

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D173/01

Profits tax – real property – whether the gains arising from the disposal of property were liable for profits tax – sections 2, 14(1) and 68(4) of the Inland Revenue Ordinance (‘ IRO ’).

Panel: Kenneth Kwok Hing Wai SC (chairman), Sammy Chan Yin Nin and Andy Lam Siu Wing.

Dates of hearing: 22 and 23 February 2002.

Date of decision: 26 March 2002.

The appellant, a company incorporated in Hong Kong, appealed against the determination of the Commissioner whereby the profits tax assessment for the year of assessment 1996/97 was increased. The assessor maintained that the gain on disposal of the property was trading profit chargeable to profits tax and considered the commissions to Mr I and Company H were not deductible.

The principal grounds of appeal were that the gain from the disposal of the subject property was capital in nature and was not liable to profits tax as the property was acquired for long term investment purposes.

Held:

On the question of intention, it was clear from the evidence of the finance manager of the appellant that he played no part in the decision to acquire the property. He was not even a director. The Board did not accept his testimony on intention. Further there was no evidence of the appellant’s financial ability to keep the property on a long term basis. The appellant failed to prove:

- (a) that at the time of the acquisition the intention was to hold the property on a long term basis;
- (b) that such intention was genuinely held, realistic or realisable;
- (c) its financial ability to keep the property on a long term basis.

Appeal dismissed.

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Cases referred to:

Simmons v CIR 53 TC 461
All Best Wishes Ltd v CIR [1992] 3 HKTC 750
Marson v Morton [1986] 1 WLR 1343

Leung Wing Chi for the Commissioner of Inland Revenue.
Iris Cheng Man Wai of PricewaterhouseCoopers Limited for the taxpayer.

Decision:

1. This is an appeal against the determination of the Commissioner of Inland Revenue dated 27 November 2001 whereby the profits tax assessment for the year of assessment 1996/97 dated 3 December 1997, under charge number 1-1086555-97-8, showing assessable profits of \$22,946,210 (after setting off of loss brought forward of \$2,070,643) with tax payable of \$3,786,124 was increased to assessable profits of \$25,886,210 (after setting off of loss brought forward of \$2,070,643) with tax payable of \$4,271,224.

The agreed facts

2. The following facts are agreed and we find them as facts.
3. The Appellant has objected to the profits tax assessment for the year of assessment 1996/97 raised on it. The Appellant claimed that the gain it derived on disposal of a property is capital in nature and should not be assessable to profits tax.
4. The Appellant is a private company incorporated in Hong Kong on 14 December 1982. At all relevant times, the Appellant had an issued capital of \$100,003 and its directors were Mr A and Mr B. The Appellant described its nature of business as property investment.
5. On 3 June 1994, a property (‘ the Property’), a three-storey building, was assigned to the Appellant with existing tenancy at \$24,000,000.
6. By an agreement for sale and purchase dated 20 March 1996, the Appellant sold the Property to Company C (‘ the Buyer’) for \$58,000,000. The sale was completed on 30 April 1996.

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7. In its profits tax return for the year of assessment 1995/96, the Appellant declared a loss of \$2,154,086 for the year ended 30 April 1995. In computing the loss, the Appellant deducted a rebuilding allowance of \$160,000 in respect of the Property.

8. In response to the enquiries raised by the assessor on the acquisition and disposal of the Property, Accountants' Firm D, on behalf of the Appellant, stated that:

- (a) Although written feasibility studies had not been carried out, the Appellant considered that it was feasible to acquire the Property as a long term investment in terms of return of capital because it was located in the central area of District E and should be able to yield a much higher rental income.
- (b) Details of the existing tenancy were as follows:

Location	Terms of tenancy
Shop 1, G/F	Monthly tenancy at \$1,000/month
Shop 2, G/F	Two years from 1-1-1993 at \$32,000/month
Shop 3, G/F	Monthly tenancy at \$13,800/month
Shop 4, G/F	Monthly tenancy at \$7,500/month
Shop 5, G/F	Monthly tenancy at \$1,100/month
Shop 6, G/F	Two years from 16-8-1993 at \$23,000/month
1/F	Two years from 10-4-1993 at \$7,500/month *
2/F	Two years from 1-6-1994 at \$7,000/month *

* The tenancy agreements of 1/F and 2/F were terminated on 28 November 1994 and 28 February 1995 respectively.

- (c) Upon acquisition of the Property, the Appellant commenced to recover possession from the tenants. It paid compensations to the tenants of 1/F and 2/F so as to terminate the tenancy agreements early.
- (d) The acquisition of the Property was financed by advances from a related company, Company F.

