INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D34/92

Profits tax – acquisition of properties – subsequent sale at a profit – whether profit liable to be assessed to profits tax.

Panel: William Turnbull (chairman), Chiu Chun Bong and Benjamin Kwok Chi Bun.

Dates of hearing: 11 and 12 August 1992.
Date of decision: 19 October 1992.

The taxpayer was a private limited company which purchased three industrial units subject to existing tenancies. The taxpayer proceeded to give notice to quit to the tenants and subsequently sold two of the industrial units and retained one. A net gain or profit was made on the disposal of the two industrial units. The profit was assessed to profits tax and the taxpayer appealed to the Board of Review and submitted that the two industrial units which had been sold were acquired as long term capital assets.

Held:

There was no evidence to support the alleged intention of the taxpayer to acquire and retain the industrial units in question. The evidence was indicative of an intention to acquire the units with either the intention of retaining the same for rental purposes or turning the same to account by way of sale. The taxpayer had failed to discharge the onus of proof.

Appeal dismissed.

Cases referred to:

Marson v Morton [1986] Simon TC 463
Simmons v IRC 53 TC 461
Hillerns and Fowler v Murray 17 TC 77
Shadford v H Fairweather & Co Ltd 43 TC 291
Cunliffe v Goodman [1950] ALL ER 720
Richfield International Land and Investment Co Ltd v CIR 2 HKTC 444
D41/92, IRBRD, vol 6, 211
D62/91, IRBRD, vol 6, 476

Yim Kwok Cheung for the Commissioner of Inland Revenue.
Andrew Chung instructed by Edward Wong & Ng for the taxpayer.

Decision:

This is an appeal by a private limited company against a profits tax assessment for the year of assessment 1988/89 wherein the gain on the disposal of two properties was subjected to profits tax. The facts are as follows:

1. The Taxpayer is a private company incorporated in Hong Kong on 28 April 1987. The controlling shareholders of the Taxpayer were Mr X and his wife Mrs X.

2. By agreements made in early 1987 Mr X agreed to purchase three industrial units in a multi-storey industrial building, namely units B7, B9 and B10, and on 6 May 1987 Mr X nominated the Taxpayer to be the purchaser of the three industrial units. On 9 May 1987 the Taxpayer acquired the three industrial units.

3. The three industrial units, B7, B9 and B10 were purchased subject to existing tenancies which were due to expire on 18 May 1988, 30 April 1988 and 31 May 1988 respectively. The monthly rental for industrial unit B7 was $16,100, that for B9 was $15,100, and that for B10 was $10,460.

4. The Taxpayer instructed its solicitors to give six months' notice to quit to all of the three tenants of the three industrial units and such notice to quit was given to the said tenants.

5. Industrial unit B7 comprised an area of 4,361 square feet, B9 comprised an area of 3,750 square feet and B10 comprised an area of 2,433 square feet.

6. The sitting tenants of the industrial unit B9 and industrial unit B10 surrendered vacant possession thereof at the end of their respective tenancies. The tenancy of the sitting tenant of industrial unit B7 was renewed for a further period of one year from 20 May 1988 to 19 May 1989 at a monthly rent of $19,320 representing $4.43 per square foot.

7. On 17, 19, 22 and 24 May 1988 the Taxpayer placed an advertisement in a newspaper in which it offered industrial unit B7 for sale subject to the existing tenancy but with vacant possession by the end of the then current tenancy, May 1988, at $750 per square foot and industrial unit B9 for sale with vacant possession at $850 per square foot or for rent at $9 per square foot.

8. Industrial unit B10 was sold in May 1988 at a price of $1,824,750 and industrial unit B9 was sold in August 1988 at a price of $3,183,250. A net gain or profit on disposal of these two industrial units was made of $2,095,558.

9. In its audited accounts for the period ended 31 March 1988 and in its profits tax return for the year of assessment 1987/88 the Taxpayer classified the surplus or gain on the disposal of the two industrial units B9 and B10 as being a capital gain and did not offer the

same for assessment to profits tax. The same audited accounts showed that the Taxpayer had purchased listed securities and disposed of the same making a loss of $422,450 which the Taxpayer claimed as a trading loss and which was allowed as a deduction in the year of assessment 1987/88.

10. After making enquiries the assessor decided that the profit or gain on the sale of the two industrial units was chargeable to profits tax and on 20 December 1990 raised a profits tax assessment for the year of assessment 1988/89 on net assessable profits of $2,460,716 with tax payable thereon of $418,321. The net assessable profits included the gain or profit which the Taxpayer made on the sale of the two industrial units B9 and B10.

11. The Taxpayer through its tax representatives objected to the assessment on the ground that the gain or surplus made on the sale of the two industrial units was a capital gain and submitted that the three industrial units had been purchased together as long-term capital investments.

