Case No. D33/95

Profits tax – compensation for loss of rental income – whether assessable to profits tax.

Panel: Kenneth Kwok Hing Wai QC (chairman), Cheung Wai Hing and Calvin Fung Chor Hang.

Date of hearing: 19 January 1995.
Date of decision: 28 June 1995.

The taxpayer purchased property and in the event of the rental income being less than a stated sum compensation would be paid. The taxpayer received compensation which was assessed to profits tax. The taxpayer argued that the compensation was in effect a reduction of the purchase price and should not be subject to tax. The Revenue argued that the compensation was in lieu of rent.

Held:

The compensation was of an income nature and was subject to profits tax.

Appeal dismissed.

[**Editor's note**: The taxpayer has filed an appeal against this decision.]

Cases referred to:

London & Thames Oil Wharves Ltd v Attwooll 43 TC 491
Raja's College v Gian Singh & Co Ltd [1977] AC 313

Amy Wong for the Commissioner of Inland Revenue.
Y T Tang of Messrs W M Sum & Co for the taxpayer.

Decision:

1. This is an appeal against the determination dated 24 March 1994 by Mr A K Gill, Deputy Commissioner of Inland Revenue, reducing the additional profits tax assessment dated 11 June 1991 for the year of assessment 1990/91 in accordance with the Taxpayer's calculation of rebuilding allowance, but rejecting the Taxpayer's contention

that the sum of $3,360,192, made up of 12 monthly sums of $280,016, should be excluded from the assessment.

The Facts

2.1 The Taxpayer was incorporated in August 1988 as a private company in Hong Kong. The nature of its business as described in the profits tax returns has been 'property investment'.

2.2 By an agreement for sale and purchase dated 16 December 1988 ('the agreement') made by Company A ('the vendor') as vendor and the Taxpayer [through its trustee, Company B], as purchaser, the vendor agreed to sell and the Taxpayer agreed to purchase Property X on the terms and conditions stated therein.

2.3 The sale and purchase of Property X was subject to the then existing tenancy of the tenant, Company C, under a tenancy agreement dated 11 March 1988 for a term of three years from 1 May 1988 to 30 April 1991 at a monthly rental of $368,802, exclusive of rates, as particularised in the third schedule to the agreement.

2.4 The purchase price under the agreement was $77,858,200, and $778,582 being the initial deposit should be paid on signing of the agreement, $14,793,058 being the further deposit should be paid on or before 30 December 1988 and $62,286,560 being the balance of purchase price should be paid on the date of completion – see clause 2 and part II of the first schedule to the agreement.

2.5 The date of completion under the agreement was on or before 1 July 1989 before 12:00 noon – see clause 3 and part III of the first schedule to the agreement.

2.6 Clause 25 of the agreement provided that the agreement superseded all previous contracts or agreements entered into between the vendor and the Taxpayer in respect of the sale and purchase of Property X.

2.7 Clause 28 of the agreement provided that:

> '[Property X] is sold subject to and with the benefit of the existing tenancies particulars whereof are set out in the third schedule hereto … The basis of this agreement is that the rent of the whole of [Property X] agreed to be sold is now $368,802 per month exclusive of rates. If it shall be proved that the rent of [Property X] is less than $368,802 per month the purchase price shall be reduced by $100 for every $1 less than the sum of $368,802.'

2.8 Clause 29 of the Agreement provided that:

> 'It is further agreed that upon [the Taxpayer] paying the vendor the whole of the purchase price, as from the date of completion the vendor would pay to [the Taxpayer] a sum of $280,016 per month from 1 July 1989 to 30

> April 1991 (hereinafter referred to as 'the said period') on the first day of each month. The vendor however would be discharged from all liabilities and obligations in making such payment to [the Taxpayer] on the date on which the tenant of the existing tenancy as specified in the third schedule hereto deliver vacant possession to [the Taxpayer] during the said period or on the date on which the existing tenancy in any way determine during the said period. The vendor would in any event have no further liability whatsoever to effect any payment whatsoever to [the Taxpayer] upon the expiration of 30 April 1991 (this clause shall survive after completion).'

