

**Case No. D23/13**

**Profits tax** – whether gain on disposal of properties chargeable to profits tax – sections 2(1), 14(1) and 68(4) of the Inland Revenue Ordinance.

Panel: Huen WONG (chairman), Chan Chi Hung SC and Chu Siu Lun Ivan.

Dates of hearing: 18 June 2013 and 28 August 2013.

Date of decision: 20 November 2013.

The Taxpayer asserted that the Subject Properties were acquired for long-term investment purpose and their disposal was to settle huge external liabilities.

**Held:**

The Board held that the Taxpayer had failed to prove its case that the Subject Properties were purchased for investment purposes. As such, the Taxpayer had failed to discharge its onus of proving that the assessment appealed against was excessive or incorrect.

**Appeal dismissed.**

Cases referred to:

Liquidator of Lionel Simmons Properties Ltd v Inland Revenue Commissioners [1980] 1 WLR 1196  
All Best Wishes Ltd v Commissioner of Inland Revenue 3 HKTC 750  
Brand Dragon Limited (In Members' Voluntary Liquidation) and another v Commissioner of Inland Revenue 5 HKTC 502  
Marson (Inspector of Taxes) v Morton [1986] STC 463  
Lee Yee Shing v Commissioner of Inland Revenue [2008] 3 HKLRD 51  
Real Estate Investments (NT) Ltd v Commissioner of Inland Revenue (2008) 11 HKCFAR 433  
D4/01, IRBRD, vol 16, 126

Chung Cheuk Ming and Wong Yau Shing of Wu Wong Consultants Limited for the Appellant.

Chan Tsui Fung, Wong Kai Cheong Tony and Wong Suet Mei for the Commissioner of Inland Revenue.

**Decision:**

**Background**

1. Company A ('the Appellant') had previously objected to the Profits Tax Assessment for the year of Assessment 2007/08 raised on it. A determination was made on 4 March 2013 ('the Determination') by the Deputy Commissioner of Inland Revenue rejecting the Appellant's objection. The Appellant now appeals to this Board.

2. At the hearing, Mr Chung Cheuk Ming, the representative of the Appellant (Mr Chung) and Ms Chan Tsui Fung, the representative of the Commissioner of the Inland Revenue (the Revenue) agreed that the Facts as stated in paragraph 1 of the Determination except subparagraphs 1(21)(a) and (b) should be adopted as agreed facts of this appeal.

**Agreed Facts**

3. (a) The Appellant was a private Company incorporated in Hong Kong on XX November 1997. The Appellant closed its financial statements annually on 31 December.

(b) At all relevant times, the issued share capital of the Appellant remained at \$10,000. The shareholders and directors of the Appellant were Mr B and his wife, Ms C.

4. In the directors' reports of the Appellant for the years ended 31 December 2004 to 31 December 2007, the principal activities of the Appellant were described as follows:

<u>Year ended at 31 December</u>	<u>Principal activities</u>
2004	Garment trading and properties investment
2005	Property investment
2006	Property investment
2007	Trading of garment and properties investment

5. (a) Mr B and Ms C were shareholders and directors of three other private companies incorporated in Hong Kong, namely Company D, Company E and Company F.

(b) In the directors' reports of Company D for the years ended 31 December 2005 to 2007, the principal activity of Company D was described as property investment.

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6. During the period from XX November 1997 (date of incorporation) to 31 December 2007, the Appellant purchased and sold the following properties:

<b>Location of Property</b>	<b>Purchase</b>	<b>Sales</b>
	(a) Agreement date (b) Assignment date (c) Price	(a) Agreement date (b) Assignment date (c) Price
Address G ('Property G')	(a) 01-11-2000 (b) 15-12-2000 (c) \$3,750,000	(a) 17-10-2005 (b) 01-11-2005 (c) \$4,200,000
Address H ('Property H')	(a) 03-04-2001 (b) 20-04-2001 (c) \$19,180,000	(a) 03-10-2003 (b) 15-10-2003 (c) \$18,380,000
Address J ('Properties J')	(a) 30-11-2000 (b) 17-10-2002 (c) \$21,361,600	(a) 25-03-2006 (b) 22-04-2006 (c) \$27,600,000
Address K ('Properties K')	(a) 20-10-2003 (b) 10-11-2003 (c) \$16,800,000	(a) 24-07-2004 (b) 12-08-2004 (c) \$23,620,000
Address L ('Properties L')	(a) 25-03-2004 (b) 14-10-2004 (c) \$27,600,000	(a) 25-04-2005 (b) 09-06-2005 (c) \$38,880,000
Duplex M1 at Address M ('Properties M')	(a) 25-03-2004 (b) 14-10-2004 (c) \$29,280,000	(a) 15-11-2006 (b) 02-01-2007 (c) \$34,800,000
Address N ('Properties N')	(a) - (b) 03-08-2006 (c) \$6,000,000	(a) - (b) 10-10-2007 (c) \$10,000,000

7. (a) On 19 November 2004, the Appellant executed a legal charge over Properties J in favour of Bank P for a loan of \$18,000,000 ('the Bank P Loan'). The Bank P Loan was repayable by 300 monthly instalments of \$78,055.20 each subject to changes in interest rate.
- (b) On 15 December 2005, the board of directors of the Appellant resolved, among others things, that the Appellant should sell Properties J for the purposes of 'redemption to the borrowing bank and overdue account'.
- (c) On 22 April 2006, the legal charge referred to in Paragraph 7(a) was discharged.

