

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D33/93

Profits tax – industrial building allowance – whether property trading stock or a long term investment.

Panel: Robert Wei Wen Nam QC (chairman), Foo Tak Ching and Michael A Olesnicky.

Date of hearing: 9 September 1993.

Date of decision: 4 November 1993.

The taxpayer acquired a piece of land from the government and erected thereon an industrial building.

The taxpayer stated its intention in acquiring and developing the property as being for the purpose of trading. Subsequently the taxpayer claimed a change of intention and said that with effect from 30 March 1987 the developed property was held as a long term capital asset. The assessor refused to accept that there was a change of intention on 30 March 1987 and the Commissioner confirmed this decision of the assessor. The taxpayer appealed to the Board of Review.

Held:

The onus of proof is on the taxpayer to show that there was a change of intention. Though evidence had been called with regard to the change of intention it was rejected by the Board because it conflicted with other clear evidence before the Board.

Appeal dismissed.

Yim Kwok Cheong for the Commissioner of Inland Revenue.

Lam Wai Hay of Messrs W H Lam & Co for the taxpayer.

Decision:

Introduction

1. In this appeal a company is appealing against the 1989/90, 1990/91 and 1991/92 profits tax assessments raised on it as revised or confirmed, as the case may be, by the Commissioner of Inland Revenue in his determination dated 3 May 1993. The question

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is whether industrial building allowance should be granted in respect of a building (the building) erected on a plot of land in Place X (the land) (collectively referred to as the developed property).

### Facts

2. The facts stated in paragraph 1 of the Commissioner's determination are agreed by the parties and are reproduced below:

- (1) R Limited (the Taxpayer) has objected to the 1989/90, 1990/91 and 1991/92 profits tax assessments raised upon it. The Taxpayer claims that it should be granted industrial building allowance in respect of a building called 'R Industrial Building' (the building).
- (2) The Taxpayer was incorporated as a private company in Hong Kong in 1980. At all the relevant times, the Taxpayer described the nature of its business as 'property investment'.
- (3) In mid-1980, in a public auction, the Taxpayer acquired from the government a plot of land in Place X (the land) at a cost of \$13,000,000.
- (4) The agreement and conditions of sale of the land ... contained the following building covenant:

'The purchaser shall develop the lot by the erection thereon of a building or buildings ... to be completed and fit for occupation before the expiration of 36 calendar months from mid-1980 and shall expend thereon such a sum of not less than \$1,740,000.'
- (5) The Taxpayer recorded the cost of the land and the subsequent development expenditure of the building as current asset in its accounts for each of the years ended 31 March 1982 to 1986.
- (6) On 17 October 1983, Messrs W H Lam & Co (the representative) when claiming a deduction of the interest expense incurred by the Taxpayer in the 1982/83 year of assessment on premium instalments to the Hong Kong government, wrote on behalf of the Taxpayer in the following terms.

'... In substance, there were financial expenses incurred on money borrowed on the purchase of the land which is held by the company as trading stocks ...'

The representative subsequently agreed with the assessor that the interest expense was part of the cost of the building which was then under construction and that it was not deductible as an expense under section 16.

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- (7) In its 1983/84 profits tax return, the Taxpayer declared a loss of \$10,606,406 which was arrived at after the deduction of a sum of \$10,400,000 representing the diminution in value of the land. The assessor did not at first accept that the diminution in value was deductible.
- (8) In its 1984/85 profits tax return, the Taxpayer declared a profit of \$3,316,244 before the set-off of the loss of \$10,606,406 brought forward from the 1983/84 year of assessment.
- (9) On 21 November 1985, the assessor raised a profits tax assessment with an assessable profit of \$3,316,244 on the Taxpayer for the 1984/85 year of assessment without making any allowance for the loss brought forward from the 1983/84 year of assessment.
- (10) On 5 December 1985, the representative objected against the 1984/85 profits tax assessment on behalf of the Taxpayer on the ground that the assessor failed to deduct any of the loss brought forward from the 1983/84 year of assessment. To support the Taxpayer's claim that the diminution in value of the land was deductible as a decrease in value of trading stock, the representative wrote in the following terms:

‘First of all, we wish to point out that the construction work of the building ... was completed during the year. Occupation permit to the said building was obtained. Our clients wanted to sell the completed building unit by unit, but due to the inactive demand in the market, none of the units was sold. They then decided to let the building and earned some rent ...’

