

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D23/92

Profits tax – whether profit or gain on disposal of property was capital and not subject to profits tax.

Panel: William Turnbull (chairman), Kenneth Ku Shu Kay and Harry Wilken.

Date of hearing: 24 June 1992.

Date of decision: 25 August 1992.

Mr X was a senior employee working for a brokerage company and was entitled to the provision of quarters free of charge. To take advantage of this benefit he and his wife arranged to purchase a property in the name of the taxpayer which is a private limited company owned by Mr X. The property was let to the employer and was made available to Mr X free of charge as his quarters. Mr X subsequently decided to up-grade his quarters and proceeded to purchase another property also in the name of the taxpayer. This second property was subsequently found to be unsuitable for his purposes and was sold by the taxpayer at a profit. The profit was assessed to profits tax. The taxpayer claimed that the profit was a capital gain made on the disposal of a capital asset.

Held:

In the circumstances of this case Mr X had caused the taxpayer to acquire the second property as a capital asset intending it to be a residence for Mr X. Accordingly when it was sold in unforeseen circumstances the profit or gain was a capital profit or gain and not subject to profits tax.

Appeal allowed.

S P Barns for Commissioner of Inland Revenue.

S Kambil of Ting Ho Kwan & Chan for the taxpayer.

Decision:

This is an appeal by a private limited company incorporated in Hong Kong against a profits tax assessment raised on it for the year of assessment 1988/89. In that assessment the profit or gain on the disposal of a property was assessed to profits tax and the Taxpayer claimed that the same was a capital gain or profit and not chargeable to profits tax. The facts are as follows:

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1. Mr X was a senior employee working for a brokerage company in Hong Kong ('the employer'). Under the terms of his employment, Mr X was entitled to the provision of quarters to be provided free of charge by his employer.
2. The Taxpayer was a private limited company incorporated in Hong Kong which was owned by Mr X and his wife. The Taxpayer was used by Mr X and his wife to benefit from the provision of quarters offered by his employer. Mr X arranged for the Taxpayer to purchase a flat at site B which was then leased by the Taxpayer to the employer and in turn provided by the employer to the Taxpayer as his residence. To purchase the flat at site B the Taxpayer partly used monies provided by the Taxpayer and partly borrowed money from a bank by way of an instalment loan repayable over ten years. For convenience we refer to this flat as 'B flat'.
3. For some years Mr X lived with his wife in B flat. Mr X and his wife formed the intention that they would like to move from site B to another flat with a more pleasant environment. After making enquiries, Mr X found a suitable development in site A which he and his wife liked. The development comprised a number of blocks of flats some of which had been newly renovated. He looked at a ground floor flat in one of the renovated blocks which he liked. He decided to purchase this ground floor flat and paid a deposit but the owner thereof changed his mind and Mr X was not able to complete the purchase.
4. The caretaker of the development in site A told Mr X that there was another flat available in the same renovated block because the owner thereof was emigrating to Canada. Mr X visited this other flat, had a quick look at it and decided to purchase it because the price was good and it appeared to be nicely decorated. His wife did not see it until after he had agreed to purchase the same. The reason why he made an immediate decision to purchase it was because of the unfortunate experience he had previously had with the ground floor flat in the same block. He assumed that the flat which he bought would be similar to the ground floor flat. The sale and purchase agreement was dated May 1988 and completion of the purchase took place in July 1988. For convenience we refer to this second flat as 'A flat'.
5. The purchase price for A flat was \$3,150,000. One of the terms of the purchase of the A flat was that the vendor would be permitted to rent it at a rental of \$25,000 per month for a period of 6 months pending her emigration to Canada.
6. Mr X used the Taxpayer for the purpose of purchasing A flat. To finance the purchase of A flat the Taxpayer obtained monies from Mr X and obtained a 12-month banking facilities loan of \$2,800,000 from a bank. The bank loan was a short-term facility on terms which were very favourable to the Taxpayer because it was a back to back arrangement made by Mr X who maintained fixed deposits with the same bank and the bank only charged interest at 0.5% over the fixed deposit rate. When the Taxpayer purchased A flat the income of Mr X from his employment for that year was substantial being in excess of \$6,000,000.

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7. After A flat had been purchased Mr X and his wife inspected the same. The wife of Mr X was not satisfied with it because there was a step between the bedroom and the bathroom. This was not noticed by Mr X when he had first seen the flat. He had assumed that it was the same as the ground floor flat in the same block which he had tried unsuccessfully to purchase. The problem caused by the step between the bathroom and the bedroom was twofold. The wife of Mr X had a leg disability which made it inconvenient for her. In addition Mr X was required to work late at night because of his work and he did not return home on some occasions until very late. This meant that it would be inconvenient and possibly dangerous for him late at night to go from the bedroom to the bathroom. For these reasons Mr X and his wife decided that they did not want to live in A flat which Mr X had purchased.

8. The caretaker enquired of Mr X when he intended to move into A flat and Mr X told the caretaker that he and his wife had decided not to live in the flat. The caretaker then introduced an actor to Mr X who wished to buy the flat from the Taxpayer. Mr X had not yet decided to sell the flat but the actor was very persistent. He made an offer of \$4,255,000 for the flat and the wife of Mr X said that it was alright to sell the flat because they could find another one more suitable for them. For this reason Mr X arranged for the Taxpayer to sell A flat to the actor.