2.9 By an assignment dated 30 June 1989, the vendor assigned Property X to the Taxpayer.

2.10 The Taxpayer's profits tax return for the year of assessment 1990/91 was dated 6 May 1991. It disclosed assessable profits of $1,580,201. In its accounts from the date of incorporation to 30 June 1990, the Taxpayer declared that rental income of $7,785,816 had been received. $7,785,816 was made up of 12 monthly payments of (a) $368,802, being rental income from the tenant and (b) $280,016, being payment by the vendor to the Taxpayer under clause 29 of the agreement from July 1989 to June 1990. We note that $7,785,816 is less than 10% of the purchase price of $77,858,200 by $40.

2.11 On 11 June 1991, the assessor raised a profits tax assessment for the year of assessment 1990/91 on the Taxpayer in the amount of the profit returned.

2.12 After corresponding with the Taxpayer's representatives, the assessor, on 31 March 1992, raised on the Taxpayer an additional profits tax assessment for the year of assessment 1990/91, to disallow part of the rebuilding allowance originally claimed by the Taxpayer, reducing it from $706,122 to $173,408.

2.13 By letter dated 28 February 1991, the representatives lodged an objection on the basis that the rebuilding allowance should amount to $217,460 instead of $173,408. The assessor has since agreed to the Taxpayer's calculation of rebuilding allowance of $217,460, and the Deputy Commissioner has revised the additional profits tax assessment accordingly in his determination, and nothing turns on rebuilding allowance in this appeal.

2.14 By letter dated 20 March 1992, the representatives claimed that the monthly payments of $280,016 paid by the vendor should not have been included in the accounts as rental derived from Property X, as they were not rental but should be dealt with as a reduction of the purchase price. Accordingly, the Taxpayer claimed that a sum of $3,360,192 (that is, $280,016 × 12) received from the vendor should be excluded from the assessment.

2.15 By letter dated 8 June 1992, the representatives stated, inter alia, that:

> '[The vendor] asked for a price of $77,858,200 and was of the opinion that [Property X] could fetch an annual rent of $7,785,820 or a monthly rental of

> $648,818. The actual rent received however under the tenancy agreement was $368,802. There was therefore a shortfall of $280,016. Thus an agreement was reached under which [the vendor] would be paid the price of $77,858,200 and in consideration thereof would pay the [the Taxpayer] an amount of $280,016 per month till the expiry of the tenancy.
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> The payment of $280,016 in the writer's opinion is not rent and is directly related to the purchase price of $77,858,200. It was not a payment by the tenants. It was paid to [the Taxpayer] because he agreed to pay a higher price for [Property X].'

2.16 The Deputy Commissioner rejected the Taxpayer's objection to the sum of $3,360,192.

2.17 The Taxpayer appealed.

The Grounds of Appeal

3. In its appeal before us, the Taxpayer agreed the facts as stated in the determination, but contended that the Deputy Commissioner 'erred (a) in not excluding from the additional assessment an amount of $3,360,192 ("the said sum") representing monthly payments of a capital nature received by the Taxpayer's company from the vendor of a property acquired by the Taxpayer's company at the cost of $77,858,200 and (b) in regarding the said sum as profits chargeable to profits tax'.

Our Decision

4. After having carefully considered the submission made on behalf of the Taxpayer, both orally and in writing, we did not think it was necessary to call on Mrs N for the respondent. We told the parties that we would give our decision in writing. This we now do.

5. The relevant period for the year of assessment 1990/91 is from 1 July 1989 to 30 June 1990. As at 1 July 1989, Property X had been assigned to the Taxpayer; and the Taxpayer was entitled to receive rent in the monthly sum of $368,802 from the tenant and the sum of $280,016 from the vendor. There is no issue on the rental income of $368,802 per month. The issue on this appeal is whether the 12 monthly sums of $280,016 each ought to be taken into account in computing the profits of gains arising in the year of assessment 1990/91 from the Taxpayer's trade or business of property investment.

6.1 The applicable principle is stated by Diplock L J in London & Thames Oil Wharves Ltd v Attwooll 43 TC 491 at page 515, and approved by the Privy Council in an appeal from Singapore in Raja's College v Gian Singh & Co Ltd [1977] AC 313 at page 319E, in these terms:

'The question whether a sum of money received by a trader ought to be taken into account in computing the profits of gains arising in any year from his trade is one which ought to be susceptible of solution by applying rational criteria. And so I think it is. I see nothing in experience, as embalmed in the authorities, to convince me that this question of law, even though it is fiscal law, cannot be solved by logic, and that, with some temerity, is what I propose to try to do.

