

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D18/90

Profits tax – whether profit or gain on receipt of compensation for resumption of land a trading profit or disposal of a capital asset.

Panel: Howard F G Hobson (chairman), Chen Yuan Chu and Denis Evans.

Dates of hearing: 5, 6, 7 and 8 March 1990.

Date of decision: 20 June 1990.

A taxpayer owned certain land in the New Territories. An idea was given to the taxpayer that it would be in the interests of the taxpayer to develop its land with a view to long term leasing. As a result of a change of intention the taxpayer surrendered the land to the Hong Kong Government and received cash compensation. The taxpayer was taxed on the profit which arose and submitted that the profit was a capital gain.

Held:

The profit was a capital gain and not subject to profits tax.

Appeal allowed.

Case referred to:

D11/80, IRBRD, vol 1, 374

Wong Chi Wah for the Commissioner of Inland Revenue.

Benjamin Yu instructed by Lo & Lo for the taxpayer.

Decision:

The Taxpayer company ('the Taxpayer') was assessed to tax upon profits accruing in the basis period for the year of assessment 1982/83 from compensation paid to it on the resumption of certain of its properties in the New Territories. The Taxpayer objected to the assessment, in effect, on the ground that such profits were by way of a capital gain and not trading profits.

INLAND REVENUE BOARD OF REVIEW DECISIONS

1. BACKGROUND

- 1.1 The Taxpayer was incorporated in Hong Kong in the early 1970s. At all material times its paid up capital has been \$50,000 and its directors and shareholders were Messrs A, B, C and Madam D.
- 1.2 Mr A was businessman. Messrs B and C were partners in a trading company and a construction company. Madam D was a friend of Mr C.
- 1.3 Mr A proposed to Mr B that he join Mr A in buying land in X Place, through the medium of the Taxpayer. Mr B suggested to invite Mr C to join in and Mr C in turn suggested Madam D.
- 1.4 At a meeting of the Taxpayer, Messrs A, B, C and Madam D resolved to acquire Lots XYZ et al in AA 123, X Place ('the land') and also that Mr A would be chairman of the Taxpayer. Though this resolution was passed before incorporation, nothing turns on that anomaly.
- 1.5 At some time between January 1973 and March 1973 the Taxpayer bought the land together with some buildings for \$641,143 (inclusive of commission). The areas and designations of the lots were:

| | <u>Square feet</u> |
|-------------------|--------------------|
| Agricultural land | 145,056 |
| Building land | 5,226 |
| Agricultural land | <u>10,018</u> |
| | 160,300 |
| | ===== |

The purchase price was met entirely out of directors' advances.

- 1.6 The Taxpayer filed profits tax returns, showing a small amount of rental income which had ceased by the year ended 31 March 1975, and in which it described its business as 'investment'.
- 1.7 On 18 July 1973 solicitors wrote to the district office in X Place stating that the Taxpayer intended to develop the land and asked the premium involved 'for high development'.
- 1.8 Mr A himself wrote on the Taxpayer's stationery on 26 October 1973 to the principal officer, X Place district office, to say that the Taxpayer would like consent to erect residential buildings on about 5,000 square feet.

INLAND REVENUE BOARD OF REVIEW DECISIONS

- 1.9 On 12 November 1973 the district officer said he was not prepared to process the application.
- 1.10 On 10 April 1975 the Taxpayer submitted layout plans for the following developments:
- (1) 27 blocks of three storeyed European residential blocks, each block covering 1,500 square feet;
 - (2) a shopping centre; and
 - (3) swimming pool, playground and car park.
- 1.11 In his reply of 22 April 1975 the estate surveyor said ‘that it is not possible for me to deal with your application for residential development in this location as you cannot achieve compliance with the proposed layout for the area. If you require to go into more detail regarding this please do not hesitate to telephone... to arrange an appointment.’
- 1.12 By a letter of 31 May 1975 to the district office, the Taxpayer indicated that it had appointed an architect and went on to say that as the lots were separated and the total area was not large enough it intends to apply for modification.
- 1.13 The architect wrote to the estate surveyor on 11 June 1975 indicating on a block plan the idea of consolidating five lots into one single block or purchasing other lots from the Government. Mr A again wrote to the estate surveyor on the Taxpayer’s behalf on 16 June 1975 hoping that the Government would reduce restrictions so that more buildings could be constructed.
- 1.14 In a letter of 6 December 1975 to the principal officer the Taxpayer made reference to the cancellation of a factory licence and indicated that it wanted a new food production licence. This was followed, on 22 March 1976, with a formal application for one food, one garment and one brick factory, the district office representatives having in the meantime discussed the prospects with the Taxpayer.
- 1.15 The Taxpayer in a letter of 22 May 1976 to the principal officer mentioned that as it understood the 160,000 square feet of land on which the food factory was situated was classified as ‘R3’ it was hoped that the land could be exchanged on a one for one basis ‘so as to speed up the exchange of land with the Government’. On 3 June 1976 the district office said it could not deal with the application unless more details concerning the use of the land was provided. On 6 June 1976 the Taxpayer asked for an explanation.