- (11) On 28 December 1985, the representative applied for the holding over of the 1984/85 profits tax which was in dispute and wrote in the following terms:

‘The said property including land and building has at all times been held by our clients as trading-stock (of property). It has always been shown and classified under current assets ...’

‘Our clients have always treated and held this asset (land and building) as trading stock and that is why they only claimed the loss in diminution of value of \$10,400,000 in the year of assessment 1983/84 once, and do not make any further adjustment in the subsequent year of 1985 ...’

- (12) On 6 February 1986, the representative by letter provided the following arguments in support of the Taxpayer's objection against the 1984/85 profits tax assessment:

‘Once again, our clients wish us to refer you to the contents of our letter dated 28 December 1985 and wish us to stress that all the time the

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property ... at the land cost of \$13,000,000 (auctioned from the Crown by our clients) has been held as trading stock of property. Thus, the general accounting principle of valuation of stock-in-trade at the lower of cost or market value is applicable to this asset. Our clients wrote down the land cost to \$2,600,000 at 31 March 1984 based on a professional valuation is an acceptable one even for tax purpose.'

'Our clients further wish us to inform you that in view of the lower trend in the factory building market in the year of assessment 1984/85 when the developed property was completed, the directors decided not to sell the completed units until a more favourable time come. Therefore they decided to rent out the units to earn more income while waiting for the property boom to come.'

The representative enclosed with its letter a copy of the valuation report dated 20 September 1983 ... the report stated that in the opinion of the valuer, the market value of the land as at 31 March 1983 was \$2,600,000 (that is a reduction in value of \$10,400,000).

- (13) On 17 March 1986, the representative, in support of the Taxpayer's objection against the 1984/85 profits tax assessment, supplied the assessor the following further information:

'When the developed properties were nearing completion, the factory market was in the lowest level ever had. Our clients were hesitate and reluctant to sell the units at a heavy loss. They waited until the completion of the buildings. Yet, the factory market was in a low level when they obtained the Occupation Permit. Thus, they had to decide whether to sell the units at a heavy loss or temporarily let and wait for the property boom to come and then sell at no loss or hopefully at a profit. Our clients had not then advertised to sell the units in the property ... nor had they published any brochure to promote the sale of the units. However, this has not changed the nature of the property as stock held by the company. Basically, our clients consider that advertisement or brochure are only minor evidences to prove a certain intention and these evidences could well be produced far early than the property completion date under a plan in case they wish to do so.'

'The fact is our clients have never intended to hold the property as investment and this is well illustrated by their placing the property in current asset under the 'Stock' column. This was done since the first accounts were available. Taxwise, our clients have taken and are taking the risk of any property boom during the past and in the coming dates which may bring the value to a high level and yielding them a big taxable profit. However, they had not put tax as a consideration to sell their units. As a business concern, profits are most important and they believe

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the property price will go up. Thus they hold it and not to sell it until the trend comes. The decision was made before completion. Therefore no advertisement or brochure to sell the units was made.'