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8. (a) By a provisional agreement for sale and purchase dated 12 March 2004, the Appellant agreed to purchase Properties M which were then under construction. The purchase price of \$29,280,000 was payable as follows:
- |  |              |
|--|--------------|
| Initial deposit payable on 12 March 2004           | \$1,000,000  |
| Further deposit payable on or before 25 March 2004 | \$3,392,000  |
| Balance payable upon completion                    | \$24,888,000 |
- (b) On 17 June 2004, the occupation permit in respect of Properties M was issued.
- (c) On 14 October 2004, the Appellant drew down an instalment loan of \$20,496,000 ('the Bank Q Loan') from Bank Q, repayable by 240 monthly instalments of \$107,364.40 each, to finance the acquisition of Properties M.
- (d) (i) By a tenancy agreement dated 31 October 2005 ('the 2005 Tenancy Agreement'), the Appellant let Properties M for a term of 2 years from 1 November 2005 to 31 October 2007 at a rent of \$100,000 per month (inclusive of rates and management fees). In April 2006, the Appellant lost contact with the tenant and retained the tenant's deposit of \$300,000 as forfeited.
- (ii) By a tenancy agreement dated 24 May 2006 ('the 2006 Tenancy Agreement'), the Appellant let Duplex M1 for a term of 2 years from 17 June 2006 to 16 June 2008 at a rent of \$98,000 per month (inclusive of rates and management fees).
- (e) By a preliminary sale and purchase agreement dated 1 November 2006, the Appellant agreed to sell Properties M, through Company R, subject to the tenancy referred to in Paragraph 8(d)(ii).
9. (a) By two provisional agreements for sale and purchase both dated 9 April 2006, the Appellant agreed to purchase Properties N at a price of \$6,000,000 and Shop N1 on the Ground Floor of the same building ('Shop N1') at a price of \$67,500,000 with vacant possession. Properties N were connected with Shop N1 by internally built stairs. (It should be noted that this appeal does not concern the tax position of Shop N1)

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- (b) The purchase prices of Properties N and Shop N1 were payable as follows:

	<u>Properties N</u>	<u>Shop N1</u>
Initial deposit payable on 9 April 2006	\$180,000	\$2,000,000
Further deposit payable on or before 2 May 2006	\$420,000	\$4,750,000
Balance payable on or before 3 August 2006	\$5,400,000	\$60,750,000

- (c) By a provisional tenancy agreement dated 23 June 2006, the Appellant agreed to let Properties N and Shop N1 for a term of 3 years from 4 August 2006 to 3 August 2009 at a rent of \$270,000 per month (exclusive of rates and management fees) with an option to renew for a further term of 2 years.
- (d) By a nomination dated 28 July 2006, the Appellant nominated Company D to take up and execute the agreement for sub-sale and purchase (if any) and the subsequent assignment of Shop N1. Company D completed the purchase of Shop N1 on 3 August 2006.
- (e) On 3 August 2006, Company D drew down from Bank S a property loan of \$31,000,000 and a bridging loan of \$35,000,000. The loans were secured by mortgages over Properties N and Shop N1 with the Appellant, Company D and Company E as joint borrowers. The property loan was repayable by 180 monthly instalments of \$257,428 each and the bridging loan was repayable in full by one bullet instalment on 28 August 2006.
- (f) By a tenancy agreement dated 28 November 2006, the Appellant and Company D as landlord let Properties N and Shop N1 in accordance with the terms of the provisional tenancy agreement dated 23 June 2006.
- (g) By two provisional agreements for sale and purchase both dated 25 July 2007, the Appellant and Company D respectively agreed to sell, through Company T, Properties N at a price of \$10,000,000 and Shop N1 at a price of \$93,000,000 to the same purchaser subject to the tenancy referred to in Paragraph 9(f).
- (h) Company D completed the sale of Shop N1 on 10 October 2007.

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10. The balance sheets of the Appellant as at 31 December 2004 to 2007 reported the following assets and liabilities:

As at 31 December	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
	\$	\$	\$	\$
<u>Assets</u>				
Investment properties	85,086,327	52,578,496	36,704,303	-
Amount due from a director	10,247,668	19,045,099	39,899,241	20,700,195
Amount due from related companies	66,732,948	89,179,433	30,660,598	26,835,415
Tax recoverable	374,500	1,174,500	-	540,848
Cash and bank balances	67,220	145,466	338,618	7,602
Other assets	<u>12,102,076</u>	<u>847,028</u>	<u>198,432</u>	<u>12,885</u>
	<u>174,610,739</u>	<u>162,970,022</u>	<u>107,801,192</u>	<u>48,096,945</u>
<u>Liabilities</u>				
Bank overdrafts	15,996,053	6,553,838	11,063,045	-
Bank loans				
- under current liabilities	2,586,778	16,900,609	20,537,391	-
- under non-current liabilities	65,177,684	53,793,525	17,866,734	-
Other borrowings	395,832	285,367	193,313	-
Other external liabilities	5,954,219	1,636,780	6,112,890	1,121,345
Tax payable	-	-	<u>43,827,356</u>	-
	<u>90,110,566</u>	<u>79,170,119</u>	<u>99,600,729</u>	<u>1,121,345</u>
Amount due to a director	69,787,763	69,604,520	34,983,785	36,553,984
Amount due to related companies	<u>13,723,301</u>	<u>8,670,227</u>	<u>14,232,495</u>	<u>46,180,784</u>
	<u>173,621,630</u>	<u>157,444,866</u>	<u>148,817,009</u>	<u>83,856,113</u>
Net Assets / (Liabilities)	<u>989,109</u>	<u>5,525,156</u>	<u>(41,015,817)</u>	<u>(35,759,168)</u>

