Case No. D21/96

Profits tax – trading profit or capital gains – whether intention to renovate the property and hold as a long term investment.

Panel: Audrey Eu Yuet Mee QC (chairman), Philip Kan Siu Lun and David Wu Chung Shing.

Date of hearing: 14 June 1996.
Date of decision: 3 July 1996.

Appeal dismissed.

> **[Editor's note:** the taxpayer has applied for a case stated but has not pursued it despite the expiry of the extended time limit. The Board finally refused its application to state a case.**]**

Cases referred to:

> Simmons v IRC 53 TC 461
> All Best Wishes v CIR 3 HKTC 750
> Cunliffe v Goodman [1950] All ER 720
> D11/80, IRBRD, vol 1, 374

May Chan for the Commissioner of Inland Revenue.
Raymond Tse of Messrs Raymond Y K Tse & Co for the taxpayer.

Decision:

A. APPEAL

A.1 The Taxpayer appeals against the determination of the Commissioner of Inland Revenue dated 28 July 1995 upholding the profits tax assessment raised on the Taxpayer for the year of assessment 1990/91 in respect of its purchase and sale of a property ('the property').

B. BACKGROUND

B.1 The following background facts are not in dispute.

B.2 The Taxpayer was incorporated in August 1988 for the specific purpose of holding the property. Its authorized and issued capital was $10,000 and the directors were Mr A and his brother Mr B.

B.3 Mr A was the majority shareholder. He was also the majority shareholder of an associate company ('Company C').

B.4 In 1988, Company C came to know, through property agent, that the property was for sale. By an agreement dated 7 May 1988, Company C agreed to purchase the property for $16,000,000. The completion date was stated in the agreement to be 31 August 1988.

B.5 The Taxpayer was incorporate in August 1988. On 24 September 1988, the agreement was completed by Company C acting as the confirmor and the property was assigned to the Taxpayer.

B.6 By an agreement dated 17 July 1990, the Taxpayer sold the property to Company D for $32,250,000.

B.7 The Taxpayer's accounts showed that for 1 January 1990 to 30 September 1990 (the date of cessation of the company's business), there was an extraordinary item of $13,900,560 capital gains from the sale; $11,990,000 of which was distributed as dividend.

B.8 The Inland Revenue does not accept this to be capital gains. After deducting various expenses as well as the loss carried forward, the assessor arrived at a net assessable profit of $11,994,681. Profits tax payable thereon is $1,979,122.

C. THE TAXPAYER'S CASE

C.1 The Taxpayer says that its intention was to hold the property for rental purposes after renovation. The renovation was to convert the entire building, which was for mixed non-domestic and domestic purposes, into an office block for letting. The building is close to District E, a popular commercial district and it was thought that in a few years' time, the area would also become a popular commercial area. However, the Taxpayer was forced to dispose of the property in 1990 for a number of reasons. In order to carry out the renovation, it had to evict all the tenants. The compensation demanded by the tenants was much higher than anticipated. The original estimate was $500,000 but this increased to $1,500,000. Owing to the delay, the renovation costs also increased from the original estimate of $4,500,000 to $5,500,000. Company C, which was financing the project, came under financial difficulties. After the June 4th incident in 1989, the Taxpayer's bank changed its lending policy. Not only was it unwilling to finance the renovation work, it was pressing for repayment of the loans. It recommended a buyer to whom the Taxpayer reluctantly sold the property.

C.2 The Taxpayer called as its only witness Mr F. He became Company C's Assistant General Manager in September 1989. Prior to that, he was a part time consultant to Company C. He described himself as doing 'odd jobs' like issuing of cheques, carrying out administrative duties and giving advice on property dealings. He had no fixed working hours but was always available. While he was not involved in the day to day running of the business, the staff would first approach him and if he could not solve the problem, then he would approach Mr A. He was never paid by the Taxpayer but was paid his travelling expense by Company C. During his part time work as a consultant, he had a full time employment with a solicitors firm. He was a solicitor's clerk.

C.3 Mr F said that although the Taxpayer had ceased business, the money made from the sale was used by Mr a in the renovation of another property in District G and this was still held as an investment.

D. THE PROPOSED RENOVATION

D.1 The Taxpayer produced various documents evidencing its intention to renovate the property.

D.2 The Taxpayer relies on a letter dated 20 March 1988 from Mr H, an architect. On page 3 of this letter, it is said:

> 'According to the information supplied, you intend to hold the property for investment purposes. In view of the existing condition of the subject building, we would recommend that the building be renovated so as to fetch a better return on the investment.'