- (14) On 4 April 1986, the assessor accepted the Taxpayer's arguments, revised the 1983/84 and 1984/85 profits tax assessments to nil and issued to the Taxpayer the following loss computations:

### Year of Assessment 1983/84

Loss per return	\$10,606,406
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<u>Less: Interest on premium instalments to Hong Kong Government</u>	<u>376,679</u>
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Loss for the year carried forward	<u>\$10,229,727</u>
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### Year of Assessment 1984/85

Profit per return	\$3,316,244
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<u>Less: Loss set-off</u>	<u>3,316,244</u>
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Assessable Profit	<u><u>NIL</u></u>
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### Statement of Loss

Loss brought forward	\$10,229,727
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<u>Less: Loss set-off</u>	<u>3,316,244</u>
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Loss carried forward	<u>\$6,913,483</u>
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The Taxpayer did not disagree with the assessor's loss computations.

- (15) In its 1985/86 profits tax return, the Taxpayer declared a profit of \$72,851 before the set-off of the agreed loss of \$6,913,483 brought forward from the 1984/85 year of assessment.
- (16) The assessor when examining the Taxpayer's 1985/86 profits tax return noticed that the Taxpayer did not recoup any decrease in diminution in value of the land. The assessor thus requested the Taxpayer to provide a valuation of the land as at 31 March 1986.

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- (17) On 19 February 1987, the representative replied on behalf of the Taxpayer in the following terms:

‘In the current assets of the said accounts, the leasehold land of the trading stock of property ... was stated at the valuation of \$2,600,000 valued at 31 March 1984. Our clients do not intend to revalue their property every year as this will incur considerable costs to them and they in fact suffer loss in their business.’

‘In view of the circumstances stated above, please make a valuation of the market value of the property at 31 March 1986 for our clients’ agreement. As the land cost has been written down by the value of \$10,400,000, the maximum amount to be added to the revaluation of property due to appreciation in land at 31 March 1986 should be limited to \$10,400,000 only.’

- (18) On 5 March 1987, the assessor raised on the Taxpayer the following 1985/86 profits tax assessment:

Profit per return	\$ 72,851
<u>Add: Diminution in value recouped</u>	<u>10,400,000</u>
	10,472,851
<u>Less: Loss brought forward</u>	<u>6,913,483</u>
Assessable Profit	<u>\$3,559,368</u>
<u>Statement of Loss</u>	
Loss brought forward	\$6,913,483
<u>Less: Loss set-off</u> against 1985/86 profit	<u>6,913,483</u>
Loss carried forward	<u><u>NIL</u></u>

- (19) On 24 March 1987, the representative objected against the 1985/86 profits tax assessment on behalf of the Taxpayer on the ground that the decrease in diminution in value was around \$3,900,000 and that the full amount of the diminution in value should not have been recouped. The representative informed the assessor that the Taxpayer had instructed a valuer to make a valuation of the land.

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- (20) On 30 March 1987, the representative by letter informed the assessor that the valuation of the land at 31 March 1986 was \$2,800,000. The representative further suggested to the assessor that an amount of \$200,000 should be recouped when ascertaining the 1985/86 assessable profits. The representative enclosed with its letter a copy of the valuation report dated 27 March 1987.
- (21) On 12 April 1988, the assessor revised the 1985/86 profits tax assessment to nil and issued to the Taxpayer the following loss computation:

Profit per return	\$ 72,851
<u>Add: Diminution in value recouped</u>	<u>200,000</u>
	\$ 272,851
<u>Less: Loss set-off</u>	<u>272,851</u>
Assessable Profit	<u><u>NIL</u></u>
<u>Statement of Loss</u>	
Loss brought forward	\$6,913,483
<u>Less: Loss set-off</u>	<u>272,851</u>
Loss carried forward	<u><u>\$6,640,632</u></u>

The Taxpayer did not disagree to the loss computation.

- (22) In response to the assessor's enquiry as to whether any of the units in the building had been sold during the year ended 31 March 1987, the representative replied in the following terms:

'We enclose herewith a photocopy of the quotation of the R Industrial Building price lists which our clients offer for sale since May 1987. We also enclose herewith a photocopy of price list of W Industrial Centre which shows the prices of nearby Industrial Building offered by T Property Limited. You will notice that the prices asked by our clients are little bit on the high side compared with that of the W Industrial Building which is owned by T Property Limited. Our clients further wish us to inform you that up to the end of May 1987, none of the units had been sold because of the following reasons:

- (a) All the units of the building are fully let and thus the units are sold without vacant position to the buyer.

