

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D17/89

Profits tax – acquisition of industrial building – whether profit on sale was taxable as income or was realisation of capital asset.

Panel: Robert Wei QC (chairman), Edward Chow Kam Wah and Hon Lau Wah Sum.

Dates of hearing: 13, 14, 22 and 29 October 1988.

Date of decision: 2 June 1989.

The taxpayer was a company incorporated by Mr A for the purpose of acquiring an industrial building. The industrial building had previously been owned by X Limited which owned and occupied the building for the purpose of carrying on the manufacture of electronic goods. Mr A acquired control of X Limited and at that time caused the taxpayer to be incorporated for the purpose of acquiring the industrial building from X Limited. Both X Limited and the taxpayer were controlled by Mr A. The previous owner of X Limited had obtained government approval for the construction of a number of additional floors on top of the industrial building.

After acquisition of the industrial building, the taxpayer caused additional floors to be built on top of the then existing industrial building, which floors were sold at a profit. The taxpayer considered that the upper floors had been constructed with a view to resale at a profit and that the profits were accordingly taxable. The taxpayer argued that the sales of the lower floors which were sold one by one to finance the unsuccessful business of X Limited was the realisation of a capital asset and that the profits were not taxable.

Held:

Notwithstanding that the taxpayer had considered that the sale of the upper floors was a taxable transaction, the sale of the lower floors were the realisation of a capital asset made to assist the manufacturing operation of X Limited. Accordingly the profits made on the sales of the lower floors were not taxable.

J G A Grady for the Commissioner of Inland Revenue.
Benjamin Yu instructed by Vivien Chan & Co for the taxpayer.

Decision:

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1. This appeal is against the profits tax assessments for the years of assessment 1979/80, 1980/81 and 1981/82 raised on the Taxpayer. The grounds of appeal are as follows:

- (1) That the Taxpayer acquired the six-storey building (the building) as an investment and a capital asset and not for the purpose of resale at a profit;
- (2) That the gain on realization of fixed assets of the Taxpayer of which the building is one is wrongly treated as trading profits and is not chargeable to profits tax;
- (3) That the Taxpayer is entitled to an industrial building allowance in respect of the building as it is the Taxpayer's capital asset;
- (4) That the basis of calculating the cost of sales for the extension of the building is incorrect as the construction cost in respect of the extension is attributable only to the cost of sales for the extension, that is, the fifth to eleventh floors.

2. Grounds (1) to (3) concern the building as it was at the date of acquisition, which then had only six floors, that is, the ground, mezzanine and first to fourth floors (the lower floors), whilst ground (4) refers to the cost of sale of the fifth to eleventh floors which were built later (the upper floors). It is common ground that the profit made on the sale of the upper floors is chargeable to profits tax and that the cost of land attributable to the upper floors is the cost as at the date of acquisition. It follows therefore that no industrial building allowance is claimable in respect of the upper floors. The dispute is as to the manner in which the cost of sale (that is, the cost of land and construction cost) should be apportioned between the upper and lower floors. Each side insisted on its or his own formula, but little evidence was adduced to support either side's contentions. However, the parties showed willingness to seek agreement upon a remitter of this case to the Commissioner, and this we shall do.

3. That leaves the first three grounds, and the main issue here is whether the six-storey building was acquired as a capital investment or for the purpose of resale at a profit.

4. Mr A, a director and the controlling shareholder of the Taxpayer, was the only witness called at the hearing. Upon his evidence and the documents produced, we find as follows.

Facts

5. Mr A was in the family business of textile manufacturing. In early March 1977 he was looking for opportunities for diversification when he came to know a Mrs B, widow of the late Mr B, the controlling shareholder of X Ltd, a company carrying on the business of semiconductor processing, assembling and packaging. Its business associates, Mrs B told