9. A flat was sold by the Taxpayer to the actor in January 1989 for \$4,180,000 and a net profit or surplus after expenses of \$921,585 was made.

10. Subsequently Mr X and his wife found a flat in site P which for convenience we refer to as 'P flat'. The Taxpayer arranged to purchase this in the name of another company owned by himself and his wife. Mr X and his wife moved from B flat to P flat where they now live. P flat is let to the employer and provided to Mr X as quarters. Mr X arranged for this other company to obtain a loan from a bank for the purpose of buying P flat. It was the same bank which he had used to enable the Taxpayer to purchase A flat. It was a five-year fixed loan of \$4,000,000, repayable by nine half-yearly instalments of \$100,000 each and as to balance of \$3,100,000 by a 'balloon' payment at the date of maturity.

11. In its profits tax return for the year of assessment 1988/89 the Taxpayer declared a loss of \$121,711 which was arrived at after the exclusion of its gain on the disposal of A flat of \$921,585.

12. The assessor was of the opinion that the Taxpayer had acquired A flat as a trading asset and that the gain on the disposal thereof was an assessable profit. A profits tax assessment for the year of assessment 1988/89 was raised on the Taxpayer calculated as follows:

Loss per Return	(\$121,711)
<u>Add: Gain on disposal of the Property</u>	<u>921,585</u>
Assessable Profits	\$799,874

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13. By letter dated 17 May 1990 the tax representative for the Taxpayer lodged an objection to the assessment on the ground that the gain on disposal of A flat was of a capital nature and not liable to profits tax.

14. By his determination dated 20 January 1992 the Deputy Commissioner upheld the assessment as raised by the assessor. The Taxpayer duly appealed too this Board of Review.

At the hearing of the appeal the Taxpayer was represented by its tax representative and Mr X was called to give evidence. We found Mr X to be truthful in the evidence which he gave. It is not necessary for us to set out separately the facts which we find from the evidence of Mr X because we have incorporated the same into the above facts found by us. The representative for the Taxpayer submitted that on the facts before us the Taxpayer had acquired A flat as a capital asset and had subsequently changed its mind because it had been found that A flat was unsuitable for occupation by Mr X and his wife.

The representative for the Commissioner submitted that A flat had not been acquired as a capital asset and that the Taxpayer was correctly assessed to profits tax on the gain or profit which had arisen when A flat had been sold. He drew our attention to the short-term nature of the bank borrowing, to the fact that one would expect the wife of Mr X to have inspected A flat before the Taxpayer agreed to purchase it and that in reality the Taxpayer had seen a good bargain when he had arranged for Mr X to purchase A flat. He said that when looked at objectively the transaction looked more like a trading transaction than the acquisition of a capital asset.

We have the benefit of having heard Mr X give evidence and we have the benefit of more facts than were available to the assessor and subsequently the Deputy Commissioner.

Without the evidence of Mr X we would have agreed with both the assessor and the Deputy Commissioner. However having heard the full story from Mr X and accepting that he was a truthful witness we find in favour of the Taxpayer. In reality the Taxpayer was the alter ego of Mr X and his wife who were buying themselves a family home. To take advantage of the free of charge provision of quarters by the employer, Mr X and his wife used the Taxpayer to purchase their home. They first purchased B flat. They then decided to find a nicer place to live and at first chose area A. We accept the explanation of Mr X when he said that he did not want to lose the opportunity of buying A flat when it was purchased by the Taxpayer. He had already had one unfortunate incident with the ground floor flat at area A. We agree with the representative for the Commissioner when he said that the price of A flat was attractive. Indeed this accords with what Mr X told us. He said that because the owner was emigrating to Canada the price was good. However this does not convert the transaction into a trading transaction. A person who wants to buy a place for their home is just as concerned as a trader in obtaining a good price. With regard to the period of ownership by the Taxpayer we accept the explanation and evidence given by Mr

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X. He arranged for the Taxpayer to buy the flat in haste but with the clear intention that it would be the new home for himself and his wife. Later there was a change of mind because of an unforeseen disadvantage.

In reaching our decision we have taken note of the fact that Mr X and his wife subsequently arranged to acquire a new home in site P. They used a different company for this purpose but we attach no great significance to this. What perhaps is of more importance is that they arranged to borrow money from a bank to acquire all three flats which were bought. We find it of little significance that the Taxpayer purchased A flat using a general banking facilities mortgage. There was no financial pressure on the Taxpayer to sell A flat and clearly Mr X had the financial ability to cause the Taxpayer to retain A flat if it had been necessary to do so.

In all of the circumstances we find that it was the intention of the Taxpayer at the material time to acquire A flat as a capital investment and accordingly the surplus on the sale of A flat is not subject to tax.

During the hearing of the appeal it became apparent that there may be other adjustments which must be made to the assessable profit of the Taxpayer. In particular a question arose with regard to certain overseas expenses claimed as deductible for tax purposes by the Taxpayer. It may also be necessary to make certain other adjustments arising from the fact that we have found that A flat was a capital investment and not a trading asset. We allow this appeal and find in favour of the Taxpayer. To enable any necessary adjustments to be made we refer the matter back to the Commissioner to reduce the assessment in accordance with this decision.