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- (b) The prices asked by our clients are higher than that of the units compared with the industrial building such as W Industrial Building of the nearby area.'
- (23) The Taxpayer reclassified, in its 1986/87 accounts, the cost of the land and the development cost of the building from 'current assets' to 'fixed assets'. The Taxpayer, in the same set of accounts, wrote back an amount of \$2,400,000 as being a further decrease in diminution in value of the land.
- (24) In its 1986/87 to 1991/92 profits tax returns, the Taxpayer declared the following profits and claimed in respect of the building the following industrial building allowances:

<u>Year of Assessment</u>	<u>Assessable Profit (before loss set-off &amp; I.B.A.)</u> \$	<u>Industrial Building Allowance (I.B.A.)</u> \$
1986/87	2,615,139 (after adding back \$2,400,000)	2,962,397 (I.A.) 592,479 (A.A.)
1987/88	917,818	592,479 (A.A.)
1988/89	2,290,142	592,479 (A.A.)
1989/90	3,897,875	592,479 (A.A.)
1990/91	3,924,978	592,479 (A.A.)
1991/92	3,934,660	592,479 (A.A.)

[Note: I.A. stands for initial allowance and A.A. stands for annual allowance.]

- (25) The assessor did not accept that the building qualifies as an industrial building and on divers dates issued the following loss computation or assessments:

(a) Year of Assessment 1986/87

Profit per return	\$2,615,139
<u>Less: Loss set-off</u>	<u>2,615,139</u>
Assessable Profit	<u><u>NIL</u></u>

Statement of Loss



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	Loss brought forward	\$6,640,632
	<u>Less: Loss set-off</u>	<u>2,615,139</u>
	Loss carried forward	<u>\$4,025,493</u>
(a)	<u>Year of Assessment 1987/88</u>	
	Profit per return	\$917,818
	<u>Less: Loss set-off</u>	<u>917,818</u>
	Assessable Profit	<u>NIL</u>
	<u>Statement of Loss</u>	
	Loss brought forward	\$4,025,493
	<u>Less: Loss set-off</u>	<u>917,818</u>
	Loss carried forward	<u>\$3,107,675</u>
(c)	<u>Year of Assessment 1988/89</u>	
	Profit per return	\$2,290,142
	<u>Less: Loss set-off</u>	<u>2,290,142</u>
	Assessable Profit	<u>NIL</u>
	<u>Statement of Loss</u>	
	Loss brought forward	\$3,107,675
	<u>Less: Loss set-off</u>	<u>2,290,142</u>
	Loss carried forward	<u>\$ 817,533</u>
(d)	<u>Year of Assessment 1989/90</u>	
	Profit per return	\$3,897,875
	<u>Less: Loss set-off</u>	<u>817,533</u>
	Assessable Profit	<u>\$3,080,342</u>

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Tax Payable thereon	<u>\$ 508,256</u>
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### Statement of Loss

Loss brought forward	\$817,533
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<u>Less: Loss set-off</u>	<u>817,533</u>
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Loss carried forward	<u><u>NIL</u></u>
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(e) Year of Assessment 1990/91

Assessable Profit	<u>\$3,924,978</u>
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Tax Payable thereon	<u>\$ 647,621</u>
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(f) Year of Assessment 1991/92

Estimated Assessable Profit	<u>\$4,000,000</u>
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Tax Payable thereon	<u>\$660,000</u>
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[Note: The 1991/92 estimated assessment was raised when the Taxpayer failed to submit the return within the stipulated time.]

- (26) The representative, on behalf of the Taxpayer disagreed with the 1986/87 to 1988/89 loss computations and objected to the 1989/90 and 1990/91 profits tax assessments on the ground that industrial building allowances should be granted in respect of the building.

