Case No. D23/88

Profits tax – sale of land – whether profits were trading gains or realization of capital – evidential matters: short holding period, small capitalization, use of directors' loans and dishonesty of taxpayer – s 14 of the Inland Revenue Ordinance.

Panel: H F G Hobson (chairman), Alexander Au Siu Kay and Stephen Cheung Chi Chung.

Date of hearing: 29 June 1988.
Date of decision: 14 July 1988.

The taxpayer company was assessed to profits tax on gains which it made from the resale of office premises.

The taxpayer had purchased the premises in November 1980 for $1,385,000. It resold them in May 1981 for $1,880,000. Subsequently, it turned out that both the purchase and resale prices had been understated in the assignment documents, presumably in order to minimize stamp duty.

The taxpayer alleged that the premises were acquired for the use of the group of companies to which the taxpayer belonged; that the premises were leased to a related company (a property dealer); that no formal lease agreement was entered into because of the relationship between the parties; that the taxpayer's capital of $4 was sufficient for investment purposes in view of the availability of directors' loans; and that the premises were resold only because the lessee found more suitable accommodation elsewhere. On the last point, the only evidence as to the lessee's use of alternative premises was dated after the taxpayer had agreed to sell the premises.

Held:

The profits were assessable.

(a) The taxpayer's low capitalization carried an implication of an intended resale because of the ease with which loans could be redeemed. This implication can be rebutted. However, the failure by the directors to give evidence meant that the Board could not determine their ability to maintain their loans to the taxpayer.

(b) There was no evidence before the Board that the related company had actually used the premises.

(c) As to the reason given as to why no formal lease had been entered into, there was no evidence before the Board that the taxpayer and the lessee were in fact related.

(d) The short period for which the premises were held by the taxpayer, the uncertainty concerning the availability of directors' loans, the resale before alternative premises were acquired, and the understatements of the purchase and sale prices weighed against the taxpayer. It was impossible to conclude that the taxpayer had acquired the premises as a long-term investment.

[Editor's note: This case offers little by way of principle, but it highlights the fact that the Board of Review will not accept mere allegations of fact unless evidence to prove such facts is tendered.]

Appeal dismissed.

Case referred to:

Hillerns and Fowler v Murray (1932) 17 TC 77

Lee Yun Hung for the Commissioner of Inland Revenue.
Thomas Lai of Chan Lai Pang & Co for the taxpayer.

Decision:

The question for our deliberation was whether the profit made by the taxpayer company (the company) from the sale of two office premises (the property) constituted a capital gain or, as determined by the Commissioner of Inland Revenue, a taxable profit.

1. Facts

There was no argument as to the facts as found by the Commissioner, no witnesses were called and no additional written testimony was tendered.

The uncontested facts may be summarized as follows:

1.1 The company was incorporated in August 1980. At all relevant times, its paid-up capital has remained at $4.

1.2 In July 1980, Mr X (a director of the company) entered into an agreement to purchase the property for $1,385,000. In another sales & purchase agreement dated November 1980, Mr X nominated the company as the purchaser.

1.3 In May 1981, the company entered into an agreement to sell the property for $1,880,000.

1.4 In correspondence with the Revenue, the company made the following assertions (taken almost verbatim from the Commissioner's determination):

1.4.1 The original intention was to acquire a property for the group's own use, not for rental.

1.4.2 The decision to acquire the property was made in July 1980 when the group needed to establish its first office. No directors' resolution was made at that time.

1.4.3 The property was let to Company A (a related company) for the period 1 October 1980 to 31 July 1981 at a monthly rental of $15,000. No tenancy agreement was executed. Messrs X and Y are common directors and shareholders of Company A and the company.

1.4.4 Decoration work had been done and the cost of such decoration was incurred by Company A (the operating company of the group) and included in its accounts.

1.4.5 Time and monies spent on the decoration of this new office are concrete evidence of the company's intention to acquire the property as its group's office.

1.4.6 The acquisition was partly financed by advances from directors amounting to $435,000 and partly by a mortgage of the property to a finance company for $950,000.

1.4.7 The company received monthly rental amounting to $15,000 which was quite sufficient to cover the monthly instalment payment of $16,770.10.

1.4.8 The decision by Company A to move out of the premises was made in late April or early May 1981. Initially Company A had intended to move to premises which could not be available on schedule. (A copy of the confirmation of a tenancy dated 25 May 1988 was produced before us.)

