprised those parts of the buildings which remained in the ownership of the Taxpayer after sale of all other units in the buildings.

6. The Taxpayer classified all of the properties as trading stock and, though most were let or leased to obtain rental income, they were available for sale should

the opportunity arise. The Second Property was different from the rest because two of its floors were used by the Taxpayer and the Public Company and other group companies as their Head Office and the parts which were let out were retained for possible future expansion of the group.

7. The Taxpayer claimed, in its 1974/75 tax computation, industrial building and rebuilding allowances in respect of the properties. The assessor challenged these claims to allowances because he was not satisfied that the properties which had been previously classified as trading stock had been changed into long term capital assets and he pointed out to the Taxpayer that, if there had been a change of intention, tax would be assessed on the enhanced value at the date when the change had taken place under the Sharkey v Wernher principle: [1956] AC 58.

8. Because there would have been a substantial sum of tax to pay under the Sharkey v Wernher principle, the Taxpayer withdrew its claim for the capital allowances and agreed that the properties remained trading stock. The Taxpayer confirmed this by letter dated 7 January 1975 signed by its tax representatives which clearly stated that as at that date all of the properties (inter alia) were trading stock. That letter also placed on record that certain other properties were fixed assets held as investments and entitled to capital allowances. The contents of that letter were accepted by the assessor as being factually true and correct.

9. The Taxpayer continued to use the expression ‘fixed assets’ in its audited accounts to describe trading as well as long-term capital assets.

10. During the year ended 30 September 1980, the Taxpayer sold part of the Third Property at a profit of $2,208,996; during the year ended 30 September 1981, the Taxpayer sold parts of the Third, Fourth and Sixth Properties at a profit of $3,948,598; and, in the year ended 30 September 1982, the Taxpayer sold part of the Fifth Property at a profit of $1,300,450. The Taxpayer claimed that the profits on these sales were capital in nature and not taxable.

11. For the years 1976/77 to 1979/80, the Taxpayer did not claim any capital allowances on any of the properties. For the years 1980/81, 1981/82 and 1982/83 the Taxpayer claimed industrial building allowances in respect of the unsold parts of the Fifth Property and rebuilding allowances in respect of the First and Second Properties and the unsold parts of the Third Property.

12. The Taxpayer supported its claim that the profits on sale of parts of the properties were capital in nature and its claims to the allowances on the alleged fact that, on 30 September 1977, the directors of the Taxpayer had changed the properties from trading stock to long term capital investments. A copy of the resolutions passed on 30 September 1977 was supplied to the assessor on 17

March 1982 and subsequent thereto the tax representatives of the Taxpayer submitted that the Sharkey v Wernher principle should apply to the change of intention of the Taxpayer.

13. The resolutions passed on the 30 September 1977 related only to the First, Second, Third, Fifth and Sixth Properties but did not refer to the Fourth Property. It was resolved that four of the five properties would be kept 'for long term investment from now onward'. With regard to the Second Property, it was resolved that those parts which were rented would be kept for rental collection and the two floors which were the general office of the Taxpayer would 'be kept for long term investment'.

14. The assessor rejected all of the claims of the Taxpayer, assessed all of the profits to tax as being trading profits and disallowed the industrial building allowances and the rebuilding allowances. The Commissioner by his determination dated 24 September 1985 unheld the assessor's decisions and the Taxpayer appealed to the Board of Review.

15. At the hearing of the appeal, Mr X gave evidence and we accept the truth of the evidence which he gave. He confirmed that up to 30 September 1977 the properties had been held by the Taxpayer as part of its trading stock. He confirmed that the properties had remained part of the trading stock after the Public Company became a quoted company and also confirmed that the proposal to convert the trading stock into capital assets prior to 1975 had been abandoned because of the tax implications at that time. It was apparent from the evidence given by Mr X that he did not understand the legal distinction for tax purposes between the trading stock of a property development or trading company and long term capital investments. It appeared that in his mind a long term capital investment is property which is let out for rental income for a long period of time but which will be sold if the opportunity arises or if it is thought expedient so to do.

16. Mr X stated that the policy of the Taxpayer when developing new buildings was to sell all of the upper floor units and to retain the ground floor shops for rental purposes. However, it was apparent that though this may have been a general guiding principle the Taxpayer did not necessarily sell all upper floor units and did not necessarily retain all ground floor units.

The Taxpayer in fact made appropriate decisions to suit its own purposes and the individual circumstances of its various developments. Accordingly, we find as a fact that the policy as outlined by Mr X was no more than a general indication and of little value in relation to any particular units in any specific buildings.

17. Mr X said that the properties had been retained by the Taxpayer to obtain rental income so that dividends could be paid to shareholders. Whilst we accept the truth of this statement, it was also apparent from what he said in evidence that rental income from trading stock and rental income from long term investments were treated in the same way.