11. The detailed income statements of the Appellant for the years ended 31 December 2004 to 2007 presented the following operating results:

Year ended 31 December	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
	\$	\$	\$	\$
<u>Turnover</u>				
Sale of goods	12,894,196	-	-	-
Rental income	<u>851,700</u>	<u>782,194</u>	<u>883,419</u>	<u>6,333</u>
	13,745,896	782,194	883,419	6,333
<u>Less: Cost of sales</u>	<u>11,176,861</u>	-	-	-
Gross profit	2,569,035	782,194	883,419	6,333
<u>Other Revenue</u>				
Management fee income	660,000	660,000	-	-
Gain on disposal of properties	6,820,000	10,547,699	4,960,747	7,844,192
Gain on disposal of motor vehicle	-	-	-	121,541

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Year ended 31 December	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
	\$	\$	\$	\$
Other income	<u>1,311,587</u>	<u>435,319</u>	<u>827,386</u>	<u>77,587</u>
	<u>11,360,622</u>	<u>12,425,212</u>	<u>6,671,552</u>	<u>8,049,653</u>
<u>Less: Expenses</u>				
Selling and distribution costs	485,999	25,240	-	-
Administrative expenses	7,794,912	5,331,907	4,340,701	1,546,656
Tax penalty	-	-	22,900,000	374,588
Finance cost	<u>2,055,175</u>	<u>2,800,374</u>	<u>3,601,612</u>	<u>871,760</u>
	<u>10,336,086</u>	<u>8,157,521</u>	<u>30,842,313</u>	<u>2,793,004</u>
Profit before tax	<u>1,024,536</u>	<u>4,267,691</u>	<u>(24,170,761)</u>	<u>5,256,649</u>

12. In reply to enquiries made by an assessor of the Revenue ('the Assessor') about the disposal of Properties J in the year of assessment 2006/07, the Appellant's former representatives, Company U ('the Former Representatives') stated the following:

- (a) Bank P forced the Appellant to sell Properties J to repay the Bank P Loan in default.
- (b) The Appellant had cash flow problem few months before the actual default. The default meant that the Appellant had no cash for repayment at that time. The decision to sell Properties J to solve the cash flow problem was made when the directors found it difficult to raise cash for future repayment.
- (c) The Appellant appointed an estate agent for selling the properties on 1 January 2006.
- (d) The sale proceeds of Properties J were mainly used to repay bank loans.

13. Regarding the Bank P Loan in default, the Former Representatives provided, among other things, a copy of a letter from Bank P dated 21 March 2006 notifying the Appellant that unless the following sum in respect of the loan was paid within 7 days, Bank P should take appropriate proceedings to recover the arrears outstanding and enforce the security:

	\$
15 <sup>th</sup> instalment due on 19 February 2006	106,504.60
16 <sup>th</sup> instalment due on 19 March 2006	<u>106,504.60</u>
	<u>213,009.20</u>

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14. In response to the Assessor's request for a breakdown of bank interest expenses incurred by the Appellant for the years of assessment 2004/05 to 2006/07, the Former Representatives provided schedules which showed, among other things, that the Appellant had paid the following amounts of late charges on loans:

Year ended 31 December	<u>2004</u>	<u>2005</u>	<u>2006</u>
Late charges	\$386	\$8,850	\$295,298

15. The Appellant filed Profits Tax Return for the year of assessment 2007/08 together with its audited financial statements and tax computation for the year ended 31 December 2007. In the return, the Appellant declared Adjusted Loss of \$321,728 after deducting, among other things, bank loan interest of \$787,653 and bank overdraft interest of \$63,675, and excluding gain on disposal of Properties M and Properties N (collectively 'the Subject Properties') in the total amount of \$7,844,192 as follows:

	\$
Gain on disposal of Properties M	4,272,217
Gain on disposal of Properties N	<u>3,571,975</u>
Total	<u>7,844,192</u>

16. By a letter dated 4 March 2009 to the Former Representatives ('the 2009 Letter'), the Assessor requested the Appellant to furnish information and documents about, among other things, the Subject Properties and the bank loan interest of \$787,653 for the year of assessment 2007/08. The Assessor also proposed to add back bank overdraft interest to the extent of \$35,536 for the year of assessment 2007/08 as disallowable portion attributable to financing non-income producing assets.

17. Having failed to receive a reply to the 2009 Letter, the Assessor raised on the Appellant the following Profits Tax Assessment for the year of assessment 2007/08 to disallow the Appellant's claim for exclusion of the gain on disposal of the Subject Properties and deduction of the bank loan interest and to add back the disallowable portion of bank overdraft interest:

	\$
Loss per return	321,728
<u>Less:</u> Gain on disposal of the Subject Properties	7,844,192
Bank loan interest	787,653
Disallowable portion of bank overdraft interest	<u>35,536</u>
Assessable Profits	<u>8,345,653</u>
Tax Payable thereon (after tax reduction)	<u>1,435,489</u>

18. The Appellant, through the Former Representatives, objected to the above assessment claiming that it was excessive.



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19. After an exchange of correspondence, the Appellant agreed that bank loan interest and bank overdraft interest in the total amount of \$586,513 should be added back when computing its Assessable Profits for the year of assessment 2007/08.

