INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D34/93

Profits tax – sale of properties – whether profits assessable to profits tax.

Panel: William Turnbull (chairman), Walter Chan Kar Lok and Edward Chow Kam Wah.

Dates of hearing: 23, 24 November 1992 and 9, 10 March 1993.
Date of decision: 10 November 1993.

The taxpayer was a company which purchased certain residential units on two floors of a building. The properties were shown as fixed assets and a rebuilding allowance was claimed in respect thereof. All of the units on one of the two floors were sold after approximately one and a half years. The profit was assessed to profits tax and the rebuilding allowance in respect of the floor which had been retained was disallowed. The taxpayer appealed to the Board of Review. The persons who had control of the taxpayer at the relevant time were not available to give evidence and evidence was given by others who had no personal knowledge of the events at the relevant time.

Held:

The objective facts clearly indicated an intention to trade in property. A rebuilding allowance had been claimed in respect of the property, disallowed by the assessor, and this decision of the assessor had not been challenged by those having control of the taxpayer at the relevant time. On a review of the evidence the Board were satisfied that it had in fact been the intention of the taxpayer to trade in the properties.

Appeal dismissed.

Cases referred to:

Lionel Simmons Properties Ltd (in liquidation) and others v CIR 53 TC 461
Richfield International Land and Investment Co Ltd v CIR 2 HKTC 444 (Court of Appeal), 3 HKTC 167 (Privy Council)
Chinachem Investment Co Ltd v CIR 2 HKTC 261
BR 9/74, IRBRD, vol 1, 153
D11/80, IRBRD, vol 1, 374

Jennifer Chan for the Commissioner of Inland Revenue.
Alice Chan of Messrs Price Waterhouse 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 certain surpluses which it derived from the sale of properties were assessed to profits tax. The facts of the appeal are as follows:

1. The Taxpayer was incorporated in early 1987 as a private company in Hong Kong.

2. The Taxpayer was controlled by Mr X who also owned 50% of the issued share capital thereof. The remaining 50% thereof was owned by Ms Z. Mr X also controlled a public listed company in Hong Kong ('A Limited').

3. In mid-1987 the Taxpayer acquired a number of residential units on two floors of a building in site A ('the property') at the price of $7,900,000. Certain of the units on each of the two floors were acquired with vacant possession and certain of the units on each of the two floors were acquired with existing tenancies. The purchase of the property by the Taxpayer was financed by an interest free loan from Mr X.

4. In the accounts of the Taxpayer for the period from incorporation to 31 March 1988 the property was classified as 'fixed assets' and in its proposed tax computation for the year of assessment 1987/88 the Taxpayer claimed a rebuilding allowance in respect of the property. The shareholder's loan from Mr X was shown in the accounts of the Taxpayer as a current liability.

5. In late 1988 the Taxpayer sold all of the units on one of the two floors ('the Units sold') for a consideration of $4,500,000.

6. In late 1988 the Taxpayer became a wholly owned subsidiary of A Limited which was no longer controlled by Mr X.

7. The assessor raised on the Taxpayer a profits tax assessment for the year of assessment 1987/88 showing the assessable profits which the Taxpayer had returned in its profits tax return of $56,415 with tax payable thereon of $10,154.

8. Subsequently on receipt of further information the assessor was of the opinion that the property was not held by the Taxpayer for long term investment purposes and on 20 November 1989 the assessor raised on the Taxpayer an additional profits tax assessment for the year of assessment 1987/88 in which he disallowed the rebuilding allowance previously granted and brought into assessment additional assessable profits of $29,625 with additional tax payable thereon of $5,332. The Taxpayer did not object to this assessment.

9. In its accounts for the year ended 31 March 1989 the Taxpayer showed as an 'extraordinary item' the profit or surplus of $1,158,607 which had arisen on the sale of the units sold. The Taxpayer did not offer this profit for assessment in its profits tax return.

10. On 14 May 1990 the assessor raised on the Taxpayer a profits tax assessment for the year of assessment 1988/89 as follows:

Loss per computation		($8,296)
Add: Profits on disposal of the Units Sold	$1,158,607	
Rebuilding allowance not due	18,094	1,176,701
Assessable Profits		1,168,405
Tax Payable thereon		$198,628

11. The Taxpayer objected to this assessment on the ground that the profit or surplus on the disposal of the units sold was a capital profit and not subject to profits tax.

12. The matter was referred to the Commissioner of Inland Revenue who by his determination dated 1 August 1992 decided that the profit or surplus arising on the sale of the units sold had been correctly assessed to profits tax and confirmed the assessment against which the Taxpayer had objected subject to a small reduction thereto of $46,528 being the writing back of a depreciation expense which arose as a result of the sale and the Commissioner accordingly reduced the assessable profits from $1,168,405 to assessable profits of $1,121,877 with tax payable thereon of $190,719.