The total cost of the renovation works was estimated in the letter at $4,500,000. For the services to be provided, the architect asked for $100,000, $30,000 of which was payable as deposit upon confirmation of instruction. The letter appears to have been accepted and signed by Company C on 23 March 1988, one and half months before the sale and purchase agreement.

D.3 The Taxpayer also relies on the minutes of meeting of the directors of the Taxpayer dated 31 August 1988. According to this minutes, the property was to be purchased for long-term investment in respect of rental income. It was also resolved to appoint Mr H as the architect to carry out the renovation work of the building for up-grading rental income in future.

D.4 On 1 September 1988, Mr H wrote to Mr A to inquire whether his services would be required. The Taxpayer replied on 8 September 1988 saying that the proposal on renovation work had been submitted to the company's banker. Hopefully the bank would grant a loan of about $4,500,000 for the renovation work.

D.5 The Taxpayer produced one quotation. This is from Company I, a construction company, which is owned by another of Mr A's brothers. This quotation is dated 11 August 1989. The total fee quoted is $6,157,800, much higher than the original estimate of $4,500,000 or the revised estimate of $5,500,000 as mentioned earlier. It was not explained how this quotation came to be obtained and dated 11 August 1989.

D.6 The last letter in this series was dated 25 November 1991 from Mr H to Mr A of the Taxpayer. It begins:

> 'I refer to your recent enquiry concerning my letter to you dated 1 September 1988.'

It goes on to explain that building costs had increased by an average of 18% for 1988. By the date of this letter, the Taxpayer had not only sold the property but had already ceased business. By then, the Taxpayer could no longer have the intention to renovate the property, maybe the letter was obtained, after the event, in order to support its case that the renovation costs had increased from the original estimate of $4,500,000 to $5,500,000.

D.7 At the hearing, the Taxpayer also produced a cash flow projection which Mr F said he had seen in May 1988. That cannot be right as the document shows the Taxpayer's name at the top but the Taxpayer was not incorporated until August 1988. According to the cash flow projection, there would be a full year's of letting by July 1989 and the Taxpayer would break even in 1993.

D.8 No renovation work was ever carried out.

E. THE FINANCING

E.1 The acquisition of the property was financed in the following manner:

	$
Cost of Property	16,000,000
Commission	1,500,000
Legal fee, stamp duty and other expenses	541,660
Total cost	18,041,660
	========

Loans from Bank J

- instalment	5,500,000
- overdraft	4,000,000
Loan from a director, Mr A	3,000,000
Loan from Company C	5,541,660
	18,041,660
	========

E.2 The rental income was not sufficient to cover the interest expenses. This can be illustrated in two ways. We refer to paragraph (11)(e) of the determination which sets out the information provided by the Taxpayer's representative.

	Period from August 1988 – December 1989 $
CASH PAYMENT – MONTHLY	
Bank overdraft per month	41,666.66
Mortgage loan repayment per month	93,092.46
Current account with Company C – interest payment at 15% per annum on monthly balance owing	80,000.00
Total:	214,758.12
CASH RECEIPTS	
Monthly rental income (approx.)	79,000.00
MONTHLY CASH SHORTFALL	(135,758.12)
	=========

Further, from the Taxpayer's profit and loss accounts, the deficiency of rental income appears as follows:

	31 March 1988 to 31 December 1989 $	**1 January 1990 to 30 September 1990 $**

Rental Income	1,279,829	542,426
Interest expenses		
Instalment loan	790,862	421,003
overdraft	625,293	255,981
Loan from related company	-	1,427,263
	1,416,155	2,104,247
	=======	=======
Returned loss	($355,438)	($1,550,442)
	=======	========

E.3 In order to carry out the renovation, the Taxpayer had to borrow further sums. The original estimate was $4,500,000 for the renovation and $500,000 for removal compensation payable to the tenants, a total of $5,000,000. This estimate later went up to $5,500,000 for the renovation works and $1,500,000 for compensation, a total of $7,000,000. The total of $7,000,000 was to be financed by further borrowings from the bank. Owing to the change of the bank's lending policy and Company C's own difficulties, the funding did not materialize.

F. THE EVICTION OF TENANTS

F.1 According to Mr H's letter of 20 March 1988, the renovation costs of $4,500,000 was estimated on the basis that there would be vacant possession. Mr F explained that if the building was tenanted, the renovation expenses would be significantly increased. Thus no renovation work could begin, and there was no point in paying Mr H, before all the tenants could be evicted.