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him, included some world famous names in the electronics industry. She wanted to sell the company which was in need of an injection of funds. Mr A was intrigued. He saw in the company an opening for diversification. He consulted his friend Mr C, reputed to be a capable and experienced businessman in the semiconductor field with a similar textile family background. His intention was to invite Mr C to become his partner if he succeeded in purchasing the semiconductor business from Mrs B. Mr C agreed to join in principle and to take at least a 40% interest, subject to consent being obtained from Mr C's principal, for whom Mr C was working as a processing contractor. As required by Mr C, Mr A caused a feasibility report to be made on X Limited which he received in early April 1977. It showed that the company had been making losses in recent years and recommended cuts in overheads, particularly in the number of staff. It drew attention to a stable potential in the area of LCD (liquid crystal display) watches. Mr A was impressed with the future of LCD watches. He was a stranger to the electronics business, but he was aware of a general feeling that electronics was going to be a star in the industrial field. X Limited was the owner-occupier of the six-storey building the subject of this appeal which had a building potential for seven more floors. In fact the late Mr B had submitted to the Building Authority plans for building more floors although not to the maximum capacity. The negotiations between Mrs B and Mr A were successful. At the suggestion of Mrs B, the building and the shares of X Limited were sold separately. The transactions took place in April 1977 when the building was sold for \$8,500,000 to the Taxpayer, of which Mr A was a director and the controlling shareholder, whilst all the 600 shares of X Limited were sold to Mr A and his associate at \$1 per share. The Taxpayer was incorporated as a private company in January 1977. Mr A acquired shares in the Taxpayer in order to acquire the building. At all relevant times its authorized and paid-up capital remained at \$2,500,000 and \$2,250,000 respectively. The purchase of the building was financed by a bank loan of \$6,500,000 secured by a mortgage of the building to be repaid by six equal monthly instalments commencing on 20 October 1978. In view of the change in ownership of the building, it was necessary for the Taxpayer to lease it back to X Limited, which it did. The lease, reserving a rent of \$60,000 per month, was for the term of one year with a clause for earlier determination, but there was no particular reason for the shortness of the term except that a shorter term attracts less stamp duty. Ever since the acquisition of the Taxpayer and X Limited, Mr A remained in control of both companies.

6. Upper floors. In May 1977 the Taxpayer submitted to the Building Authority for approval structural plans for erecting on top of the building the upper floors. Approval was granted in August 1977. In January and February 1978 the Taxpayer placed advertisements for sale of the upper floors with local newspapers inviting enquiries. Building work commenced in about May 1978. On 20 June 1978, to finance the construction of the upper floors the Taxpayer obtained a bank loan of \$4,500,000 repayable on 19 June 1979. On 26 September 1978 the Taxpayer for the consideration of \$9,500,000 sold the upper floors which were then under construction. A deposit was paid upon signing the agreement and the balance was paid on completion of the works. The construction of the upper floors was completed in about August 1979. On 28 January 1983 through its tax representatives the Taxpayer conceded to the Revenue that 'the extension of fifth to

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eleventh floors after acquisition is for trading purpose' and submitted a computation based on the cost of land as at the date of acquisition.

7. Lower floors. On the lower floors X Limited was an uninterrupted failure. Mr C, on whom Mr A had placed high hopes, failed to keep his promise to participate in the business. Being new to the line of electronics, Mr A was unable to provide the management and leadership the business needed. During the summer months of 1978, a theft occurred when hundreds of thousands of dollars' worth of stock and parts were stolen. A major problem caused by the theft was that the company could not meet delivery dates. Staff morale was seriously affected. Mr D, the manager from pre-acquisition days who had stayed on, resigned. A replacement was found for Mr D, but that did not improve the fortunes of the company. It went on making losses from year to year and relied on loans from the Taxpayer for survival until it ceased its business operations sometime in 1981. To continue to make loans to X Ltd, the Taxpayer raised funds by selling the lower floors part by part during the period from November 1980 to April 1981. Part of the lower floors was sold in January 1981 to Y Limited, a subsidiary of the Taxpayer's, which was to make a fresh start with the electronics business on a smaller, more compact scale on self-owned premises. However, this new company did not fare any better than X Limited, and closed its doors after an unsuccessful start.

8. All the proceeds of sale of the upper and lower floors, so far as available for the purpose, were transferred to X Limited to its rescue, as the following figures demonstrate:

<u>Proceeds of sale</u>	\$
Upper floors	9,500,000
Lower floors	<u>18,280,000</u>
	27,780,000
<u>Less:</u>	
Cost price of the 6-storey building and expenses	8,799,805
<u>Additions to lower floors</u>	
Year ended 31/12/80	535,961
Year ended 31/12/81	<u>176,250</u>
	712,211
Cost of construction of upper floors	<u>5,470,680</u>

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	14,982,696
Balance	12,797,304
	<u>Amount due by X Limited</u> <u>as at years ended 31/12</u>
1978	781,827
1979	3,855,749
1980	6,887,261
1981	12,215,870
1982	12,066,055

The balance of the proceeds of sale amounting to \$12,797,304 includes interest expenses. The proceeds of sale of the lower floors include \$4,600,000 from Y Limited. Amounts due by X Limited at year ends do not include interest as the advances were interest free.