13. By letter dated 25 August 1992 notice of appeal was given against the determination of the Commissioner on the ground that the profit or surplus arising on the sale of the units sold should not be assessable to profits tax.

At the hearing of the appeal the Taxpayer was represented by its tax representative and three witnesses were called to give evidence. Unfortunately for the Taxpayer the witnesses who gave evidence had no direct knowledge of the events which took place at the time when the property was acquired by the Taxpayer.

One of the three witnesses gave evidence as a property expert as to what in his opinion a speculator in property would consider of importance. One gave evidence, also as an expert, regarding how an auditor would classify fixed assets and current liabilities and the meaning thereof, and similar questions. One witness had been the group accounting manager of A Limited since July 1991. The property expert witness had some knowledge of the property and the group accounting manager had greater knowledge. However the evidence of neither of them is of great assistance to us in trying to decide what was the intention of the Taxpayer when it acquired the property. Neither had first hand knowledge of the property or the Taxpayer or the intention of Mr X at that time. The nearest evidence

was that given by the group accounting manager who said he had met someone who had said he had known Mr X when the Taxpayer had acquired the property. With due respect we are unable to accept the evidence of the group accounting manager so far as establishing the intent of either the Taxpayer or Mr X. It was far too remote and can hardly even merit the description of hearsay evidence.

The evidence given before us did include statements regarding the nature of the property and though the evidence related to the situation some years later we are prepared to accept that the nature of the property was the same when it had been acquired by the Taxpayer.

The representative for the Taxpayer submitted that the property was not suitable to be acquired as trading assets and was therefore acquired as capital assets. She referred to the evidence which we have accepted which showed that the property was used to provide certain entertainment or an establishment where rooms could be rented by customers on an hourly basis. She submitted that such type of premises would not be of any interest to someone who wished to speculate with a view to purchase and resale at a profit. She submitted that there are three purposes for which a person would acquire property namely for self occupation, for rental, or for speculation. She said that only if property were acquired for speculation would it not be a long term investment.

She drew our attention to the relationship between the Taxpayer and Mr X. She submitted that because of subsequent events Mr X was obliged to transfer his beneficial interest in the Taxpayer to A Limited. She said that Mr X had been heavily invested in trading in the Hong Kong stock market prior to the stock market crash in 1987 which occurred just after the Taxpayer acquired the property. She submitted that as a result of the crash in 1987 Mr X had been obliged to dispose of the property. From her submission it was clear that she had conducted a very extensive enquiry into the affairs of the Taxpayer, Mr X, and A Limited. However it was apparent from her submissions that what she required us to do was to infer from subsequent events that the intent of the Taxpayer had been to acquire the property as a long term investment.

The representative for the Commissioner submitted that the property had been acquired by the Taxpayer as trading assets. In her submission she referred us to the following cases:

Lionel Simmons Properties Ltd (in liquidation) and others v CIR 53 TC 461
Richfield International Land and Investment Co Ltd v CIR 2 HKTC 444 (Court of Appeal), 3 HKTC 167 (Privy Council)
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The representative for the Commissioner took us through the evidence and facts which were before us and reminded us that the onus of proof is upon the Taxpayer.

She submitted that the intention at the time of acquisition of the property by the Taxpayer was for trading purposes.

As mentioned above it was quite clear that the representative for the Taxpayer had carried out a detailed investigation into the affairs of the Taxpayer and those associated with it. Unfortunately however she did not or was not able to, as the case may be, call evidence from any of the people who had contemporaneous knowledge of what was the real intention of the Taxpayer. As the representative for the Commissioner rightly said the onus of proof is upon the Taxpayer, the weight of this burden of proof varies greatly from case to case.

In the present case there is a clear prima facie inference that the Taxpayer was trading in the property. When the simple objective facts are looked at we find that the Taxpayer purchased a number of units on two different floors of a building in August 1987. Just over twelve months later the Taxpayer sold all of the units which it had purchased on one of the two floors at a substantial profit. It had originally shown the property in its accounts as fixed assets and had claimed a rebuilding allowance. However on 20 November 1989 the assessor reassessed the Taxpayer to profits tax by disallowing the rebuilding allowance previously granted. The Taxpayer at that time did not object to this reassessment. The reassessment took place immediately after the sale by the Taxpayer of the units sold and it must have been clear to the Taxpayer at that moment in time that if the Taxpayer did not object to the reassessment it would inevitably lead to the assessment for profits tax purposes of the surplus which the Taxpayer had made on the sale of the units sold. This is of course exactly what happened. In our opinion this clearly raises a prima facie case that at the relevant time the Taxpayer acquired the units sold and indeed the entirety of the property for trading purposes.