The representative further objected against the 1991/92 profits tax assessment on the ground that it is excessive.

- (27) On 25 May 1991, the representative submitted to the assessor the following documents:

- (a) a copy of the minutes of the directors' meeting on 30 March 1987; and
- (b) a schedule showing the tenants at the building and the rent received from the tenants during the year ended 31 March 1990.

The representative contended that the minutes show clearly that there was a change of intention in the holding of the land and the building. The representative further agreed that some of the units in the building did not qualify as industrial buildings.

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- (28) Since adding back as profits diminution in value of \$2,400,000 in the 1986/87 year of assessment [fact (23)], the Taxpayer has not revalued the property comprising the land and the building.
- (29) In its accounts for the 1986/87 to 1991/92 years of assessment, the Taxpayer recorded the value of the property comprising the land and the building as \$19,811,986 which was computed as follows:

Premium paid for the Land	\$13,000,000
<u>Less: Diminution in value</u> [\$10,400,000 - \$2,400,000]	<u>8,000,000</u>
	5,000,000
<u>Add: Development cost of the Building</u>	<u>14,811,986</u>
	<u>\$19,811,986</u>

- (30) On 4 November 1992, the assessor requested the Taxpayer to make valuations of the property comprising the land and the building on the following dates:

31 March 1987  
31 March 1988  
31 March 1989  
31 March 1990  
31 March 1991

The Taxpayer has so far failed to make a response.

- (31) On 20 November 1992, at the request of the assessor, the Commissioner of Rating and Valuation provided in respect of the land and the building the following valuations:

<u>Date</u>	<u>Open Market Value</u>
	\$
31 March 1987	19,500,000
31 March 1988	26,000,000
31 March 1989	33,000,000
31 March 1990	38,000,000
31 March 1991	40,000,000
31 March 1992	50,000,000

- (32) The assessor having studied the valuations provided by the Commissioner of Rating and Valuation in fact (31) above decided to cancel the 1987/88 and 1988/89 loss computations. On 24 February 1993, the assessor raised on the Taxpayer the following 1987/88 and 1988/89 profits tax assessments:

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(a) Year of Assessment 1987/88

Profit per return	\$917,818
<u>Add: Diminution in value recouped</u>	<u>5,988,014</u>
	6,905,832
<u>Less: Loss set-off</u>	<u>4,025,493</u>
Assessable Profit	<u>\$2,880,339</u>
Tax Payable thereon	<u>\$518,461</u>

Statement of Loss

Loss brought forward	\$4,025,493
<u>Less: Loss set-off</u>	<u>4,025,493</u>
Loss carried forward	<u><u>NIL</u></u>

[Note: \$26,000,000 - \$19,811,986 - \$200,000 = \$5,988,014]

(b) Year of Assessment 1988/89

Profit per return	\$2,290,142
<u>Add: Diminution in value recouped</u>	<u>1,811,986</u>
Assessable Profit	<u>\$4,102,128</u>
Tax Payable thereon	<u>\$697,361</u>

[Note: \$10,400,000 - \$200,000 - \$2,400,000 - \$5,988,014 = \$1,811,986]

(33) The Taxpayer did not object against the assessments in fact (32) above and duly paid the tax charged thereunder.

(34) The assessor has since prepared to revise the 1989/90 and 1991/92 years of assessment as follows:

(a) Year of Assessment 1989/90

Revised Assessable Profit	<u>\$3,897,875</u>
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Tax Payable thereon \$ 643,149

(b) Year of Assessment 1991/92

Revised Assessable Profit \$3,934,660

Tax Payable thereon \$ 649,218

3. (1) The representative's letter quoted in paragraph 2(22) above was dated 27 July 1987.

(2) The minutes referred to in paragraph 2(27) above contained among other things the following resolution:

'2 The aforesaid property after inclusion of the above revaluation amounting to \$19,811,986 standing in the company's books be transferred to fixed assets as Leasehold Property of the company as the company has resolved at this date to change its intention in holding this property to investment and letting purposes.'