Intention

9. Upper floors. In view of the common ground that exists between the two sides as mentioned in paragraph 2 above, it is not necessary for us to make a finding of the Taxpayer's intention with regard to the upper floors yet to be built as at the date of acquisition of the building. However, in view of the common ground and the concession mentioned in paragraph 6 above, we would have found that the Taxpayer's intention as at the date of acquisition was to build the upper floors for the purpose of resale at a profit, had it been necessary for us to make finding.

10. Lower floors.

(a) Mr Grady for the Revenue submitted that the Taxpayer in acquiring the building intended to resell not only the upper floors to be built but also the lower floors at a profit, and he relied on the following facts in support of his contention:

- (i) In early 1977 Mr A became the major shareholder of the Taxpayer and of X Limited.
- (ii) Within a month of the acquisition of the building application was made to the Building Authority for approval of plans for alterations to the lower floors and the construction of the upper floors.
- (iii) Short term loans were obtained in respect of \$6,500,000 of the \$8,500,000 cost of the building, to be repaid by six equal monthly

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instalments commencing on 20 October 1978, and a building loan of \$4,500,000 to be repaid in full on 19 June 1979.

- (iv) On the date of the purchase the Taxpayer leased back to X Limited the lower floors for a term of one year at a monthly rent of \$60,000. The tenancy agreement stipulated that the landlord had the right to rebuild by constructing additional storeys and that the tenant would tolerate reasonable inconvenience etc caused by rebuilding and would not make claim against the landlord. The agreement also provided for the early determination of the tenancy.
 - (v) Although application was not made to the Building Authority for consent to commence work on the alterations and additions until April 1978, advertisements in respect of the building was placed under the heading 'Property for Sale' in a newspaper in February 1978.
 - (vi) A contract to sell the upper floors was entered into on 26 September 1978 when they were still under construction, the occupation permit being issued on 20 August 1979.
 - (vii) Although X Limited, vacated the lower floors except the second floor in April/May 1979, the Taxpayer did not lease the vacated floors to any other party.
 - (viii) Application was made to the Building Authority for approval of plans for further work on the lower floors in April 1979. Less than a year after completion of the work in June 1980 sale and purchase agreements had been entered into for all of the lower floors save 19/20 part of the mezzanine floor.
- (b) Mr Grady submitted that the above facts clearly indicated that upon acquiring the building the Taxpayer had but one intention – to develop and turn it to profit.
- (c) Mr A's evidence was to the effect that he had always treated X Limited and the Taxpayer 'as one' and that upon acquisition his intention was that the then six-storey building should continue to house X Limited as before. Mr Yu for the Taxpayer pointed out that all the proceeds of sale of the upper and lower floors, so far as available for the purpose, were lent to X Limited. This bears out, he submitted, Mr A's evidence referred to at the beginning of this sub-paragraph. We agree with that submission.
- (d) These lendings were made when X Limited was obviously on a decline. Mr Grady argued that Mr A was only interested in acquiring the property for resale at a profit, and that he took the business as well because he had to as part of a

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package deal. If that is so, why did the Taxpayer made these highly risky lendings instead of letting X Limited die a natural death? Mr Grady frankly admitted that he found it difficult to explain. On the other hand, the fact of the lendings fits in with Mr A's avowed intention. He bought the business because he thought it would give him a good opportunity to diversify into a promising new field. The property was owned by X Limited which was running the business; its building potential for the upper floors was no doubt an attraction. However, in our view, the main reason for the acquisitions was that Mr A was attracted by the business and his intention was that the lower floors should continue to serve the business as its premises. We find that his investments in the business and the property (at least to the extent of the lower floors then occupied by the business) were both long-term, and that the sales of the lower floors were realization of a capital investment necessitated by a commitment to assist the business founded on an attitude which treated the business and the premises occupied by the business as one. It follows therefore that the profits made on the sales are not taxable.

Conclusion

11. That being our decision, we hereby remit this case to the Commissioner so that the assessments in question may be revised accordingly.