F.2 It is agreed that the situation relating to the tenants was as set out in Appendix K to the Board's Bundle. It shows a total of 24 tenants. Eight of them had fixed term tenancies. Two were expiring in December 1988, four in 1989 and two in January 1990. The rest were on monthly tenancies.

F.3 Mr F said that in respect of the non-domestic tenancies, his solicitor firm served notices to quit asking the tenants to leave. These were not produced. As for the domestic tenancies, he said that the tenants were protected and the Taxpayer could not recover possession on the ground of renovation of the

property. Thus the Taxpayer could only persuade them to move by offering compensation which would be acceptable to the tenants.

F.4 In the end, the Taxpayer paid a total of $205,000 to 7 tenants who moved out in 1989 and 1990. Apart from the seven, the ground floor tenant delivered up possession on 30 June 1989 and the Taxpayer granted a licence to a bookshop whereby a borrowing fee was payable every 15 days. For the non-domestic tenants whose tenancies expired in November 1989 and December 1988 respectively, despite the service of the notice to quit, they were allowed to stay on.

F.5 By July 1990, when the property was sold to Company D, there were still 16 tenants who remained, plus the bookshop on the ground floor. Only the 7 tenants who had received the $205,000 had moved.

G. THE REVENUE'S CASE

G.1 Miss Chan for the Revenue submitted that the Taxpayer's declared intention was self-serving and was not borne out by the objective facts of the case.

G.2 She pointed out that the rental return was very low. The property was not viable as a long term investment.

G.3 She said it was difficult to accept that the Taxpayer really intended to carry out the extensive renovation works without even approaching the owner of the adjoining property. When Mr F was cross examined about his attempts to contact the owners of the adjoining property, he said that they had tried but failed to contact the owners. He did attempt to find out from one of the tenants who rented the 4th floor of the property as well as the 4th floor of the adjoining property. He said the tenant told him he could not help, may be he did not want to help. It subsequently transpired during the Revenue's closing submission that Company D, the purchaser of the property, was the purchaser of the adjoining property by a sale and purchase agreement dated November 1989 and an assignment dated December 1989. It was, however, never put to Mr F during his cross-examination and it was not accepted that the Taxpayer was aware of this fact.

G.4 Miss Chan pointed out that the Taxpayer never applied to the Building Authority for approval for the change of user from domestic to office use. She relied on section 25 of the Building Ordinance to say that approval was required.

G.5 She said that while the Taxpayer did evict some tenants, this was not actively pursued. At any rate, this was neutral in that eviction of protected tenants at low rental would enhance the value of the property on resale. The original

estimate of time and cost to obtain vacant possession of the property was unrealistic.

G.6 Miss Chan submitted that the Taxpayer did not have a stable and sufficient source of finance to keep the property on a long term basis. She further referred us to the accounts of Company C to show that there is insufficient evidence that Company C would have the ability to carry out the renovation project. The burden of proof is on the Taxpayer and they chose not to call Mr A. Mr F, who gave evidence said he was not responsible for the accounts or the financing. She also criticized the Taxpayer for not having produced any documents to show that it made approaches to banks to finance the renovation project.

G.7 She also referred to the cash flow projection submitted by the Taxpayer and said it was not a contemporaneous document. In any case it was overstating the income and understating the expenses and hardly a realistic projection.

G.8 Lastly, she also relied on the short period of ownership.

H. THE LAW

H.1 The usual cases were cited. Simmons v IRC 53 TC 461 and Lord Wilberforce were relied on for the well-known proposition that in considering whether an asset is acquired for trading or as capital, one has to look at the intention at the time of the acquisition.

H.2 All Best Wishes v CIR 3 HKTC 750 and Mortimer J were quoted to show that the intention is to be judged objectively, it must be realistic and realisable and must be tested against objective facts and circumstances.

H.3 Further the intention to invest must be a definite intention and not merely within contemplation. Asquith LJ said in Cunliffe v Goodman [1950] All ER 720 at page 724:

> *'Not merely is the term "intention" unsatisfied if the person professing it has to many hurdles to overcome, or too little control of events; it is equally inappropriate if at the material date that person is in effect not deciding to proceed but feeling his way and reserving his decision until he shall be in possession of financial data sufficient to enable him to determine whether the project will be commercially worth while. A purpose so qualified and suspended does not, in my view, amount to an "intention" or "decision" within the principle. It is mere contemplation until the materials necessary to a decision on the commercial merits are available and have resulted in such a decision.'*

H.4 In D11/80, IRBRD, vol 1, 374, the Board said at page 379:

> *'"Intention" connotes an ability to carry it into effect. It is idle to speak of "intention" if the person so intending did not have the means to bring it about or had made no arrangement or taken no steps to enable such intention to be implemented.'*

H.5 These principles are well established and accepted by Mr Tse for the Taxpayer. It was also clear that under section 68(4) of the Inland Revenue Ordinance chapter 112, the onus of proving that the assessment appealed against is excessive or incorrect shall be on the Taxpayer.