1.4.9 In July 1981, Company A entered into a tenancy agreement with a bank to rent office premises in Central District. This office provided more area at a cheaper rent of $10,494 per month, in addition to providing easier access to Company A's bankers and customers.

1.4.10 Since the registered and business office of the related companies had now been moved to the new premises, the neighbouring tenant, Company B, approached the company to acquire the property.

1.4.11 The proceeds of sale were used to repay the mortgage and directors' loans.

1.4.12 Company A is related to the company and is engaged in the business of property dealing and agency.

1.4.13 In the course of processing the objection, it came to light that the directors of the company had paid an additional sum of $858,700 for the purchase and had received an additional sum of $1,000,000 from Company B. This was said to be due to the following:

(a) The sum of $858,700 was part of the purchase price which its vendor required to be paid separately.

(b) The difference of $1,000,000 was received by the two directors equally ... This was to reimburse them for a sum of $858,700 paid by them in September 1980 to the company's vendor. This sum was not reflected in the agreement or assignment. The difference between $1,000,000 and the above sum represents interest.

1.4.14 In June 1986, the company paid additional stamp duty on its assignment to Company B.

2. Submissions

The submissions of the company's representative (Mr Lai) and the Revenue's representative (Mr Lee) plus some of our own comments thereon can be summarized as follows:

2.1 The mere fact of a $4 paid-up capital is no bar to investment. It is common for under-capitalized companies to hold properties as investments. Indeed, companies which are nominally capitalized are used to bid at public auctions. The funds for the purchase came partly from shareholders and partly from a bank mortgage.

As Mr Lee pointed out, since neither director gave evidence we have no means of judging their ability to maintain the loan position. The failure to capitalize the loans not only left the matter in doubt but also carried the implication that they had resale in mind whereupon they would simply redeem their loans – that simple step would be lost to them if they had capitalized the loans.

2.2 The shortfall between the monthly mortgage instalments and the rental from Company A was only $1,770 per month. In any event, the company's 1980 accounts showed only a small book loss of $18,799 of which $11,895.60 was depreciation.

Mr Lai acknowledged that his firm had given the accountants' certificate to the 1980 accounts of the company, qualifying them to the effect that though the accounts were prepared on a going concern basis such a basis was, in view of the company's losses and excess of liability over assets, dependent an additional financing. Mr Lai further acknowledged that the shareholders had not given the assurances which would have resulted in the certificate being unqualified.

2.3 The fact that an additional $858,000 (unrecorded in the 1980 accounts) was paid out was not suggestive of a need to resell.

Mr Lee pointed out that the directors in the 1980 accounts stated that those accounts did not omit any material information. We took this to mean that we were to infer that statements by the directors were not to be relied upon.

2.4 Although the company did not use the property save as its registered office, nevertheless Company A did.

Mr Lee's response to this was that there was no evidence before us of use of the property by staff of Company A or of the company. The company's representative in his address to us said that originally Company A had no staff and used an accountant's office as its accommodation address. Mr Lai spoke about Company A later having staff, but no particulars were forthcoming.

2.5 Nothing should be inferred from the absence of any formal tenancy agreement between the company and Company A because they were related companies.

This Board had no evidence before it as to the relationship between Company A and the company. We only had the company's representative's assertion that they were 'related', the extent and manner of which was not explained.

2.6 There was no active attempt to sell the premises. The offer of Company B was the only negotiation.

Mr Lee drew our attention to the fact that the company entered into the agreement to sell on 21 May 1981 whereas the earliest objective indication of alternative premises is a letter of 25 May 1981. In other words, the company decided to sell before actually acquiring alternative premises.

3. Conclusions

3.1 Section 68(4) of the Inland Revenue Ordinance places the onus on the company to prove that the assessment is excessive or incorrect. That onus cannot be discharged merely by a self-serving declaration of intention (Lord Hamsworth in Hillerns and Fowler v Murray (1932) 17 TC 77.

3.2 The circumstantial evidence put before us by itself was too ambiguous and insubstantial for us to draw the inference of an intention to acquire the property as a long-term investment which the company's representative urged upon us. On the other hand, the short period during which the property was held, the uncertainty concerning the directors' loans and the sale before acquiring alternative premises tended to support the Revenue's view.

3.3 Moreover, the undeclared additional considerations involved both on the purchase and the resale cast a cloud of unexplained doubt over the transactions to an extent which cannot be ignored.

For the foregoing reasons, this appeal is dismissed.