INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D26/93

Profits tax – sale of plots of land – whether profit realised on sale of long term investments.

Panel: Robert Wei Wen Nam, QC (chairman), Chen Yuan Chu and Yeung Kwok Chor.

Date of hearing: 19 July 1993.
Date of decision: 20 September 1993.

The taxpayer was a private limited company and purchased certain properties in 1973. The properties were classified as fixed assets. In 1975 and 1976 the taxpayer informed the Inland Revenue Department that the property had been acquired for redevelopment and sale. The taxpayer made a number of applications to the government for redevelopment of the land but the same were rejected. In 1986 the taxpayer made a further application for redevelopment which was accepted subject to certain conditions. The taxpayer did not pursue the development but in 1987 sold the properties. The assessor assessed the profit to profits tax on the basis that the properties were trading stock of the taxpayer. The taxpayer appealed to the Board of Review.

Held:

The Board found as a fact that the taxpayer acquired the properties with the intention to redevelop the same for sale. As this had been the intention of the taxpayer to profits arising when the properties were ultimately sold was assessable to profits tax.

Appeal dismissed.

Case referred to:

Shadford v H Fairweather & Co Ltd 43 TC 291

May Chan for the Commissioner of Inland Revenue.
The director of the taxpayer for the taxpayer.

Decision:

Introduction

1. This is an appeal by a private limited company (the Taxpayer) against the additional profits tax assessment raised on it for the year of assessment 1987/88 in the sum of $4,418,863 with tax payable thereon of $795,395. The central question for this appeal is whether the surplus arising from the disposal of two plots of land in Place X (the properties) is profit realised on the sale of long-term investments.

Agreed Facts

2. The Taxpayer was incorporated as a private company in mid-1973.

3. The late Mr L was one of the subscribers of the Taxpayer. At all relevant times, he was the controlling shareholder and director of the Taxpayer. He passed away in 1987. The present shareholding directors are Mr L1 and Mr L2 who were appointed in mid-1985.

4. By deed of assignment dated in mid-1973 the Taxpayer acquired the properties at a cost of $1,950,000.

5. The properties had all along been classified as 'fixed assets' on the Taxpayer's balance sheets.

6. The properties were located within the zone of the prevailing Outline Zoning Plans of Place X. One of the properties was an agricultural land. The other property was designated as building and garden ground. Under the terms of the Crown lease, any building development on the latter land lot would be subject to site coverage and height restriction.

7. From December 1973 to 1977 the Taxpayer, through its architect, submitted to the district office enquiries and proposals for developing the properties.

8. On two occasions in 1975 and 1976, the former tax representative of the Taxpayer advised the Revenue that the properties were intended for 'development and sale'. On one occasion in 1976 the Taxpayer signed a statement to the same effect.

9. In 1978 a firm of architects submitted on behalf of the Taxpayer an outline plan for a proposed development of the properties into a hospital and to enquire if the properties could be modified for this purpose. The proposed modification was rejected by the district office in 1978.

10. In 1986 the Taxpayer's surveyors submitted various proposals to the district office to redevelop the properties into a high rise residential building.

11. In a letter to the Taxpayer dated 4 August 1986 the district office made it a condition of any redevelopment that the maximum building height should be six storeys and the minimum flat size 100 square metre. The Taxpayer submitted development plans to meet these conditions. However, in the end, the Taxpayer did not pursue the development.

12. By deed of assignment dated 30 October 1987, the Taxpayer sold the properties for $7,700,000.

13. On 3 February 1988 the former tax representative furnished to the assessor a schedule of properties owned by the Taxpayer as at 31 March 1986. With reference to the properties in question the schedule included the comment:

> 'Appointed X Company to apply to the Government for modification of lease for the construction of high rise building for rental. No result.'

14. The Taxpayer furnished a profits tax return for the year of assessment 1987/88 showing profit on disposal of land and buildings classified under fixed assets of $4,780,284 (of which $4,418,863 related to the disposal of the properties in question).

15. On 8 March 1990 the Taxpayer lodged an objection under section 61(1) of the Inland Revenue Ordinance against the notice of additional assessment dated 12 February 1990 in respect of the proceeds from the sale of the properties.

