

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D3/88

Appeals – absent witness – evidence in writing – weight to be attached to such evidence.

Profits tax – sale of land – whether profits were trading gains or realization of capital – evidential matters: renovation of properties, grant of new tenancies and minutes – s 14 of the Inland Revenue Ordinance.

Panel: Robert W N Wei QC (chairman), Raymond J Faulkner and Lau Wah Sum.

Dates of hearing: 29 and 30 September and 6 October 1987.

Date of decision: 7 April 1988.

The taxpayer companies together purchased a property in the New Territories in November 1977 for \$3,750,000. They spent funds renovating the property in order to increase the rental yield, and granted new tenancies. They intended to redevelop the site, but this proved to be impractical unless the adjoining landowners agreed to participate. Approaches were made to the adjoining landowners, but these were rebuffed. In December 1979, the taxpayers sold the property for \$15,000,000.

The taxpayers alleged that they sold the property due to (a) the unfeasibility of redevelopment, (b) the uncertainty of land tenure in the New Territories and the need to diversify their investment portfolio and (c) the attractive price which they had been offered. The funds obtained from resale were expended primarily on acquiring further sites in the New Territories.

Minutes of board meetings and the joint venture agreement between the taxpayers were tendered. These were drafted in English, but one of the taxpayers' chairmen who signed the minutes could not read English. The minutes had been drafted by the taxpayers' auditors and tax representatives with the dates and times of meeting left blank and filled in later. One of the relevant minutes had been duplicated. Furthermore, the taxpayers did not admit the contents of one of the minutes.

A written affirmation by a director of one of the taxpayers, who was overseas, was tendered in evidence.

The Commissioner assessed the taxpayers to profits tax. The taxpayers appealed, and claimed that the property was an investment. They also claimed rebuilding allowances.

Held:

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The property was trading stock and the profits were therefore assessable.

- (a) The chief issue was whether the taxpayers originally intended to hold the property for rental income. If so, the property would have been an investment and the gains would have been capital. On the facts, however, the taxpayers intended all along to resell the property. The profits were therefore assessable.
- (b) The expenditure of funds on renovating the property, and the granting of new tenancies, were neutral factors. The former were neither expensive nor extensive. Both were consistent with both investment and holding the property pending redeveloping for resale.
- (c) The acquisition of further land in the New Territories belied the taxpayers' concern with land tenure there. The assertion that the taxpayers were swayed by the price offered was doubted, because such assertion was made for the first time only in these proceedings. In any event, an increase in value did not make the property unsuitable as a continuing investment where tenancies were short-term, because rents would also rise.
- (d) The minutes and joint venture agreement were self-serving. The facts gave rise to doubts whether board meetings had actually been held. The taxpayers lacked candour in failing to explain their refusal to admit the contents of the minutes.
- (e) The affirmation was of little weight. Important evidence carries little weight if it cannot be tested by cross-examination, especially in this case where no explanation was tendered as to why the director could not attend in person to give evidence.

Appeal dismissed.

T J Richmond for the Commissioner of Inland Revenue.
Benjamin Yu instructed by Woo, Kwan, Lee and Lo for the taxpayer.

Decision:

1. This is a joint appeal by two limited companies A Ltd and B Ltd (hereinafter called the Taxpayers) against profits tax assessments (as revised) for the years of assessment 1978/79 and 1979/80 raised on them in respect of their joint venture.
2. The notice of appeal contains the following grounds of appeal:

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- (1) The profits arising from the realization in December 1979 of the relevant property ('the Property') is not assessable to profits tax. The profits did not arise from any trade or business carried on by the Companies.
- (2) The Property was acquired by the Companies as tenants-in commons in equal shares in November 1977 with the intention of holding it as a long term investment. Accordingly, the Property was a capital asset and profits arising from its realization in December 1979 were profits arising from its realization of a capital asset which are not liable to profits tax.
- (3) The Companies had available sufficient resources (from third party financing or from its shareholders) to hold the Property as a long term investment, whether or not it was redeveloped.
- (4) That the Property was acquired by the Companies with the aforesaid intention is supported (if any support be necessary) by subsequent events: Between November 1977 and March 1978 improvement and redecoration works amounting to \$96,000 were carried out. The Property was acquired subject to existing tenancies and from acquisition to 31 October 1979 additional tenancy agreements were entered into. The rental income from the Property improved from \$26,258 per month when it was acquired to \$41,248 after the aforesaid works had been completed, representing a rental return in excess of 10%. Redevelopment plans were considered and examined by the Companies in 1979 with long term rental income in mind.
- (5) The Property being a capital asset and not being trading stock, the Companies are entitled to deduct the sum of \$30,188 representing rebuilding allowance for the year of assessment 1978/79.