12. By his determination dated 21 April 1992 the Deputy Commissioner of Inland Revenue rejected the objection made by the Taxpayer and confirmed the tax assessment dated 20 December 1990.

13. By notice dated 21 May 1992 the Taxpayer appealed against the determination of the Deputy Commissioner to this Board of Review.

At the time, date, and place set for the hearing of this appeal the Taxpayer appeared by its counsel and applied to have the hearing adjourned for a new date to be fixed on the ground that the Taxpayer had only recently instructed a firm of property surveyors to prepare a report and to give evidence to the effect that there had been a sudden up-turn in the price of the two industrial units which the Taxpayer had sold. The representative for the Commissioner opposed the application for an adjournment and pointed out that the Taxpayer had sufficient time to prepare its case and had been given adequate notice of the fixing of the time and date for the hearing. He further pointed out that the surveyor had not been involved in the transactions at the time and would be preparing a retrospective report which would be of little relevance to the question which the Board had to decide.

In all of the circumstances the Board declined to exercise its discretion in favour of the Taxpayer and directed that the hearing of the appeal should proceed. The Board indicated that further consideration could be given to the question of the Taxpayer calling an expert witness if it were to appear to the Board in the course of the hearing that such evidence was either essential or would be of advantage to the Board in deciding the matter before it.

Counsel for the Taxpayer called Mrs X to give evidence. Mrs X said that she and her husband were garment manufacturers. Her husband had been ill in hospital since October last year and was unable to come before the Board to give evidence. She said that the Taxpayer was owned and controlled by herself and her husband. She said that the Taxpayer had purchased the three industrial units as long-term investments from sitting

tenants. She said that the six months' notice to quit had been given because it was a rule that six months' advance notice must be given to tenants so as to protect the rights of the landlord. She said that it was not the intention of herself and her husband that the sitting tenants of the three industrial units would be required to vacate the units at the end of the existing tenancies. She said that she and her husband would have been prepared to renew the three tenancies if the tenants had wished to do so but at a new rent.

Mrs X said that industrial unit B7 had not been sold. Industrial units B9 and B10 had been sold in mid-1988 because the existing tenants did not wish to renew the tenancies. She said that industrial units B9 and B10 had been sold to two separate purchasers both of whom already had factory units in the same building, one adjacent and one upstairs. She said that the reason why the Taxpayer had sold the two units was because of a sharp rise in the value of the units which had been unexpected.

Counsel for the Taxpayer submitted that the Deputy Commissioner had been wrong in confirming the assessment against which the Taxpayer had appealed. He submitted that the gain or profit made by the Taxpayer on the sale of the two industrial units had been a capital gain which was not taxable under section 14 of the Inland Revenue Ordinance. He said that the sale of the units had been prompted by the change in price and drew the attention of the Board to the fact that all three industrial units had been purchased from existing tenancies and one of the three units had been retained and relet. He cited to the Board the case of Marson v Morton [1986] STC 463 and referred the Board to the badges of trade. He then took the Board through the 9 items which are particularised in the Marson v Morton case.

The representative for the Commissioner drew the attention of the Board to the fact that the onus of proof is upon the Taxpayer and then referred the Board to the following decided cases:

Simmons v IRC 53 TC 461

Hillerns and Fowler v Murray 17 TC 77

Shadford v H Fairweather & Co Ltd 43 TC 291

Cunliffe v Goodman [1950] ALL ER 720

Richfield International Land and Investment Co Ltd v CIR 2 HKTC 444

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The representative for the Commissioner drew our attention to the short period of ownership, the fact that the Taxpayer had borrowed money from the bank to finance the three units with very little paid-up capital, and the fact that notice to quit had been given to

the tenants. The representative submitted that the advertisements for the sale or letting of the two industrial units B9 and B7 were not genuine because the monthly rent proposed for B9 was substantially higher than the actual market rent at that time. The industrial unit B7 which had been relet was relet at a monthly rent of $4.43 per square foot. The industrial unit B9 was offered for rent in the newspaper advertisement at a monthly rent of $9 per square foot. He submitted that to offer one unit for sale only and one unit for sale or rent at an unrealistically high rent was not what one would expect from a person who was genuinely holding properties as long-term investments.

Towards the conclusion of the hearing of the appeal counsel for the Taxpayer indicated to the Board that he did not wish to call any further witnesses or evidence.

This appeal is one which falls to be decided entirely on its facts. There is no complex question of law or interpretation. The question to be decided is the intention of the Taxpayer at the time when it acquired the three industrial units. As was correctly pointed out by the representative for the Taxpayer the onus of proof is placed upon the Taxpayer. Unfortunately for the Taxpayer this board is not able to find that the Taxpayer has discharged the onus of proof and accordingly finds in favour of the Commissioner.