20. In reply to the 2009 Letter, the Former Representatives stated the following about the Subject Properties:

- (a) The intention with regard to the acquisition of the Subject Properties was to hold them for the long term. This agreed with the audit report and the long term loan obtained from banks.
- (b) No feasibility study was available as to the viability of the investment of the Subject Properties.
- (c) The reason leading to the disposal of the Subject Properties was to decrease the total level of liabilities of the Appellant as forced by a bank.
- (d) The sale proceeds were wholly used to repay bank loans and directors' loans.
- (e) Since the original intention of the Appellant was to use the Subject Properties for long term, the gain on their disposal was capital in nature and should not be subject to Profits Tax.

21. In response to the Assessor's further enquiries about the Subject Properties, the Appellant, through Mr Chung's firm, Wu Wong Consultants Limited ('the Representative'), replied as follows:

***Properties M***

- (a) The Appellant estimated that the rental value of Properties M was around \$100,000 per month and that the mortgage loan repayment, if repaid by 240 instalments, was also around \$100,000 per month. Therefore, the Appellant applied for a 20-year mortgage loan of \$20,496,000 (that is the Bank Q Loan) so that the rental income received would be enough for financing the monthly repayment of the loan.
- (b) The 30% down-payment of \$8,784,000 for acquisition of Properties M was paid as follows:

	\$
By the Appellant	1,000,000
By Mr B	3,392,000
By Company F	<u>4,392,000</u>
	<u>8,784,000</u>

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The source of funds of Company F was mainly from directors and related companies.

- (c) During the whole period of ownership except vacant period for soliciting potential tenants, Properties M were let to third parties, by the 2005 Tenancy Agreement and the 2006 Tenancy Agreement, for rental income. Due to the long vacant period and increase in interest rate since mid-2005, the Appellant suffered the following deficit of around \$1,860,000, which was financed by its daily operating funds:

<u>Period</u>	<u>Instalment of the Bank Q Loan</u>	<u>Rental income/ Forfeited deposit</u>	<u>Deficit</u>
	\$	\$	\$
October 2004 – October 2005	1,344,368.60	-	1,344,368.60
November 2005 – April 2006	821,197.70	800,000.00	21,197.70
May 2006	142,259.90	-	142,259.90
June 2006 – December 2006	<u>993,181.20</u>	<u>641,752.00</u>	<u>351,429.20</u>
	<u>3,301,007.40</u>	<u>1,441,752.00</u>	<u>1,859,255.40</u>

- (d) The Appellant appointed real estate agent to sell the property in around October 2006.
- (e) As at 31 December 2006, the total external liabilities (excluding tax payable) of the Appellant amounted to \$55,773,373. At the same time, the remaining valuable assets of the Appellant were the Subject Properties. The rental income generated from Properties M was unable to finance the bank borrowings. That was why the late charges paid by the Appellant increased from about \$8,000 in 2005 to \$295,298 in 2006. The sharp increase in late charges together with the extremely high gearing ratio evidenced that the Appellant was really unable to finance the Subject Properties. Thus, the directors of the Appellant decided to dispose of the properties to reduce the external liabilities.
- (f) The whole of the sales proceeds of Properties M was used to repay mortgage loan and bank overdraft in January 2007. After redemption of the Bank Q Loan, the balance of the sales proceeds was mainly used to repay bank overdraft from Bank S.
- (g) The Appellant submitted that it was unable to fully repay the overdraft due to the fact that a lot of long-outstanding debts and expenditures were

required to be settled by the sales proceeds of Properties M. There was still an overdraft balance of over \$1 million with Bank S after the Appellant repaid \$9,574,000 on 5 January 2007.

*Properties N*

- (h) The 10% down-payment of \$600,000 for acquisition of Properties N was paid by Mr B and the Appellant in the respective amounts of \$180,000 and \$420,000.
- (i) The 90% balance of \$5,400,000 was wholly financed by Company D. The loan from Company D was unsecured, interest free and had no fixed term of repayment.
- (j) The Appellant had mortgaged Properties N in favour of Bank S to secure banking facilities granted to Company D which in turn lent \$5,400,000 to the Appellant for acquiring the property. The Appellant, Company D and Company E were the joint borrowers of the facilities. The joint and several guarantees/liabilities rendered the highest protection to Bank S. The Appellant had no choice but could either accept or reject such terms as offered by Bank S.
- (k) Company D was solely responsible for the mortgage loan repayments. Therefore no significant cash outflow was incurred for the acquisition of Properties N. It might be interpreted that Properties N were held by the Appellant on trust for Company D. The Appellant was able to acquire and hold the properties for long term purpose despite the cash flow problem referred to in Paragraph 12(b).
- (l) Additional assessments were raised by the Revenue under the tax audit on the Appellant for the years of assessment 2000/01 to 2003/04. On 9 March 2007, the tax audit was finalised and the Appellant was required to settle additional tax of approximately \$22.1 million and tax penalty of \$22.9 million. The total of \$45 million had been fully settled in July 2007. The total external liabilities of the Appellant, after including the tax liabilities of \$45 million, would be around \$100M. It was not difficult to understand that the Appellant must dispose of all its properties to settle the huge liabilities.
- (m) Of the sales proceeds received, \$1,000,000 was used for financing the daily operation of the Appellant. The balance of \$9,000,000 was used to repay loan due to Company D which had advanced millions of dollars to the Appellant for the settlement of tax liabilities relating to the tax audit from March 2007 to July 2007.