3. Except as otherwise indicated below, the facts stated in paragraph 1 of the determination of the Commissioner of Inland Revenue dated 3 August 1984 are agreed. Furthermore, the parties handed up a statement of agreed facts.

4. C, a director and controlling shareholder of B Ltd, and D, a senior book-keeper of B Ltd, gave evidence for the Taxpayers. An affirmation made by E, a director of A Ltd, in the United States of America on 24 September 1987 was admitted in evidence notwithstanding an objection by Mr Richmond for the Revenue.

5. A Ltd was incorporated in Hong Kong as a private company in February 1976. In its application for registration under the Business Registration Regulations, its business was described as 'Import, Export and General Trading'. At all relevant times A Ltd has described in its profits tax returns its business as 'Investment'. Its paid-up capital has remained at \$200. The ultimate holding company of A is F Ltd. In its application for

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registration under the Business Registration Regulations, its business was described as 'Construction'.

6. B Ltd was incorporated in Hong Kong as a private company in June 1971. Its application for registration under the Business Registration Regulations stated its business to be 'Land Investment'. Since 1976 B Ltd has actively engaged in the purchase and resale of land and in the redevelopment of properties for sale. The business of B Ltd at the relevant time included property investment, property development for resale and property dealing.

7. (1) C produced a board minute of B Ltd dated 3 August 1977 recording the passing of a resolution that a joint venture scheme be entered into with A Ltd for the purpose of acquiring the Property 'as long term investment for generation of rental income on the terms as per the annexed Joint Venture Agreement'. C also produced an agreement dated 6 August 1977 whereby the Taxpayers agreed to enter into a joint venture scheme for the acquisition of the property as tenants in common in equal shares 'for generation of rental income for long term investment purposes'. Both these documents were drafted by G Co, a firm of accountants who acted as B Ltd's auditors and tax representatives.

(2) Paragraph 1(4) of the Commissioner's determination refers to a board minute of A Ltd dated 5 August 1977 recording the passing of a resolution which is in identical terms with the board resolution of B Ltd referred to in sub-paragraph (1) above except that the reference to A Ltd is replaced by a reference to B Ltd.

(3) Mr Richmond challenged the truthfulness of both board minutes and also of the quoted words in the joint venture agreement.

8. The property was a 7-storey commercial building with sitting tenants in some of the units. The Taxpayers purchased it in November 1977.

9. According to C, the Taxpayers purchased the property because of its good location, fair purchase price and anticipated high growth in rental income, and it was acquired as a long term investment for rental income. There were in all 20 units, 12 of which were either vacant, or on monthly tenancies, all on tenancies already expired or soon expiring. The remaining 8 tenancies would expire between 1978 and 1980, or 1982 if an option to renew the tenancy on the ground floor for two years at the prevailing market rent was exercised. At the time of the purchase, it was estimated that, with some renovation works done to the property, rental income could be substantially increased, thereby producing a 12% return. C stated that he considered a 12% return as satisfactory. Renovation works to the total value of \$96,000 were executed during the period from November 1977 to March 1978. As a result, the rental income increased from \$26,000 per month to \$40,000 per month, producing a return of about 12% as expected. Tenancies were granted and renewed, as the case may be, for terms varying from one to three years, with expiry dates ranging from 20 January 1979 to 30 April 1981, or 30 April 1983 if an option to renew the tenancy in the basement was exercised.

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10. The purchase price of the property was \$3,750,000 which was partly financed by a mortgage loan of \$2,600,000 for a fixed term of two years. C's evidence in this regard was that the usual practice at the time was to borrow for six months to a year, that two years was considered as very long and sufficient, and that he anticipated no difficulties in extending the loan if necessary.

11. C stated that, not long after they had acquired the property, the Taxpayers intended to redevelop it jointly with the owners of adjacent sites and that they started negotiations with the adjacent owners early in 1978 or, in his own words, 'as soon as possible'.

12. In May 1978, the Taxpayers instructed their architects to draw up redevelopment plans for the property. The architects submitted general plans for a 20-storey office building to the Building Authority which approved the plans in May 1979.

13 The architects made a report dated 10 May 1979 on the feasibility of the proposed redevelopment of the property, estimating the annual return on 80% occupancy of the new building at 7% and stating that the building cost for the site would be relatively high because of the anticipated difficulties in foundation work and retaining wall work.

14. C stated in chief that the Taxpayers asked the architects to do the feasibility study on the basis of estimated rental income. In cross-examination he stated that an increase in rental income would reflect an increase in the value of the property and that from rental income one could arrive at the value of the property by using the multiplier of 12.