I start by formulating what I believe to be the relevant rule. Where, pursuant to a legal right, a trader receives from another person compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits (if any) arising in any year from the trade carried on by him at the time when the compensation is so received, the compensation is to be treated for income tax purposes in the same way as that sum of money would have been treated if it had been received instead of the compensation. The rule is applicable whatever the source of the legal right of the trader to recover the compensation. It may arise from a primary obligation under a contract, such as a contract of insurance, from a secondary obligation arising out of non-performance of a contract, such as a right to damages, either liquidated, as under the demurrage clause in a charter-party, or unliquidated, from an obligation to pay damages for tort, as in the present case, from a statutory obligation, or in any other way in which legal obligations arise.'

6.2 Diplock L J went on to say that:

'But the source of a legal right is relevant to the first problem involved in the application of the rule to the particular case, namely, to identify what the compensation was paid for. If the solution to the first problem is that the compensation was paid for the failure of the trader to receive a sum of money, the second problem involved is to decide whether, if that sum of money had been received by the trader, it would have been credited to the amount of profits (if any) arising in any year from the trade carried on by him at the date of receipt, that is, would have been what I shall call for brevity an income receipt of that trade. The source of the legal right to the compensation is irrelevant to the second problem. The method by which the compensation has been assessed in the particular case does not identify what it was paid for; it is no more than a factor which may assist in the solution of the problem of identification.'

7. The source of the Taxpayer's legal right to receive the monthly sum of $280,016 from July 1989 to June 1990 was clause 29 of the agreement. It arose from a primary obligation under a contract. Clause 29 survived the completion of the sale and purchase of Property X.

8. The first problem is to identify what the payment under clause 29 was for.

9. The Taxpayer contended that it was a reduction of the purchase price. We reject this contention. We do not see how clause 29 can be construed as a reduction of the purchase price when the legal right under clause 29 to receive the monthly sum could not and would not arise unless and until the whole of the purchase price should have been paid and completion of the sale and purchase should have taken place, the material words being 'upon [the Taxpayer] paying the vendor the whole of the purchase price, as from the date of completion'. Furthermore, if the payment was meant as a reduction of the purchase price, the parties could have expressly said so, as they did in clause 28, but they did not in the case of clause 29.

10.1 In our decision, the purpose of the payment under clause 29 was to compensate the Taxpayer's failure to receive rental income in the sum of $648,818 per month during the term and the subsistence of the tenancy existing at the date of the agreement.

10.2 The right of the Taxpayer to receive payment under clause 29 arose only on completion. On completion, the Taxpayer became the owner of Property X and the landlord of the tenant. So long as the tenancy was subsisting, the Taxpayer was entitled to receive 368,802 each month as rent from the tenant, which was less than the sum of $648,818 by the sum stipulated in clause 29.

10.3 If the tenancy should terminate for any reason, whether by a surrender of the tenancy by the tenant, or by effusion of time, or otherwise, the Taxpayer would be free to lease Property X at the then fair market rent, and the right of the Taxpayer to receive payment under clause 29 would on its express terms cease on the expiry of the then existing tenancy by effusion of time or earlier termination thereof in any way whatsoever. The period for payment under clause 29 was 1 July 1989 to 30 April 1991. The commencement date was the date of completion under the agreement, and the expiry date was the date of expiry of the then existing tenancy. Further, the vendor would be discharged from liability under clause 29 upon delivery up of 'vacant possession' to the Taxpayer or 'on the date on which the existing tenancy in any way determine'.

10.4 Our view stated in Paragraph 10.1 above is reinforced by what the Taxpayer's representatives stated in their letter dated 8 June 1992 quoted in Paragraph 2.15 above.

11. Having identified the purpose of the payment under clause 29 as compensation for the Taxpayer's failure to receive rental income in the sum of $648,818 per month during the term and the subsistence of the tenancy existing at the date of the agreement, in other words, as the shortfall in rental income, the answer to the second problem is that if the payment under clause 29 had been received as rental, it would have been credited as an income receipt of the Taxpayer for the year of assessment 1990/91.

Appeal dismissed

12. Thus, the appeal fails. We dismiss the appeal and confirm the assessment appealed against.