I. REASONS FOR DETERMINATION

I.1 From the various documents produced, the Taxpayer did have in mind the option of holding the property as a long term investment. However this is not sufficient. The law requires not merely contemplation subject to many hurdles yet to be overcome. There must be an objective, realistic and realizable intention to proceed.

I.2 It is accepted that the property in its existing condition was not viable as a long term investment. The rental was very low. Most of the tenants were protected. The figures in E.2 illustrate the situation. There was a large gap between the rental received and the income expenses. Mr F described this property as an uncut, unpolished jade. To become a viable long term investment, the existing tenants had to be evicted, the property renovated, the user converted and the property relet as an upgraded office block. Thus it is to these steps that we must turn in order to decide if the Taxpayer had discharged its onus and proved a realistic or realizable intention of acquiring this property as a long term investment.

I.3 We first consider the physical condition of the property. As described in the letter from Mr H dated 20 March 1988, the property shares a party wall with the adjoining building. The two buildings are so designed that they share a common lift lobby and corridor which are accessible to both the single staircase as well as the single lift serving the individual buildings. Mr F explained that there were mutual grants of rights of way over the shared areas. It is difficult to see how the renovation project can be carried out without the co-operation of the owner next door. This is particularly so when one considers the list of renovation works set out in the same letter and encompassed in the $4,500,000 renovation budget. The entrance lobby, which is shared, is to be finished with terrazzo tiled floor and wall up to the lift lobby on the first floor. All common floor area is to be finished with mosaic tiles. All internal common wall area is to be finished with glazed tiles. Upgrading of the external wall is also proposed. While it is theoretically possible just to upgrade that part of common area pertaining to the Taxpayer's property, one cannot ignore the disruption and effect on the adjoining property or the rights of way. The clearest case is

the proposal to replace the existing lift by a modern passenger lift. This is the same lift which serves both buildings. In case of the Taxpayer's building, all that tenants would have to be evicted. There is however no proposal to evict the tenants next door. It is simply unrealistic and impracticable to talk about renovating the property when there is no consent or co-operation from the adjoining owner.

I.4 Mr Tse for the Taxpayer said in his opening that the key was the cash flow projection which was prepared by the architect at the time. He says this shows that the renovation is a commercially viable proposition. Mr F initially said he saw this document in May 1988. It was put to him that the Taxpayer's name appeared on the top of the cash flow projection, but the Taxpayer was not incorporated until 9 August 1988. Mr F said in any case the document was prepared before the Taxpayer purchased the property. Mr H, the alleged author of this document, was not called. In his letter of 20 March 1988, Mr H estimated that, after renovation, the rental per month would be $239,680. This makes about $2,876,160 a year. Yet in the cash flow projection, the rental income projected was $3,200,000 a year for the first two years. A note was sought to be added to this figure of $239,680 to the effect that the directors thought this was conservative and the projected monthly rental should be $267,680. In his letter of 20 March 1988, Mr H estimated a period of about 6 – 7 months for evicting the tenants and the completion of the renovation works. This does not appear to be taken into account in the cash flow projection at all. It shows a full year's income of $3,200,000 for the year up to July 1989. No time appeared to have been contemplated for the eviction of tenants or the carrying out of renovation works. There is nothing in any of the three letters from Mr H which refers to this cash flow projection. For these reasons, we have considerable doubts and do not accept that this was a document prepared by the architect at the time.

I.5 In any case, the projection appears over optimistic. There is provision for repayment of the $5,550,000 Company C loan in 1993, 1994 and 1995. But there is no provision for interest payable on the Company C loan which accrued at 15% per annum. There is provision for repayment of the $3,000,000 loan from Mr A in 1995. This is also without interest. There is provision for building renovation loan of $4,500,000 and interest. But there does not appear to be any provision for the compensation payable to the tenants for removal. As for rental income, the projection showed a full year rental being collected by July 1989. This simply cannot be possible when the property was not assigned to the Taxpayer until September 1989. The rental income projection is increased every 2 years and 100% occupancy is assumed.