18. Mr X stated that the Taxpayer was confused with regard to the distinction between fixed assets and trading stock. However, under cross-examination he confirmed that he understood that tax should be payable on any increase in value of trading stock which was reclassified as long term capital investments under the Sharkey v Wernher principle.

19. Reference is made later in this decision to certain evidence before us which has not been separately set out in these facts.

The onus of proof in all tax appeals lies upon the taxpayer. In this appeal, with the exception of the Second Property the Taxpayer has failed to discharge the onus of proof and to satisfy us that the properties were converted from trading stock to long term capital investments as at 30 September 1977.

This case depends entirely upon its facts and the construction of its facts.

It appears that the Taxpayer from the time when the Public Company became quoted in 1972 (and possibly earlier) was actively considering reclassifying the properties as long-term capital investments. There was a suggestion that the properties had been reclassified in 1972 (letter dated 30 September 1974 from the Taxpayer to its tax representatives) and there were further suggestions that the properties had been reclassified in or about 1975 (when the assessor considered invoking the Sharkey v Wernher principle). However, for the expedient reason of not wishing to pay tax at that time, the Taxpayer agreed with the Inland Revenue Department that as at 7 January 1975 (letter of that date from its tax representative to the Assessor) all of the properties were still trading stock.

It is not impossible for a property trading company to convert trading stock into long-term capital investments but there must be clear and unequivocal evidence of this change of intention. The mere fact that trading stock is held for a long period of time or that it is let out for rental purposes is not conclusive of a change of intention (James Hobson & Sons Ltd v CIR (1957) 37 TC 609). Furthermore, a self-serving statement of intention by a taxpayer on its own does not establish a change of intention. Obviously the taxpayer must make such a statement because the taxpayer is the only person who can confirm that there has been a change of intention, but the statement of intention made by a taxpayer must be unequivocal and carefully checked with all the other facts to establish its bona fides.

In the present case, the Taxpayer was a property developer and property trading company. On its own evidence, all of the properties up to 30 September 1977 were trading properties. If the only facts before us were that the Taxpayer had formally resolved to

change its intention and to hold the properties as long-term capital investments, and had then proceeded to hold the properties for a lengthy period, we would have accepted that there had been a change of intention and no doubt the assessor would have done likewise. However, on the facts before us we are not able to accept the resolutions of the Board of Directors on 30 September 1977 as being conclusive and unequivocal.

The Taxpayer had at various times previously either purported or attempted to convert the properties into capital assets but had not done so because it would have meant paying tax. In our opinion, the resolution passed on 30 September 1977 was no more than a further attempt by the Taxpayer to put itself in a position to negotiate with the Inland Revenue Department at some future date depending upon how events might transpire. This appears to have been the policy of the Taxpayer throughout. There is also the unexplained inconsistency that the Board resolutions of 30 September 1977 omitted to mention the Fourth Property even though it was subsequently included with the other five properties when claiming that the properties were all capital assets.

The classification of assets as either fixed assets or properties in the accounts of the Taxpayer was meaningless for tax purposes. Properties admitted by the Taxpayer to be trading stock were included as fixed assets, and when giving evidence Mr X said that the classification was used to distinguish premises under development from those which had been completed. There was no evidence given of any distinction or change being made as a result of the 30 September 1977 resolutions.

The fact that the properties were rented and indeed rented for long periods of time must be set amongst the other facts. The taxpayer, on its own admission, held trading stock for long periods of time during which they were rented. The Taxpayer's policy was not consistent. It would be different if the Taxpayer had only leased out long term capital investments or had only leased out trading stock temporarily pending sale, but it did not.

The only property where we can see any real and true intention to hold as a long terra capital investment was the Second Property which the Taxpayer retained throughout the period and no part of which was ever sold. Mr X in his evidence said that the Second Property was held by the Taxpayer because it was the group head office and the parts which were leased were held to enable the group to expand. This in our opinion does demonstrate a clear intention to retain the Second Property as a long term capital investment.

We find on the facts that, with the exception of the Second Property, all of the properties remained throughout the period in question trading stock and must so be treated for tax purposes. Accordingly we uphold the decision of the Commissioner with regard thereto. With regard to the Second Property, we find on the facts that the Taxpayer did decide to change the Second Property from being part of its trading stock, into a long term capital investment with effect from the 30 September 1977. This means that in the years under appeal the Taxpayer was entitled to a rebuilding allowance in respect of the Second Property, and we remit the assessments appealed against to the Commissioner with a

direction that he allow the rebuilding allowance in respect of the Second Property only and that in all other respects the assessments be confirmed.