INLAND REVENUE BOARD OF REVIEW DECISIONS

- 1.16 Subsequently the Taxpayer entered into detailed and protracted negotiations, both in writing (commencing formally with a letter from the Taxpayer's architect on 5 November 1976) and verbally, with the estate surveyor in the district office, X Place, in connection with the proposal to surrender the majority of the lots in return for a regrant of building land.
- 1.17 Delays occurred and agreement between the parties could not be reached for various reasons including:
- (a) which of the lots were to be surrendered;
 - (b) the size and location of the regranted area;
 - (c) the quantum of premium to be paid to the Government;
 - (d) vacant possession not being granted by the Taxpayer on the lots to be surrendered by it; and
 - (e) delays to the original proposal for regrant due to problems with relocation of certain structures in the regrant area on which tenancies with the Government were held.

However the district office on 30 March 1979 wrote to say that it would recommend an in situ exchange and set out the terms – other than the premium. Then on 10 July 1979 the senior estate surveyor advised that the premium had been assessed at \$1,945,000. As no response was received to that letter it lapsed.

- 1.18 On 6 May 1980 whilst discussions were still in course between the Taxpayer and the district officer, the architect submitted detailed building and layout plans to the Public Works Department. The master layout plan envisaged nine blocks of three storey residential buildings, sixty-eight car parks, a swimming pool and children's playground. These plans were submitted on the basis of a proposed 'in-situ' exchange of land dated 30 March 1979 but in which the amount of the premium was not quantified. The building plans were approved on 9 August 1980.
- 1.19 In a letter dated 1 December 1980 the district officer made to the Taxpayer a formal offer for an 'in-situ' exchange of land. This proposal contained, inter alia, the following terms and conditions:
- (a) the Taxpayer to surrender 5,226 square feet of building land, 120,654 square feet of agricultural land and 10,018 square feet of 'missing agricultural lots' in exchange for a regrant of 54,300 square feet of building land;

INLAND REVENUE BOARD OF REVIEW DECISIONS

- (b) a building covenant of \$5,700,000 to be fulfilled within 36 months;
- (c) vacant possession of surrendered lots to be given within six months; and
- (d) a premium (unspecified) to be paid to the Government.

1.20 Although the Taxpayer accepted the proposal set out in paragraph 1.19 above on 10 December 1980, assessment of the premium payable and the drawing up of the conditions of grant were delayed due to the fact that structures still existed on the land to be surrendered. The Taxpayer commenced legal proceedings against the illegal occupiers of the land and in 1981 the structures were finally cleared.

1.21 On 13 November 1981 the district officer, after receipt of advice of vacant possession, issued a revised formal offer for the exchange of land together with a copy of a layout plan of the area. This revised offer required fulfilment of a building covenant of \$9,100,000 within 48 months. Again the amount of premium was not specified.

1.22 The Taxpayer, on 20 November 1981, agreed to all the conditions of the proposal and asked to be informed of the premium as soon as possible, and on 18 January 1982 the district officer, X Place, advised that he would recommend a premium of \$7,500,000.

1.23 On 21 January 1982 the district office advised the Taxpayer that the Government would be resuming Lot ABC in AA 123 (not one of the lots the subject of the in-situ land exchange).

1.24 On 29 January 1982 the Taxpayer wrote to the district officer, X Place, in the following terms:

‘ We have withdrawn our application for the in-situ exchange of the above lots vide our letter of 29 January 1982, copy attached for your reference.

We understand that the Government is planning to resume the area for development affecting our lots. We are prepared to surrender them for cash compensation in lieu of Letters B. You will note that all the structures on the above lots have now been cleared. We should be most grateful if you could include all our land into your resumption exercise of the area.’

1.25 By way of a notice in the Government Gazette, most of the land was resumed and the Taxpayer received \$11,504,000 in compensation.

INLAND REVENUE BOARD OF REVIEW DECISIONS

The foregoing background is not in dispute and most of it is culled from the Commissioner's determination and correspondence produced during the hearing.

2. ADDITIONAL EVIDENCE

Two witnesses gave evidence on oath.