***Director***

- (n) Mr B was an experienced property investor. He had invested in a lot of properties for long or short-term purposes through various companies. His source of funds was mainly from the profits derived from disposal of properties.

***Support from related companies***

- (o) The Appellant's total external liabilities plus the tax liabilities arising from the tax audit were over \$100 million. The market value of the Subject Properties was just \$44.8 million. The Appellant was unable to repay the liabilities without financial support from related companies. In fact, the Appellant had sought help from all related companies which held properties at that moment. All the related companies had approached real estate agents to sell their properties to support the Appellant.
- (p) Selling of properties within companies owned by Mr B and Ms C to pay the tax liabilities of \$45 million was the most urgent matter. Finally, Company D had sold the majority of its properties (some were sold at a profit and some were sold at a loss) to finance the Appellant.
- (q) It was not realistic for the Appellant to decrease its total level of liabilities by calling for repayment from directors or related companies who owed money to the Appellant. The related companies might not be able to repay the loan due to the Appellant if they did not hold any properties or valuable assets. Even if the related companies held properties or other valuable assets, the timing to realise them was another factor.
- (r) By the time the tax audit on the Appellant was finalised, the Appellant held only Properties N and there were no other operating funds in its bank accounts. Therefore, the settlement of the tax liabilities were mainly financed by related companies.

***Gain on disposal***

- (s) It was argued that the gain on disposal of the Subject Properties should be non-taxable on the following grounds:
  - (i) The Subject Properties were acquired for long-term investment purpose. Except the vacant period for soliciting potential tenants, the properties were let to third parties for rental income during the whole period of ownership.

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- (ii) The Appellant had total external liabilities of around \$100 million (including tax payable of \$45 million). The only way for the Appellant to settle the huge liabilities was to dispose of all of its properties and to seek financial support from other related companies.
- (iii) The sales proceeds of the Subject Properties were used to reduce the liabilities of the Appellant.

22. The Representative provided to the Assessor, among other things, the following documents:

- (a) A copy of an undated statement of account in respect of the sale of Properties M showing that sales proceeds to the extent of \$19,531,440.20 were applied to redeem the Bank Q Loan and the net balance payable to the Appellant was \$11,180,633.15.
- (b) A copy of the statement of account dated 31 January 2007 from Bank S to the Appellant showing that the overdraft balance of \$11,062,845.44 was reduced by a deposit of \$9,574,000 to \$1,488,845.44 on 5 January 2007.
- (c) A copy of a statement of account in respect of the sale of Properties N sent by solicitors to the Appellant on 9 October 2007 showing that sales proceeds to the extent of \$9,000,000 were applied to redeem the loan from Bank S.
- (d) A schedule with a copy of supporting payment documents showing that tax and penalty of the Appellant, Mr B and Ms C in the total amount of \$45,001,855.97 were settled by the Appellant, Company D and other related companies as follows:

<u>Payment date</u>	<u>Name of taxpayer</u>	<u>The Appellant</u>	<u>Company D</u>	<u>Other related companies</u>
		\$	\$	\$
20-05-2004	Mr B & Ms C	675,000.00	-	-
23-03-2005	The Appellant	800,000.00	-	-
21-07-2006	Ms C	1,500,000.00	-	-
08-02-2007	The Appellant	-	-	800,000.00
15-02-2007	The Appellant	-	1,200,000.00	-
16-03-2007	The Appellant	-	-	2,000,000.00
19-03-2007	The Appellant	-	-	2,000,000.00

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<u>Payment date</u>	<u>Name of taxpayer</u>	<u>The Appellant</u>	<u>Company D</u>	<u>Other related companies</u>
		\$	\$	\$
16-04-2007	The Appellant	-	-	2,000,000.00
27-04-2007	The Appellant	-	7,000,000.00	-
15-05-2007	The Appellant	-	-	2,000,000.00
25-05-2007	The Appellant	-	7,000,000.00	-
20-06-2007	The Appellant	-	2,000,000.00	-
25-06-2007	The Appellant	-	6,900,000.00	-
03-07-2007	The Appellant	-	-	8,543,246.97
06-11-2007	The Appellant	-	<u>583,609.00</u>	-
	Total	<u>2,975,000.00</u>	<u>24,683,609.00</u>	<u>17,343,246.97</u>

23. The Assessor has ascertained that on 29 May 2007, the Appellant and Company D appointed Company T as the sole agent for marketing, among other things, Properties N and Shop N1 by a tender exercise to be closed on 3 July 2007.

24. The Assessor was not satisfied that the gain on disposal of the Subject Properties were capital in nature. She pointed out to the Representative, among other things, that the Appellant had appointed Company R to sell Properties M before the properties were assigned to the Appellant and that external liabilities of the Appellant had been high since the year ended 31 December 2004.

25. By a letter dated 22 February 2012, the Representative put forward the Appellant's argument for acquiring the Subject Properties for long-term investment using six badges of trade as follows:

***The subject matter of the realisation***

- (a) The Subject Properties did generate huge rental income. The rental income nearly covered the monthly mortgage payment of the properties. The subject matter did yield the owner an income.

***The length of period of ownership***

- (b) Under the existing rules of Special Stamp Duty ('SSD'), a seller was not required to pay any SSD if his/her property was held over 2 years. The message brought out was that if one owned a property for over 2 years, he/she might not be considered holding the property for trading purpose.
- (c) Properties M had been owned by the Appellant for over 2 years. Even under the existing rules of SSD, the Appellant would not be considered as a speculative trading investor.