### The Issue

4. The question of industrial building allowance turns on the question of whether the developed property was at the relevant times trading stock or a long-term investment. It was emphatically declared by the Taxpayer on more than one occasion (see paragraphs 2(10), (11), (12) and (13) above) that its intention was to hold the developed property as trading stock, despite the fact that units in the developed property were let, because the Taxpayer was merely waiting to sell in the next boom. The assessor was persuaded by those declarations; so it is common ground that, prior to 30 March 1987, the developed property was trading stock. What is in dispute is this: whether, as the Taxpayer contended, there was on that day a change of intention on the part of the Taxpayer with regard to the status of the developed property, so that on that day it ceased to be trading stock and became a long-term investment, that is, a fixed asset. The onus is on the Taxpayer to prove that on 30 March 1987, it changed its intention as alleged.

5. The Taxpayer relied on the minutes of early 1987 as evidence of the change of intention. Its case, as put by Mr Lam, its representative, may be summarised in this way: with the development of Place X, the rental income of the developed property took an upward trend over the period from 1985 to 1992; the Taxpayer's change of intention was brought about by the high yields from rental income as compared with the low interest rates for savings account deposits. Mr W, managing director of the Taxpayer and its only witness, identified his signature on the board minutes dated early 1987 (see paragraph 3(2) above) and confirmed the contents thereof. His evidence lacked detail and particularity; in his evidence in chief he sought in a general way to prove the Taxpayer's case as to why the

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Taxpayer changed its intention in early 1987; in cross-examination things took a dramatic turn when he agreed that, prior to early 1987, the Taxpayer had been letting units in the developed property in order to wait for sale in a more favourable market, and that attitude continued after 30 March 1987. We accept that testimony. There was evidence, which we also accept, that offers were made to sell the units in the developed property since May 1987 (see paragraph 2(22) above). Mr W stated that the Taxpayer did not offer to sell the units since May 1987 and that offers for sale were made to the tenants prior to May 1987 by passing a price list to them; we do not accept those statements as they contradict the evidence offered by the representative's letter dated 27 July 1987 (see paragraph 2(22) and paragraph 3(1) above) which we accept. In his closing submission Mr Lam stated that the phrase 'since May 1987' used in that letter was a mistake on the representative's part; we are unable to accept that statement as no evidence was called to prove the alleged mistake. Further, as the Commissioner pointed out in his determination, the Taxpayer did not object to the 1987/88 and 1988/89 profits tax assessments under which the Taxpayer was assessed with the recovery in value of the land and was denied industrial building allowance in respect of the building (see paragraphs 2(32) and (33) above), which indicates that the Taxpayer tacitly accepted that the developed property was the Taxpayer's trading stock. Last but not least, as Mr Yim, the Commissioner's representative, pointed out in his submission, at all relevant times the developed property was predominantly financed by 'Amount Due to Directors' classified as 'Current Liabilities' in the Taxpayer's accounts; notwithstanding the alleged change of intention on 30 March 1987, the financial arrangement remained the same as that for financing trading stock of the Taxpayer.

### Conclusion

6. For the reasons stated above, we are unable to accept the 30 March 1987 minutes (see paragraph 2(27) and paragraph 3(2) above) as evidencing any true change of intention, although we accept that Mr W signed the minutes. Indeed, on the evidence, we have no hesitation in finding that there was no change of the Taxpayer's intention on 30 March 1987. Whether there was any subsequent change of the Taxpayer's intention thereafter is not an issue before us for determination.

### Decision

7. Since this appeal stands or falls on the one issue of whether there was a change of intention on 30 March 1987, and since we have found that there was no change of intention on that day, this appeal is dismissed and the assessments in question as revised or confirmed, as the case may be, by the Commissioner are hereby confirmed.