Mr B

- 2.1 Apart from the instant case he had never been involved in land development.
- 2.2 Mr A (who has since died) told him that it should be possible to buy land near X Place with a view to developing apartments and renting out to the Government, fire services and a Government agency ('the Government agency'). The Government agency offered the most attractive terms. Mr A and Mr B both knew of two people (one of whom was Mr E, who was well known to Messrs A and B) who had put up residential apartments in the New Territories (but not at X Place) and let them out to the Government agency. Mr B said it was Mr E's project which 'inspired us'. Mr B said there was no market in the X Place area in those days for ordinary private lettings or sales of the type of premises needed by the Government agency. Mr E himself had tried to sell his development but he had been unsuccessful. Mr A evidently had some land in mind: Mr A emphasised that it would have to be a long term transaction not a short term deal. Messrs B, C and Madam D agreed that Mr A would put up the deposit to buy the land and would attend to all the necessary negotiations with the Government whilst the three of them would put up the main capital. Mr A however undertook to provide any shortfall. Mr A's shareholding would be 40% and the others 20% each. That decision having been reached, Madam D advanced \$420,000, Mr C \$162,527 and Mr B \$40,000. The paid up capital was \$50,000. (It would appear that Mr A was reimbursed the deposit he paid. \$230,000 of Madam D's advance was secured by mortgage at some time between 1 April 1973 and 31 March 1974.)
- 2.3 Apart from bare agricultural land there were about ten buildings most of which were let out. One was a food factory which had ceased operation.
- 2.4 The attraction of letting to the Government agency lay in the fact that the Government agency would either pay six months' rent in advance or pay the entire three years' rent in a lump sum less 10% discount.
- 2.5 Mr A expected to be able to exchange with the Government the total (about 5,000 square feet) of the superficial areas of the lots which had houses for a single plot upon which the Taxpayer could build low rise apartments. Mr A thought it would take about two to three years to get the necessary approvals.

INLAND REVENUE BOARD OF REVIEW DECISIONS

- 2.6 He said that Mr A had developed, sometimes alone and sometimes in conjunction with others, several properties in X Place most of which he owned and let out though he had given three to his children.
- 2.7 Mr B said that he would have no difficulty producing his share of the capital costs of development in 1973 assuming it was within say \$1,000,000: in any event since he and Mr C owned a construction company the Taxpayer would get reasonable credit.
- 2.8 At no time was there any suggestion of selling the land.
- 2.9 Mr A called on the district officer X Place both before and after the letter of 18 July 1973 (paragraph 1.7 above) with a view to expediting the application for exchange and Mr B went with him on one occasion.
- 2.10 Mr B explained the original and revised plans and that the amenities intended to be included would, the directors felt, make the apartments more readily lettable to the Government agency: one of the developers of property let to the Government agency had similar facilities.
- 2.11 As a precaution against the possibility of the Government refusing permission for the intended development of residence, the Taxpayer decided to get permission to run factories on part of the land. However as the Taxpayer wanted to surrender all the land in the proposed exchange this aspect was not pursued.
- 2.12 On 10 July 1979 (paragraph 1.17 above) the senior estate surveyor advised that the premium was assessed at \$1,945,000 giving the Taxpayer 28 days to respond. A discussion was held between the directors and a solicitor because of this.

The solicitor drafted a letter whereby the Taxpayer accepted the Government's terms. This draft was typed out immediately and signed by Mr A and sent to the district office. The district office never received the letter. Mr B was unsure why it was not sent and assumed that Mr A had forgotten it. The directors' intention was however to accept the offer. Although Mr A still went regularly to the district office he would not normally go into the estate surveyor's department since his visits were largely concerned with the affairs of villagers which was the district officer's main concern. When the district office wrote on 22 January 1980 (in response to a letter from the Taxpayer of 4 August 1979 which is missing) saying that its offer had been withdrawn, the other directors asked Mr A what had happened to the acceptance letter: Mr B recalls only that Mr A apologized to the directors for his lapse.

INLAND REVENUE BOARD OF REVIEW DECISIONS

- 2.13 Mr B was cross-examined at length, in particular concerning the capital of the Taxpayer, the financial capacity of Mr A (in which respect Mr B said he knew Mr A had a deposit of \$2,000,000 to \$3,000,000 with a bank), the disparity of the advances from directors and Mr B's business relationship with Mr A. Mr B for a short period managed a restaurant in X Place of which Mr A was the major one of twenty shareholders. Mr B acknowledged that the restaurant ran at a loss but due to illness Mr B resigned and did not know what happened afterwards.

When asked why the Taxpayer did not accept the Government's offer of 18 January 1982 (paragraph 1.22 above) of a premium of \$7,500,000, Mr B said he and Mr A thought the Government was trying to create difficulties by increasing the premium from \$1,900,000 to \$7,500,000: had the Government stuck to the original figure of \$1,900,000 Mr B said the Taxpayer would certainly have accepted.