- (d) Although Properties N had been owned by the Appellant for less than 2 years, the circumstances leading to the realisation should also be considered. The mere fact that a property was acquired and disposed of in a short period of time did not necessarily make the transaction a trade. It was necessary to look at all facts as a whole.

***The frequency or number of similar transaction by the same person***

- (e) The Appellant had the following history of property transactions for the period before the year of assessment 2007/08:

<u>Location of property</u>	<u>Length of ownership</u>	<u>Usage during ownership</u>	<u>Profit/(Loss) on disposal</u>	<u>Tax Treatment</u>
Property G	59 months	Letting	\$350,465	Taxable
Property H	30 months	Letting	(\$1,680,384)	Non-deductible
Properties K	42 months	Letting	\$4,960,747	Non-taxable
Properties J	9 months	Vacant	\$6,820,000	Taxable
Properties L	12 months	Vacant	\$10,197,234	Taxable

The profit or loss on disposal of properties that were held for more than 2 years was treated as capital gain or loss (the profit on disposal of Property G was incorrectly classified by the Former Representatives as taxable profit). For the 2 properties that were held for less than 2 years, the Appellant agreed that they were of trading nature.

- (f) As Properties M were owned by the Appellant for more than 2 years, the claim for capital gain was consistent with the Revenue's usual tax practice.
- (g) Properties N were held for less than 2 years. However, before the year of assessment 2007/08, the Appellant was running on a going concern basis. It was due to the unexpected tax liabilities of around \$45 million in relation to the tax audit that the Appellant was forced to sell the remaining property to repay the liabilities. Hence, the length of ownership should not be the critical factor for assessing whether Properties N were for long term investment purpose or trading purpose.

***Supplementary work on or in connection with the property***

- (h) Properties M were first-hand properties which had been fully decorated and furnished. Properties N were leasing properties for commercial use. It was not usual for property owner to inject additional investment on decoration or furniture on such properties that were held for leasing

purpose. That was the reason why the Appellant did not incur any supplementary work on the properties.

*The circumstances that were responsible for the realisation*

- (i) The Appellant had incurred external liabilities of over \$100 million whereas the total market value of the Subject Properties at that time was \$44.8 million only. The Appellant could not settle its liabilities without disposing of the Subject Properties in the market.
- (j) If the Appellant had other ways to release the financial pressure, it would absolutely not dispose of the Subject Properties as the Appellant was always a long-term investor in the real estate market.

*Motive*

- (k) The original motive might be changed by various external factors such as shortage of cash, improvement of living condition, etc. Also, the surrounding circumstances had to be considered. Some properties might be held shorter than the original plan but that did not affect the intention of holding the properties for long-term investment purpose. It had been emphasised that the purpose of disposing of the Subject Properties was to resolve the extreme financial difficulties of the Appellant, especially the tax liabilities arising from the tax audit.

26. The Representative further stated the following about the appointment of Company R and the financial position of the Appellant:

- (a) The Appellant appointed Company R and a few real estate agents to sell Properties M on 17 May 2004. It had also kept contacting the agents continuously to change the asking price during the initial ownership period. However, the Appellant had also kept contacting the agents continuously to solicit potential tenant after the assignment. The Appellant did not disagree that it had intended to sell the properties to earn short-term profit, but it also intended to hold the properties for long-term letting purpose if short-term profit could not be earned. This 'dual-motive' was not uncommon for property investors in Hong Kong. The original motive might be affected by various external factors and other surrounding facts should be taken into consideration.
- (b) In fact the Appellant acquired Properties M and Properties L at the same time in October 2004. The Appellant did have the dual motives on these properties originally. Both properties were offered for disposal and rental after the assignments. Properties L were sold in 2005 and the profit was assessed to tax accordingly. On the other hand, Properties M



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could not be sold and were let to a third party. The gain on disposal of Properties M should be capital in nature and non-taxable.

- (c) The Appellant's external liabilities as at 31 December 2006 were \$99,600,728 while the Appellant only held 2 properties with book value of \$36,704,303. Although the total external liabilities of the Appellant as at 31 December 2004 were \$90,110,566 which were also very high, the Appellant held 4 properties with book value of \$85,086,327. To determine whether the Appellant was in financial difficulty, the absolute amount of liabilities was not the critical factor. Instead, the net asset value should be the main consideration.
- (d) The Appellant emphasised that it had not been forced by any bank to sell any of its properties throughout all years of assessment. There was a misunderstanding or misinterpretation between the Appellant and the Former Representatives in answering the Assessor's enquiries at Paragraph 12. In fact, the financial position of the Appellant in April 2006 had been gradually improved compared with the years 2004 and 2005 as 4 properties were sold at a profit of around \$22 million.

27. The Representative subsequently informed the Assessor that rental income in respect of Properties N in the amount of \$205,395 was not recorded in the accounts of the Appellant and should be included in the Appellant's Assessable Profits for the year of assessment 2007/08.