The Board fully accepts the explanation given for Mr X not being able to appear before it and give evidence. Mrs X was called and gave evidence and was cross-examined. She said that the Taxpayer had purchased the three industrial units as long-term investments. The intention of the Taxpayer at the time of acquisition is all important but a self-serving statement by a witness is of limited value until it has been tested against the objective facts. In this case the objective facts point towards trading rather than long-term investment.

Mrs X said that the value of the two units sold had doubled in value unexpectedly. Under cross-examination she said that the sudden increase in value had taken place during a period of some two months before sale. She also said that the two units which were sold to repay the bank borrowings and to provide working capital for the garment manufacturing business of herself and her husband.

We are prepared to accept that the giving of notice to quit was equivocal. Mrs X said that the giving of notice to quit was in her opinion necessary to protect the rights of the owner of the premises and this would be the case whether she intended to try to continue to rent the premises or intended to sell the same.

No satisfactory explanation was given to us with regard to the meaning of the advertisement placed in the newspaper. During May 1988 industrial unit B7 was publicly offered for sale with imminent vacant possession at what was clearly a realistic sale price of $750 per square foot. The sales price was realistic because this was in line with the price which was achieved for industrial unit B10. Industrial unit B9 was offered for sale with vacant possession also at a realistic price of $850 per square foot because this was the approximate price at which it was sold. No satisfactory explanation was given with regard to the rent of $9 per square foot, for industrial unit B9, and no explanation was given as to

why B7 was offered for sale only but B9 was offered for sale or rent. Industrial unit B7 was re-let at $4.43 per square foot and not sold. We are left to conclude that the newspaper offered to let industrial unit B9 at $9 per square foot was not a genuine offer intending to find a tenant.

No evidence was called or given with regard to the intention of the Taxpayer at the time when the three industrial units were purchased other than the self-serving statement by Mrs X that they were to be long-term investments. No evidence was given of any feasibility study or expected rate of return, etc. If the Taxpayer had genuinely purchased the three industrial units intending to retain them for the long term and collect rental income one would expect much stronger evidence than we have in this case. Whilst we do not attach any great importance to the fact that the Taxpayer had a low paid-up capital and borrowed heavily to finance the purchase of the three units we would have expected to have evidence that Mr X and his wife had investigated the return which would be obtained from the three units and evidence to show that they had decided that the price being paid for the three units and the rental income return on the three units made this an attractive long-term investment. Any such evidence is absent. Indeed we have evidence to the contrary from Mrs X herself who said that one of the reasons for selling the two units was to repay the bank borrowings and provide working capital for her garment business. We also note that the grounds of appeal filed on behalf of the Taxpayer by its solicitors included a statement that the reason for the sale of the two industrial units was because of an increase in the interest rate payable by the Taxpayer for the mortgage loan after the purchase of the units by the Taxpayer.

Mrs X in her evidence said that there was a change of intention because the value of the factory units had risen substantially over a very short period of time. This was obviously the case because the Taxpayer only owned the units for approximately one year. She said that the value had risen suddenly during tow months and when asked how she knew about this she said that she monitored the value of property by reading newspapers. If there was such a sudden and dramatic increase in the value of the industrial units in question we wonder whether it could be attributed partly to the fact that the Taxpayer purchased the units together subject to existing tenancies which had some length of time to run. When the units were sold or offered for sale it was possible to offer them with vacant possession. It is a well-known fact that property with vacant possession is often more valuable than property with sitting tenants. The Taxpayer had taken steps to ensure that its rights would be fully protected by giving notice to quit to all three tenants. Whilst it can be said that this enabled the Taxpayer to negotiate for the highest possible rental in the market it also at the same time enabled the Taxpayer to offer the premises for sale with vacant possession which is in fact what it did and it actually sold the premises with vacant possession.

We have very carefully reviewed the evidence before us and we can find no clear indication to support the submission that the Taxpayer truly intended to retain the three industrial units as long-term investments at the time when it purchased the same. The evidence and facts point rather to an intention on the part of the Taxpayer to purchase the units at an attractive price with the intention of either continuing to rent the same or if market conditions permitted to sell the same at a profit.

The simple facts of this case are that the Taxpayer purchased three industrial units in May 1987, sold one unit at a substantial profit in May 1988 and offered for sale the other two units at prices which would also give substantial profit and proceeded to sell one of the other two units at a substantial profit in August 1988. These facts show that the Taxpayer had not formed an intention to retain the properties as long-term capital investments but had acquired the same with the intention of either retaining them for rental purposes or to turn the same to account by way of sale as soon as vacant possession was available and the price was attractive. The onus of proof is upon the Taxpayer to prove its claimed intention and this it has failed to do.

On the facts as found by us we find in favour of the Commissioner and dismiss this appeal.