He explained that after the Government had paid the resumption compensation the proceeds were shared amongst the shareholders and due to Mr A's deteriorating health and Mr B's own health being poor (they had both had major operations) the Taxpayer did not pursue any other investments.

Mr B acknowledged that due to increased plot ratio and allowing for inflation the Government's \$7,500,000 offer was not effectively so remarkably higher than its \$1,900,000 offer. However he explained that the directors had been guided by their architect at the time of the second offer and accepted his comments concerning the development based on \$7,500,000.

Mr B mentioned that had the original exchange gone through then the shareholders intended to increase the Taxpayer's capital.

We found this witness to be truthful.

Mr F

- 2.14 This gentleman had been a member of the staff of the X Place district office from 1971 to 1979. He knew Mr A well since one of his duties was to liaise with a rural committee of which Mr A was the chairman. He confirmed that Mr A had put up several properties in X Place.
- 2.15 Mr F said that in 1972 the district officer, who served on a security committee comprising the Government agency, asked him to approach some local people to see if they would be interested in building quarters for the Government agency. Though Mr F did not think there would be much interest he approached Mr A (because Mr A had built flats in X Place and let them out. He put the idea to Mr A but stressed that he was not sure if the Government would approve). He also mentioned that the Government servants wanted quarters.

INLAND REVENUE BOARD OF REVIEW DECISIONS

He brought Mr A to discuss the matter with the district officers who also told Mr A he could not guarantee that the Government approval would be forthcoming but hoped Mr A would try to get the land. Mr A then bought the land.

Mr F said there was no market in X Place area at that time for the sale of the type of properties that would be needed for the Government agency, the only alternative to renting them to the Government agency would be to let them out as weekend retreats. Mr F confirmed Mr B's evidence concerning the Government agency's terms of letting. He also said that a large recreational development near X Place was not approved until mid-1975, that is to say this project had not happened at the time Mr A bought the land. [This point had arisen in cross-examination of Mr B who was unsure when that development, where the properties were sold, had occurred.]

Mr F said that about the time of the \$7,500,000 offer he was asked by a district office official to try to persuade Mr A to drop his development proposals because the district office wanted to develop the area for recreational use. Mr F took Mr A to see the official and following this meeting Mr A signed the letter dropping the Taxpayer's application (paragraph 1.24 above).

Mr F was cross-examined concerning the Government agency and Government's policy regarding quarters. He said neither of them were building quarters in the X Place area at the time (1973) – their respective policies were to rent premises. Apart from quarters for junior ranks the Government agency had built no properties for senior staff until 1976/77 when it then built several.

Mr F said that he believed Mr E had told him that the Government agency was willing to pay a rent of \$3.5 per square foot.

Mr F remembered that when Mr A had found the land and knew the asking price he approached Mr F who took him to the district office and it was after this meeting that Mr A decided to commit himself whereupon he went ahead and bought the land.

We found this witness to be truthful.

3. SUBMISSIONS

- 3.1 The Commissioner's representative submitted that until 1980 the Taxpayer's minutes did not show what the Taxpayer's intention was, that the Taxpayer did not immediately after acquisition propose the exchange of land, that there was no strong evidence of financial capacity to develop and hold the proposed property as an investment and it had made no investigation into obtaining long

INLAND REVENUE BOARD OF REVIEW DECISIONS

term financing. In the latter respect he drew our attention to D11/80 decision that ‘intention connotes an ability to carry it into effect...’.

It was also suggested that the disparity in contributions by the shareholders was itself more consistent with a short term commitment where these disparities are settled quickly.

- 3.2 The Taxpayer’s Counsel submissions were brief. The idea of buying land for development and letting to the Government agency came in the first instance via the district office, that of itself was indicative of the original intention and nothing thereafter occurred to suggest that a long term investment was not intended.

4. CONCLUSIONS

We consider the evidence of both witnesses to be reliable and find the following as matters of fact.

- 4.1 The district office put the idea of buying land with the intention of building apartments to let out to the Government agency into Mr A’s head.
- 4.2 Mr A established from Mr E that the idea was a feasible proposition.
- 4.3 Mr B, Mr C and Madam D agreed to join Mr A in the venture on the basis that Mr A would be entitled to 40% of the profits in return for finding the land, and seeing the venture through.
- 4.4 Mr B, Mr C and Madam D believed that they could finance the project but if any shortfall were to occur they could rely on Mr A for finance.
- 4.5 At no time did any of the directors consider reselling.

There was nothing in any of the evidence presented to us that seriously undermines any of the foregoing findings, we therefore hold that the Taxpayer bought the land as a long term investment.

It follows that we allow this appeal and direct that so much of the 1982/83 assessment as relates to the profit made as a result of the Government’s resumption be annulled.