28. On 14 December 2012, the Appellant was issued the following statement of loss for the year of assessment 2006/07:

	\$
Adjusted Loss for the year	2,934,560
<u>Add:</u> Loss brought forward	-
Loss carried forward	<u>2,934,560</u>

29. The Assessor maintained that the gain on disposal of the Subject Properties should be chargeable to Profits Tax. The Assessor considered that the Profits Tax Assessment for the year of assessment 2007/08 should be revised as follows:

	\$
Loss per return	321,728
<u>Less:</u> Gain on disposal of the Subject Properties Paragraph 15 above	7,844,192
Non-deductible bank interests Paragraph 19 above	586,513
Rental income of Properties N Paragraph 27 above	<u>205,395</u>
Assessable Profits	8,314,372
<u>Less:</u> Loss brought forward and set-off Paragraph 28 above	<u>2,934,560</u>
Net Assessable Profits	<u>5,379,812</u>

Tax Payable thereon (after tax reduction)	\$ <u>916,467</u>
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### Authorities

30. Representatives' of both parties referred the Board to the following authorities:

- (a) Liquidator of Lionel Simmons Properties Ltd v Inland Revenue Commissioners [1980] 1 WLR 1196 ('the Simmons case')
- (b) Section 14(1) of the Inland Revenue Ordinance ('the IRO')

31. The Revenue made further references to the following:

- (a) Sections 2(1) and 68(4) of the IRO;
- (b) All Best Wishes Ltd v Commissioner of Inland Revenue 3 HKTC 750 ('All Best Wishes');
- (c) Brand Dragon Limited (In Members' Voluntary Liquidation) and another v Commissioner of Inland Revenue 5 HKTC 502;
- (d) Marson (Inspector of Taxes) v Morton [1986] STC 463;
- (e) Lee Yee Shing v Commissioner of Inland Revenue [2008] 3 HKLRD 51;
- (f) Real Estate Investments (NT) Ltd v Commissioner of Inland Revenue (2008) 11 HKCFAR 433;
- (g) Board of Review Decision D4/01, IRBRD, vol 16, 126.

### The Law

32. Both parties had referred the Board to the leading authorities in this area of the law. In particular, in the Simmons case it was stated that 'trading requires an intention to trade. Normally the question to be asked is whether this intention existed at the time of acquisition of the assets. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment?' It was further stated that 'it is not possible for an asset to be both trading stock and permanent investment at the same time.'

33. In the much cited case of All Best Wishes, it was stated that 'the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of the evidence....including things said and things done. Things said at the time, before and after, and things done at the time, before and after.'

34. Regarding the ‘badges of trade’, it is trite law that they can only provide common sense guidance to detect whether an intention was to trade or to invest. There can never be a comprehensive list of all ‘badges’ relevant to a particular set of circumstances leading to a particular conclusion. The venerable ‘Six Badges of Trade’ will certainly not be sufficient in modern times. The Board takes the view that the length of ownership of any property does not always support a case for an intention to hold as an long-term investment. Hence, it does not assist the Appellant’s case by relying on the fact that it had owned Properties M for more than two years. Similarly the relatively short duration of the Appellant’s ownership of Properties N does not necessarily lead to its being held as a trading stock. The Board need to consider all the surrounding circumstances.

35. It is of course most important to remember that under section 68(4) of the IRO, the onus of proving that the assessment appealed against is excessive or incorrect is on the Appellant.

### **Findings**

36. At the hearing, in addition to the submissions mentioned in the agreed facts stated above, Mr Chung referred the Tribunal to a witness statement made by Ms C. Although not originally intended to, Ms C decided to give evidence under oath.

### ***Properties M***

37. Ms C testified that the true reason for the purchase of Properties M were actually very personal and that she had never disclosed them to her tax representatives before.

38. In March 2004, in addition to the purchase of Properties M, Ms C and her husband Mr B also purchased another set of properties in the same development i.e. ‘Properties L’. The purchase of two similar sets of properties was prompted by the decision of Ms C and Mr B to separate from each other.

39. At the time of their acquisition, the two sets of properties were still under construction. Ms C said that she could not live with Mr B any longer, she and her boyfriend, one Mr V, decided to rent a place at Location W, which was close to the school where the daughter was studying. The idea was that Ms C and her boyfriend would later move into Properties M; whilst Mr B and the daughter would move into Properties L. These arrangements would allow Ms C to continue to look after the daughter.

40. Ms C said that she was pregnant at the time of the purchase of the properties in question. She did not have time and was not in the mood of acquiring properties for trading. Her other daughter, one with Mr V, was born in August 2004.

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41. According to Ms C, she tried to persuade Mr V to move in to Properties M but in vain. In fact, Ms C also came to realise that it had better avoid the embarrassment of Mr B bumping into Mr V if they lived in close proximity. Hence, one year after the purchase, Ms C decided to drop her plan by disposing of Properties L but keeping Properties M for leasing.

42. At the hearing, a lot of time was spent on the computer records of an estate agent which the Revenue relied upon for the proof of the Appellant having actively instructed an agent to sell at varying prices Properties M since 17 May 2004. Mr Chung argued that these records were fragmented and not conclusive of the Appellant's intention to trade at the time of acquisition. Had the Appellant intended to sell, it would have engaged a bigger estate agent. Besides, it was market practice that estate agents would follow up with estate owners; in particular, first-hand owners and update the market value of properties.

43. The Board took the view that the evidence relating to the computer records and the identity of the estate agent was neutral. It did not point towards the Appellant's intention one way or the other. However, the tax representative's contention that there was a 'dual-motive' on the part of the Appellant since it had also instructed the estate agent continuously to look for potential tenants could not stand. As mentioned in Paragraph 32 above, it was held in the Simmons case that it was not possible for an asset to be both trading stock and permanent investment at the same time. The Board need to make a finding according to available evidence whether Properties M were held for one purpose or another. It should be noted that the Appellant had previously agreed that Properties L were held as trading stock and were taxed accordingly.