16. On 17 August 1990 the assessor wrote to the Taxpayer advising that she was of the opinion that the properties were the Taxpayer's trading stock and invited the Taxpayer to withdraw the objection. However, if the Taxpayer intended to pursue the case, the assessor asked for documentary evidence to support that the Taxpayer either had the original intention to develop the properties for long-term investment, or had changed its intention from properties trading to long-term investment.

17. In a letter to the Revenue dated 28 February 1991, the new representative of the Taxpayer submitted that there was no change in the Taxpayer's intention in holding the properties as long-term investments as such a change should be reflected in the accounts. Enclosed with the letter were, among other things, a statement from Mr C dated 7 February 1991 advising that he held discussions with the late Mr L concerning the use of the properties for development of a private hospital.

Intention to Redevelop for Rent or for Sale?

18. In the communications to the Inland Revenue Department in 1975 and 1976, the intention of the Taxpayer in acquiring the properties was stated to be to redevelop them for sale (see paragraph 8 above). It is not in dispute that the statements of intention were made in the following circumstances:

(a) In response to the assessor's enquiry (whether the properties had been purchased 'for redevelopment and sale or for letting purposes'), the former representative of the Taxpayer informed the assessor by letter dated 27 February 1975 that the properties had been acquired for 'redevelopment and sale purposes'.

(b) By letter dated 11 December 1976 the former representative applied on behalf of the Taxpayer to the assessor for discharge of property tax raised on the Taxpayer for the year of assessment 1976/77 in respect of the properties. Among other things the former representative stated that the properties had been acquired 'for redevelopment and sale purposes.'

(c) In its application for exemption from property tax dated 29 December 1976, the Taxpayer stated that the properties were to be used for 'redevelopment and sale purposes'. This application was signed by one of the Taxpayer's directors, the late Mr C.

19. Having considered those statements of intention and the arguments put forward by Mr B the Taxpayer's representative at the hearing, we have no hesitation whatsoever in saying that in purchasing the properties the Taxpayer intended to redevelop them for sale. Mr B called no witnesses. His arguments are summarised and dealt with below.

20. All properties at all times were posted in the Taxpayer's books as fixed assets. Mr B relied on that as proof of the Taxpayer's intention towards those properties. Here we accept the submission of Miss Chan the representative of the Commissioner that the accounting presentation is, of itself, inconclusive in deciding the true nature of a transaction. In Shadford v Fairweather & Co Ltd 43 TC 291, Buckley J stated at 299:

> 'For, however genuinely the accounts may have been framed by those responsible for them, and however carefully they may have been studied by those responsible for auditing them, the other evidence may show that in fact they do not truly indicate the nature of the relevant operations.'

In the present case the Revenue relied on the three statements of intention mentioned in paragraph 18 above as showing the true status of the properties; we think that they were entitled to do so. Mr B submitted that the statements of intention made by the former representative (see paragraphs 18(a) and (b) above) did not represent the true intention of the Taxpayer; we do not agree. He further submitted that the third statement (see paragraph 18(c) above) was signed by the late Mr C under circumstances which made it extremely unlikely that he was aware of the issues surrounding the application for exemption from property tax; there was not a scrap of evidence to prove those allegations, and we are bound to reject them. Mr B also attacked the representations which the former representative made to the assessor concerning a claim for loss on disposal of certain other properties of the Taxpayer which had been classified as fixed assets in the balance sheets. The way we look at the episode is that in order to support the claim, the former representative had contended that those other properties had been purchased for development for sale, but that later that contention was abandoned. That the former representative was able to raise the point at all demonstrates that the classification in the accounts was not conclusive.