We now turn to analyse in further detail the evidence given or laid before the Board and submissions made on behalf of the Taxpayer to see if the burden of proof placed by section 69(4) of the Inland Revenue Ordinance has been discharged.

First of all we have the fact that the property was shown as capital assets in the audited accounts of the Taxpayer and a rebuilding allowance was claimed. Whatever value this might have had is negated by the fact that the assessor at that time reassessed the Taxpayer on the basis that the property was not a capital asset and accordingly not entitled to a rebuilding allowance. The Taxpayer did not object to this reassessment. There is nothing before us to suggest that the matter was overlooked by the Taxpayer or that there were any other reasons for the Taxpayer not to object.

The main thrust of the case put before us for the Taxpayer was that the property was not suitable as a speculative investment for trading purposes. With due respect we cannot agree with this submission. The real situation is, if anything, rather to the contrary. The representative for the Taxpayer submitted that a long term investment would be either for the Taxpayer's own occupation and use or for rental purposes. Clearly the property was less than salubrious. There is no acceptable evidence before us that it was the intention of the Taxpayer to use the property for its own use and occupation. A witness said that

someone had said long after the event that it had been the intent of Mr X 'to start some business' in the property and that 'later the plan had been cancelled and some units had been sold and some rented out.' Mr X was not called to give evidence nor was the person who was alleged to have made the statement about Mr X. As stated above we reject such evidence as of no value to us.

The alternative long term use submitted to us was for rental purposes. The representative for the Taxpayer submitted that part of the property was purchased with existing tenants and that an attempt was made by the Taxpayer to let out portions which were vacant. With due respect we do not find any sufficient evidence before us to support the proposition that the Taxpayer intended to let out the vacant parts of the property. Indeed the evidence before us is to the contrary. Evidence was given before us that one witness who visited the property in late 1991 feared for his safety and that there were major difficulties in trying to collect rent from the type of tenant of such premises. If any inference is to be drawn from the nature of property then the inference must surely be that the property was not suitable for rental purposes in the ordinary sense.

Perhaps one of the stronger pieces of evidence before us are the minutes of the directors' meeting of the Taxpayer held in late 1989. This meeting took place at the time when Mr X was selling or transferring the beneficial ownership of the Taxpayer to A Limited. The following was recorded:

> 'Tax liabilities
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> It was reported by the joint auditors that a possible tax liabilities in the region of $200,000 would be attributable to the activities of the company (Taxpayer) prior to its sale to (A Limited). A solicitor firm has previously discussed with (Mr X) who agreed to bear the said tax liabilities.
>
> It was resolved that the company (the Taxpayer) would procure (Mr X) to sign a letter of agreement to pay the tax liabilities.'

We attach some importance to this extract from the directors minutes because it shows that on 28 October 1989 the tax position of the Taxpayer had been studied and discussed with Mr X. The joint auditors, not just one audit firm, reported that there was a possible tax liability. Clearly in October 1989 the joint auditors were not satisfied that the property was a long term capital investment. Mr X agreed to be responsible for any tax liabilities that there might be. Less than one month later the assessor on 20 November 1989 reassessed the Taxpayer by disallowing the rebuilding allowance. No objection was taken to this by the Taxpayer. It is clear to us that if the Taxpayer is to succeed in this appeal Mr X or at the very least a representative from the two joint auditors should have been called to give evidence with regard to what was the real intention of the Taxpayer at the time of acquisition of the property.

We also note that when the reassessment was made on 20 November 1989 there appears on the reassessment the following statement:

> ‘Assessor’s note:
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> Rebuilding allowance claimed withdrawn as it did not appear that the properties were held for long term purposes.’

This was clear and concise notice to all concerned at that time that the Taxpayer’s claim that the property was a long term asset was not accepted by the Commissioner. Not only was no objection taken to this by the Taxpayer but presumably the additional tax of $5,332 was paid by the Taxpayer.

For the reasons given we find that the Taxpayer has not been able to satisfy the burden of proof placed upon it by section 68(4) of the Inland Revenue Ordinance and we accordingly dismiss the appeal. The profits tax assessment for the year of assessment 1988/89 dated 14 May 1990 showing assessable profits of $1,168,405 with tax payable thereon of $198,628 is ordered to be reduced to assessable profits of $1,121,877 with tax payable thereon of $190,719 as determined by the Commissioner of Inland Revenue in his determination dated 1 August 1992.