I.6 Even accepting the cash projection or accepting that the renovation project will turn the property into a commercially viable long term investment, that is still not enough. For it is idle to talk about intention if there is not the means to carry it out. The onus is on the Taxpayer to show that it did have the means to

carry out the renovation works. The Taxpayer chose not to call Mr A. It was explained that Mr A was out of town for business. No adjournment was applied for. When Miss Chan for the Revenue commented in her closing on the absence of Mr A, Mr Tse sought a brief moment to take instructions. After that, he informed the Board that he had instructions from client that they do not wish to call Mr A to give further evidence to the Board. Mr F who was called was not responsible for the accounts.

I.7 According to fact (10) in the determination, the Taxpayer's representatives had informed the Inland Revenue that the further finance of $7,000,000 for the renovation ($5,500,000 for the renovation and $1,500,000 for compensation to the tenants) was not available due to Company C's credit being frozen by its bankers in late 1988. That is very soon after the property was purchased and that casts even more serious doubt on the Taxpayer's ability to hold the property long term. It may be this was a mistake for late 1989. According to Mr F, Company C was in financial difficulties in late 1989. There is no evidence as to when the Taxpayer approached the bank, if at all, for the $4,500,000 or the $7,000,000 for the renovation. The Taxpayer's 8 September 1988 reply to Mr H said the Taxpayer had submitted the renovation proposal to the company's banker. At the time, presumably Company C was not in financial difficulties. It was before the June 4th incident. There is no explanation as to why the proposal was not approved, if it had been submitted for approval. If the Taxpayer genuinely held the intention to carry out the renovation works, all this should have been budgeted into the financial arrangements. Yet there did not appear to be the case.

I.8 The Taxpayer was holding the property which according to Mr F was bought at a 'cheap' price. By July 1990, the value had increased to double its original price. The indebtedness to Bank J was only $4,000,000 overdraft and $5,500,000 instalment loan, totalling $9,500,000. Despite the assertion that Bank J was pressing for repayment of the loans, no document to such effect was ever produced. Instead there is produced Appendix I to the Board's Bundle which shows that on 25 May 1990, Bank J made two further loans to the Taxpayer, one for $2,000,000 and another for $1,500,000. Mr F explained that the two loans effectively totalled $3,000,000 rather than $3,500,000 because $500,000 was due for repayment in a few days' time. This $3,000,000 was then repaid to Company C so that Company C could repay the same to Bank J for Company C's own indebtedness. This showed that the financial difficulties lay with Company C. The Taxpayer had no resources of its own. The issued capital was only $10,000. It relied on Company C or Mr A. If Company C or Mr A did not have the resources to finance the renovation project or the ability to acquire bank finance for the same, there could not have been any viable renovation project. The Taxpayer has not proved that Company C or Mr A or the Taxpayer had the resources or the ability needed for the renovation project.

I.9 The Taxpayer had taken no steps to implement the renovation project. Despite the early correspondence with the architect, no instruction to go ahead was ever given. No deposit was paid to him. No time table was drawn up. No plan was prepared. The only quotation came from a related contractor dated after the June 4th incident when it was said that the bank had changed its lending policy. Many of the items therein appeared to involve structural work for which approval from the Building Authority would have been necessary. No submission for approval was made to the Building Authority. Considering the importance of contacting the owner next door, little appears to have been done in this regard.

I.10 The only thing the Taxpayer did was to evict some 7 out of the 24 tenants by paying compensation of $205,000. Unless the Taxpayer was prepared to be very generous in the compensation, it was simply unrealistic to assume that all the tenants, particularly the protected tenants, who were under no legal compulsion to move, could be persuaded to do so within a year as suggested by Mr F. Considering that this was a prerequisite to the renovation project, it is surprising that hardly any study appeared to have been made. It did not feature in the architect's letter of 20 March 1988 or the cash flow projection.

I.11 When a protected tenant paying a low rental vacates the property, it enhances the value and the marketability of the building as a whole. Thus the eviction of the tenants is a neutral factor and cannot, on its own, be sufficient indicator of an intention to keep the property as a long term investment.

I.12 Mr F said after Mr A received his dividends, he sued the money to invest in another renovation project in District G. He still holds that property. But that is a totally separate venture. Whether that was a venture in the nature of trade or a capital investment offers no clue as to how we must look at the transaction in front of us.

I.13 Having carefully examined all the documents and considered the oral evidence and submissions, we are not persuaded, for reasons given, that the Taxpayer had discharged the onus of proving that there was a realistic and realisable intention to hold the property as a long term investment. In the circumstances, the appeal is dismissed and profits tax is payable as set out in B.8 above.