9. The assessor was of the view that the Property was the Appellant's trading asset and that the Appellant was not entitled to any rebuilding allowance in respect of the Property. The assessor issued to the Appellant a loss computation for the year of assessment 1995/96 as follows:

	\$
Loss per return [paragraph 7]	2,154,086
<u>Less: Rebuilding allowance in respect of the Property</u>	<u>160,000</u>
Loss for the year	1,994,086

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<u>Add: Loss brought forward</u>	<u>76,557</u>
Loss carried forward	<u><u>2,070,643</u></u>

10. The Appellant disagreed with the 1995/96 loss computation and claimed that rebuilding allowance should be granted.

11. On 14 March 1997, the Appellant resolved to change its accounting year end date from 30 April to 31 December. For the year of assessment 1996/97, the Appellant's financial statements covered the period from 1 May 1995 to 31 December 1996.

12. The Appellant declared in its profits tax return for the year of assessment 1996/97 a loss of \$2,176,875 and did not offer for assessment the gain of \$27,193,728 on disposal of the Property.

13. The Appellant's profit and loss account for the period from 1 May 1995 to 31 December 1996 shows the following particulars:

	\$	\$
Rental income		606,700
Interest income		769,700
Sundry income		<u>64,230</u>
		1,440,630
<u>Less:</u>		
Auditor's remuneration	15,000	
Bad debts provision	46,000	
Bank charges	220	
Loan interest paid	3,039,900	
Legal and professional fees	* 460,777	
Rates	90,902	
Repairs and maintenance	6,600	
Sundry expenses	6,930	
Water and electricity	<u>1,176</u>	<u>3,667,505</u>
Loss before exceptional item		(2,226,875)
<u>Add: Exceptional item</u>		<u>27,193,728</u>
Profit before taxation		<u><u>24,966,853</u></u>

* Included professional fee of \$360,000 for preparing tenancy agreement

14. The assessor raised on the Appellant the following profits tax assessment for the year of assessment 1996/97 to include the gain on disposal of the Property:

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	\$
Loss per return [paragraph 12]	(2,176,875)
<u>Add: Gain on disposal of the Property</u>	<u>27,193,728</u>
Profit for the year	25,016,853
<u>Less: Loss brought forward and set-off [paragraph 9]</u>	<u>2,070,643</u>
Assessable profits	<u>22,946,210</u>
Tax payable	<u>3,786,124</u>

15. The Appellant objected against the profits tax assessment for the year of assessment 1996/97 on the ground that the gain on disposal of the Property was capital in nature and not assessable to profits tax.

16. The Appellant stated that:

(a) Unsecured loans had been obtained from two related companies, Company F and Company G, to finance the acquisition of the Property and the Appellant's operation.

(b) The tenants of the G/F shops surrendered their respective units on the following dates:

Location	Date of surrender
Shop 1, G/F	31-3-1995
Shop 2, G/F	31-12-1995
Shop 3, G/F	31-12-1995
Shop 4, G/F	30-11-1995
Shop 5, G/F	31-3-1995
Shop 6, G/F	15-8-1995

(c) It considered the market rental of the Property during the period from June 1994 to April 1996 was about \$300,000 per month.

(d) The Appellant renovated the Property in order to attract potential tenants at better rental. The renovation work was divided into two phases. The first phase started in late 1995 after the Appellant had gained possession of the first and second floors. The second phase started in March 1996 and was in respect of the ground floor. The Property looked like a new building after the renovation.

(e) After the renovation had been completed, the Appellant appointed agents to let out the Property. No documentary evidence could be adduced to prove the appointment of agents as instructions were given verbally.

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- (f) It was approached by the Buyer who offered to buy the Property.
- (g) The gain on disposal of the Property was computed as follows:

	\$	\$
Selling price		58,000,000
<u>Less:</u>		
Purchase cost	24,978,910	
Legal fee and compensation for recovery of property or surrender of tenancy	171,020	
Renovation cost	2,998,692	
Commission fee for disposal	2,580,000	
Legal fee for disposal	<u>77,650</u>	<u>30,806,272</u>
Gain on disposal		<u><u>27,193,728</u></u>

- (h) The commission on disposal of the Property was paid to:

	\$
Company H	580,000
Mr I	<u>2,000,000</u>
	<u><u>2,580,000</u></u>

17. The Appellant elaborated on the commission on disposal of the Property [paragraph 16(h)] and the professional fee for preparing tenancy agreement [paragraph 13] as follows:

- (a) Commission on disposal of the Property
- (i) ‘ [Mr I] was the agent acting for the buyer who had exerted effort for the completion of the deal and in return to his service a commission of \$2,000,000 was paid to him.’
- (ii) ‘ (Mr I) was referred to the company by [Company H] and commission of \$580,000 was paid to [Company H].’
- (iii) ‘ the amount was paid to (Mr I) by a deduction of a sum of \$2,000,000 from the deposits payable by the buyer company to us on signing of the agreement.’
- (b) Professional fee of \$360,000

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It was commission paid to Company H for soliciting and preparing a tenancy agreement dated 30 April 1996 by which the Appellant leased the Property to Company J for a term of six year commencing on 30 April 1996.

- (c) The total commission of \$940,000 (\$580,000 + \$360,000) to Company H was settled through a related company, Company G.

18. The assessor has ascertained that Mr I was a shareholder and director of the Buyer and that the directors of the Appellant were also directors of Company H and Company J during the relevant period.

19. The Appellant provided a copy of the bill issued by Solicitors' Firm K in support of the legal fees on recovering possession of the Property. It shows that the Appellant obtained vacant possession of the shops on the G/F on the following dates:

Shop 1	27-12-1995
Shop 2	3-1996
Shop 3	3-1996
Shop 4	3-1996
Shop 5	27-12-1995

20. The assessor maintained that the gain on disposal of the Property was trading profit chargeable to profits tax and considered that the commissions to Mr I and Company H were not deductible. She proposed to increase the profits tax assessment for the year of assessment 1996/97 as follows:

	\$
Profit for the year already assessed [paragraph 14]	25,016,853
<u>Add:</u>	
Commission to Mr I [paragraph 16(h)]	2,000,000
Commission to Company H [paragraph 17(c)]	<u>940,000</u>
	27,956,853
<u>Less: Loss brought forward and set-off [paragraph 9]</u>	<u>2,070,643</u>
Assessable profits	<u><u>25,886,210</u></u>
Tax payable	<u><u>4,271,224</u></u>

The appeal

21. The objection having failed, the Appellant appealed on the following grounds:

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- ‘
- (1) the gain from the disposal of the subject property is capital in nature and is not liable to profits tax as the property was acquired for long-term investment purpose;
 - (2) the tenancy commission payable to [Company H] in an amount of \$360,000 is deductible for profits tax purpose as it was incurred for the purpose of our trade;
 - (3) tax loss brought forward from the prior years should be adjusted to \$2,230,643 by taking into account the rebuilding allowance in respect of the subject investment property for the year of assessment 1995/96 in an amount of \$160,000;
 - (4) had the gain from the disposal of the property been determined to be liable to profits tax, the commission in an amount of \$2,000,000 payable to [Mr I] as agency fee for disposal of the property is deductible for profits tax purpose; and
 - (5) had the gain from the disposal of the property been determined liable to profits tax, the commission payable to [Company H] in an amount of \$580,000 as agency fee for disposal of the property is deductible for profits tax purpose.’

22. At the hearing of the appeal, the Appellant was represented by Miss Iris Cheng Man-wai of PricewaterhouseCoopers Limited. The Respondent was represented by Miss Leung Wing-chi, assessor.

23. The Appellant called Mr L, the finance manager of the Appellant, to give oral evidence. The Respondent adduced no oral evidence.

24. Miss Iris Cheng Man-wai cited Simmons v CIR 53 TC 461.

25. Miss Leung Wing-chi cited All Best Wishes Ltd v CIR [1992] 3 HKTC 750.

Our decision

26. Section 68(4) of the IRO provides that the onus of proving that the assessment appealed against is excessive or incorrect is on the Appellant. Section 2 defines ‘trade’ as including ‘every trade and manufacture, and every adventure and concern in the nature of trade’. Section 14(1) excludes profits arising from the sale of capital assets.

27. We remind ourselves of what Sir Nicholas Browne-Wilkinson VC said in Marson v Morton [1986] 1 WLR 1343 at pages 1347 to 1349 and [1986] STC 463 at pages 470 to 471;

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what Lord Wilberforce authoritatively stated in Simmons v IRC [1980] 1 WLR 1196 at page 1199 and (1980) 53 Tax Cases 461 at pages 491 to 492; and the statement of the law by Orr LJ at pages 488 and 489 of the report in Tax Cases, which was approved by Lord Wilberforce as a generally correct statement (WLR at page 1202 and Tax Cases at page 495).