44. The Board found that Ms C had been less than full and frank in her evidence. It was obvious that she was a very shrewd and experienced business person quite capable of making tough decisions. At the material time, she was operating and owning a score of companies embarking upon trading and real estate investment businesses to the tune of hundreds of million dollars. Ms C was also a seasoned negotiator when it came to negotiating with the Revenue. It was noted that in the years between 2005 and 2006 she had appeared before the tax assessors at the Revenue on many occasions to discuss the Appellant's tax position involving substantial amount of tax money. It is therefore inconceivable that Ms C would choose to suppress the real reason for the purchase of Properties M simply for fear of disclosing her separation with Mr B to her tax representatives and the Revenue even though substantial amount of money was at stake.

45. According to Ms C, the only reason she had changed her mind was because her father-in-law, Mr B's father, passed away the year before. However, as pointed out by the Revenue, even at the time of the filing of the grounds of appeal in April 2013, i.e. after the death of Ms C's father-in-law, the Appellant still failed to state its true reason. Besides, the true reason for the purchase would have been more convincing, had Mr B been called to give evidence at the hearing. It coupled with the inconsistent tax treatment by the Appellant of Properties L, which formed part and partial of the family arrangements making the non-disclosure of the separation of Ms C and Mr B as the true reason look very much an

afterthought. The Board therefore rejected this part of Ms C's evidence in its entirety. Other than the so-called true reason, the Appellant did not pursue its earlier submissions regarding Properties M.

***Properties N***

46. The background of the purchase and sale of Properties N was stated in Paragraphs 9 and 21 above. The Appellant submitted that these properties were acquired for leasing purpose. They were leased together with Shop N1 for a monthly rental of \$270,000 during the entire period of the Appellant's ownership. As mentioned in Paragraph 9, Shop N1 was connected to Properties N through internal staircases.

47. The leasing of the properties alone did not necessarily signify an intention to hold as a long-term investment. It was merely one of the many factors that the Board would take into consideration in deciding whether the Appellant did intend to trade or to invest. It was certainly not a decisive factor. Under certain circumstances, properties, in particular, commercial properties with sitting tenants could be more saleable.

48. At the hearing, Ms C submitted that the sale of Properties N was necessitated by the tax audit in 2007 resulting in the Appellant's additional tax liability of \$22.1 million and tax penalty of \$22.9 million totally \$45 million. Details are stated in Paragraph 21(1) above.

49. The Revenue submitted that the tax audit had been in progress since 2005. The Appellant entered into an irrevocable contract to purchase Properties N on 9 April 2006 when it should have been aware of its additional tax liability. Further, shortly after the Revenue issued its demand for additional tax on 14 November 2006 and the settlement of the tax audit on 9 March 2007, the related companies of the Appellant, namely, Company X had disposed of a number of properties yielding a total gain of about \$65 million. This amount exceeded the Appellant's additional tax liability. The Revenue argued that these sales with a substantial gain demonstrated that the Appellant was not in any financial difficulties at the material time.

50. Further, in the year 2007 just before the Appellant entered into an agreement to sell Properties N, its related companies, namely Company X, Company Y and Company Z together had purchased four properties. The total purchase price was about \$154 million. This suggested that at that time the Appellant and its related companies could not be short of cash by any stretch of imagination.

51. When questioned why the Appellant and its related companies would make such substantial commitments when it was supposed to be facing financial pressure due to the additional tax liability, Ms C explained that when the Appellant had decided to sell some properties, it realised that it would make more profit than it expected. In order not to leave the money idling in the bank, the Appellant and its related companies had to acquire other properties. It was normal that one had to realign one's portfolio according to the market

situation. In the course of explaining the situation, Ms C referred to the properties involved as 'stock'. That said, the Board would not read too much into this expression used by Ms C.

52. What was more important was the fact that the explanation proffered by Ms C did not tally with the chronology of events. The timing of the acquisition of the said four properties was clearly before the disposal of Properties N. The Board found it difficult to accept the submission that the Appellant was facing financial difficulties due to tax liability but having disposed of some properties only to find that it had too much cash. It was not credible that the Appellant did not anticipate such a swing from being cash tight to being cash rich at the material time.

53. The Board also found some force in the Revenue's submission that before the completion of the purchase, the Appellant nominated Company D 'to take up and execute the Agreement for Sub-sale and Purchase (if any) and subsequent Assignment of Shop N1'. This nomination demonstrated that the Appellant was contemplating at an early stage the sale of Properties N which were connected and therefore had to be sold together with Shop N1. Ms C's evidence in answering this submission by putting everything down to market practice and following lawyers' advice was evasive and unconvincing.

54. The Board took note of the Revenue's submissions in refuting the Appellant's argument that the amount of tax involved in the disposal of Properties N was insignificant; hence, there was no reason to avoid paying tax. Bearing in mind the gain made by Company D in disposing Shop N1 was about \$21 million. The tax effect of this disposal has hitherto not been settled between Company D and the Revenue.

55. As in the case of Properties M, the Appellant's case would have been stronger, had Mr B who was a director of the Appellant and its many related companies as well as signatory in various transactions given evidence at the hearing. The Board therefore rejected Ms C's evidence relating to the purpose of the purchase of Properties N.

## **Conclusion**

56. The Board held that the Appellant had failed to prove its case that the Subject Properties were purchased for investment purposes. As such, the Appellant had failed to discharge its onus of proving that the assessment appealed against was excessive or incorrect. The appeal is hereby dismissed.