21. We now move on to Mr B's submission regarding the application for modification of lease conditions to permit the proposed development of the properties into a private hospital (see paragraph 9 above). To adopt Mr B's words, 'putting forward a

proposal does not in itself prove an intention since the power to make the proposal a reality (that is, the authorities' permission) is outside the Taxpayer's control. Hence the proposal remains a desire or a hope only'. However he went on to argue that 'the discussions and proposals surrounding the private hospital and the subsequent multi-storey residential development' (which will be dealt with later) 'firmly support the company's books of account'. We disagree. There was no firm decision to build a private hospital. On behalf of the Taxpayer, the architects were merely testing the reaction of the government to the idea of putting up a private hospital on the properties; it was impossible for the Taxpayer to make a firm decision until the government had granted permission, but that moment never came because the government refused the application. In our view, the application for modification is not evidence of an intention in the Taxpayer to build a private hospital, let alone an intention to hold the properties for long-term investment. That is enough to dispose of the argument. However, since Mr B relied rather heavily on a further point, we shall state our views on it. It was put this way.

> 'An investment in a private hospital cannot be of a trading nature. [The Taxpayer] had no intention of selling the land of Mr C. It was to be their contribution to the project. Had they wished to realise their investment at any point after the project became reality, they would have had to sell their shares in the company, which would have had to have been created to own the hospital. The properties would have no longer existed as stock to be traded.'

Mr B referred to a statement signed by Mr C which alleged that in the middle of 1977, when preparing a feasibility study entitled 'Proposed Private Hospital', he discussed with the late Mr L the possibility of co-operating to sue the properties for the development of the proposed private hospital. It further stated:

> 'The principles of any possible future co-operation were not discussed in detail, but Mr L expressed an interest in his company either leasing the land on a long-term basis, or contributing the land as [the Taxpayer's] share of investment in the proposed project.
>
> 4. Mr L was very interested in using the land of Place X for the project, and submitted outline plans to the Hong Kong Government. Mr L did not offer any other land for the project.
>
> 5. In March 1978 I was informed by Mr L that the Government had refused permission to allow his company to develop the land as a private hospital.'

Miss Chan objected to Mr C's statement as he was not called; that was a valid point. Further, assuming for argument's sake that everything quoted above is true, it does not carry the argument any further. The discussions were general and exploratory; the so-called project was nothing more than just an idea. Although the late Mr L expressed an interest in two forms of co-operation, there was no commitment on the part of the Taxpayer or the late Mr L to either form; there was nothing to prevent the Taxpayer from carrying out the

development as building owner and selling it at a profit. Furthermore, as we have stated above, there was never any firm intention to build a private hospital; it is therefore idle to speculate on what form any possible co-operation might have taken.

22. As for the proposed multi-storey residential development, the agreed facts are contained in paragraphs 10, 11 and 13 above. Mr B relied on the comment contained in the schedule of properties owned by the Taxpayer as at 31 March 1986, and which reads as follows:

> 'Appointed X Company to apply to the Government for modification of lease for the construction of high rise building for rental. No result.'

He pointed to the words 'for rental' as evidence, in line with the fixed-asset classification in the books, of an intention to hold the properties for long-term investment. Miss Chan was right to point out that the comment was a self-serving statement made after the sale of the properties (see paragraph 12 above). In our view the words 'for rental' were an afterthought to which we shall attach no weight.

23. Mr B further contended that the way the Taxpayer dealt with all its properties was a reliable guide to its intention towards the properties. He stated:

> 'All properties were retained for several years, and the properties in question for fourteen years. During that period residential land prices rose steeply and subsequently fell. Had the Taxpayer had the intention of trading, he could easily have sold the properties at a much larger profit in the late 1970's or very early 1980's even without the additional planning permission, which the Taxpayer sought.'

No evidence was led to explain how the Taxpayer dealt with its other properties and why its record relating to them was a reliable guide. Furthermore, to say that the Taxpayer had no intention to trade because it did not sell the properties a few years earlier when residential land prices were higher would be to credit the Taxpayer with foreknowledge that land prices were going to fall; we see no grounds for doing so.

Conclusion

24. For all those reasons, our conclusion is that the Taxpayer's intention in purchasing the properties was to develop them for sale at a profit, and that, having attempted to develop them in various ways without success, the Taxpayer disposed of them at a profit. Mr B's central point was that the Taxpayer's intention in acquiring the properties was to hold them as long-term investments. He has failed to satisfy us that that was so.

Decision

25. This appeal is dismissed and the additional profits tax assessment in question is hereby confirmed.