28. We also remind ourselves of what Mortimer J, as he then was, said in All Best Wishes Limited v CIR (1992) 3 HKTC 750 at page 770 and page 771:

‘ Reference to cases where analogous facts are decided, is of limited value unless the principle behind those analogous facts can be clearly identified.’ (at page 770)

‘ The Taxpayer submits that this intention, once established, is determinative of the issue. That there has been no finding of a change of intention, so a finding that the intention at the time of the acquisition of the land that it was for development is conclusive.

I am unable to accept that submission quite in its entirety. I am, of course, bound by the Decision in the Simmons case, but it does not go quite as far as is submitted. This is a decision of fact and the fact to be decided is defined by the Statute – was this an adventure and concern in the nature of trade? The intention of the taxpayer, at the time of acquisition, and at the time when he is holding the asset is undoubtedly of very great weight. And if the intention is on the evidence, genuinely held, realistic and realisable, and if all the circumstances show that at the time of the acquisition of the asset, the taxpayer was investing in it, then I agree. But as it is a question of fact, no single test can produce the answer. In particular, the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of the evidence. Indeed, decisions upon a person’s intention are commonplace in the law. It is probably the most litigated issue of all. It is trite to say that intention can only be judged by considering the whole of the surrounding circumstances, including things said and things done. Things said at the time, before and after, and things done at the time, before and after. Often it is rightly said that actions speak louder than words. Having said that, I do not intend in any way to minimize the difficulties which sometimes arise in drawing the line in cases such as this, between trading and investment.’ (at page 771)

29. On the question of intention, Mr L said in his witness statement, confirmed by him on oath at the hearing of the appeal, that:

‘ It was the intention of [the Appellant] (as reflective of both its shareholders and directors) to hold [the Property] for rental and long-term investment purposes.’

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30. It is clear from his own testimony that he played no part in the decision to acquire the Property. He was not even a director. We do not accept his testimony on intention and attach no weight to it.

‘ Q Were you involved directly in the transaction relating to the acquisition of [the Property]?

A Well, all the matters related to the investment, including the sales and purchase, the decision of which were made by [Mr A], and as to me I was responsible for the legal matters and dealing with various documents. However, [Mr A] would tell me, would inform me about everything to do with the investments.

...

Chairman: Where is [Mr A]?

A He is in Hong Kong.

...

Chairman: Who or which person made the decision to acquire [the Property]?

A It is [Mr A] who made the decision.

Chairman: The senior [Mr A]?

A Yes.

Chairman: Did you take any part in the decision-making process to acquire or purchase the subject property?

A No.’

31. Further, there is no evidence of the Appellant’s financial ability, with or without the assistance of its shareholders and their companies, to keep the Property on a long term basis. There is no evidence of the net worth of the Appellant or the Appellant’s shareholders and supporters **as at the time of acquisition in June 1994**. There is no evidence on cash flow **as at the time of acquisition in June 1994**.

32. For the reasons we have given, the Appellant has not proved any of the following and its case of capital asset fails:

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- (a) that at the time of the acquisition in June 1994, the intention of the Appellant was to hold the Property on a long term basis, whether for rental income or at all;
- (b) that such intention was genuinely held, realistic or realisable;
- (c) its financial ability, with or without its shareholders or their companies, to keep the Property on a long term basis.

33. After Miss Iris Cheng Man-wai had concluded her submission but before Miss Leung Wing-chi began her submission, the Appellant abandoned ground (2) of its grounds of appeal (on \$360,000).

34. As the Appellant has failed on the capital asset point, ground (3) also fails.

35. We do not for one moment believe that the Appellant has incurred any commission payable to Mr I, whether in the sum of \$2,000,000 as alleged or at all. There is simply no evidence on whether the alleged agreement to pay commission was made orally or in writing, and if the agreement is alleged to have been made orally, there is simply no evidence on the date when, the place where, and the persons between whom the alleged agreement is alleged to have been made, or the relevant terms thereof. Significantly, no receipt has been produced. The assertion by the witness that payment was effected by deducting against the 'purchase deposit and then balance of the consideration upon completion' is contradicted by the completion statement of account issued by Solicitors' Firm K. Ground (4) fails.

36. We turn now to the commission payable to Company H in the sum of \$580,000. There is no evidence that the Buyer or Mr I was introduced by Company H. There is no basis for asserting that the alleged expense was incurred 'in the production of profits' within the meaning of section 16(1) of the IRO. Ground (5) fails.

Disposition

37. The Appellant has not discharged the onus under section 68(4) of the IRO of proving that the assessment appealed against is excessive or incorrect. We confirm the assessment as increased by the Commissioner.