15. At a meeting held on 25 May 1979 the directors of B Ltd resolved as follows:

'That the site area covering 2,400 square feet of [the Property] is considered as not suitable for 20 storeys high rising building redevelopment, therefore, the company must seek agreement either on joint development with owners of [the] adjacent building lots ... or on a right-out purchase of their interest. Such approach referred to letter of 17 May 1979 to owner and owners of prospective flats of [the adjoining lots] is hereby approved.'

The said letter dated 17 May 1979 was from A Ltd to owners of one of the adjoining lots and was in the following terms:

'Dear Sir

Re: Re-development of [the Property]

We are the owners of [the Property] since we acquired [it] in November 1977. [The building on the Property] was planned and built over 10 years ago. It lacks the facilities and the design which a modern building can provide. Furthermore it is

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standing on a valuable piece of land that deserves more intensive development to generate a higher income. In order to maximize the usage of the land, we intend to demolish the [building on the Property] and erect a higher, beautifully designed, modern building in its place. The general plans are already approved by the Building Authority.

Being the owner of our adjacent property, you are invited to participate in this redevelopment scheme. You could sell your property to us at a fair price or you could join us as partners and you will stand to gain at least twice your present office area in the new building. Please contact me for further details and we shall be happy to discuss them with you.'

16. C stated in chief that as a result of the feasibility report the Taxpayer planned to acquire the adjacent sites or to enter into joint ventures with their owners, but that they received no response from the owners. In cross-examination he stated that negotiations with the owners had started much earlier than 25 May 1979 (the date of the board meeting of B Ltd) and that, as the negotiations had been going on for a long time, they decided to write a formal letter to the owners.

17. At a meeting held on 2 November 1979 the directors of B Ltd resolved as follows:

'That the Company should sell [the Property] on the ground that –

- (1) It fail [sic] to achieve its objectives as per resolution dated 25 May 1979.
- (2) It is not worth to continue to own [the Property] if there is no prospect to acquire the adjacent building lots ... or seeking joint venture with its owners.
- (3) As the New Territories is a leased area the problem of land tenure are complex. The impact of such uncertainties facing Hong Kong makes us to diversify [sic] our investment portfolios by purchasing an rental income producing property situated in Los Angeles.'

18. In December 1979, the Taxpayers sold the Property for \$15,000,000.

19. By notice dated 7 September 1982, the Taxpayers' tax representatives objected to the assessments for 1978/79 and 1979/80 in the following terms:

'Assessment 1978/79

The depreciation claimed in the accounts for the year of assessment has been incorrectly disallowed as a deduction in arriving at the assessable profit for that year.

Assessment 1979/80

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- (i) The surplus on disposal of the company property amounting to \$10,875,558 (ie \$11,000,058 – \$124,500) has incorrectly been included in the assessable profits for the year of assessment.
- (ii) The proceeds from the sale of the property were derived from the sale of an investment property project which could not be proceeded with due to circumstances outside the control of our clients and do not come within the definition of changeability set out in section 14 of the Inland Revenue Ordinance.’

20. In support of the above objection, the Taxpayers’ tax representatives, H Co, made the following representations:

- ‘ (a) We submit details of the estimated cost of rebuilding and then projected rental yield prepared for our client on 10 May 1979. The return of 7% on capital invested was based on an 80% occupancy and is on the low side due to the unexpected high cost of the foundation work. This factor was the reason why our client sought then to get the owners of the [adjoining] properties ... to join together in a combined rebuilding project. If this had proved possible it would have meant reclassification of our clients’ site into a class ‘B’ one and so enabled the foundations to be lower on its site. This would have reduced considerably the cost of the foundation. It would have also increased the efficiency per floor and the utility areas as they could have been used by more tenants. In order to achieve this aim [one of the adjoining properties] was essential to the plan. As it was not possible to achieve this end due to failure of response from the owners of the other two properties our client decided on 25 November 1979 to dispose of what was then clearly not a viable investment proposition. The financing of the project had been arranged in part through J Finance Ltd (\$2,600,000) with further funding to be arranged through the two respective company partners of the joint investment.
- (b) The mortgage with J Finance Ltd related to the purchase of the [Property] and the principal facility to meet construction costs of rebuilding the property was to be provided by the K Bank. We attach a copy of a letter from the bank concerning the arrangement and it was the intention of the partners to fund any further finance from within their own joint resources.’

21. C stated in chief that in 1979 land prices increased quickly and that the Taxpayers sold the property because the price of \$15,000,000 which was offered towards the end of 1979 was attractive, being eight to nine times the cost, whilst on the other hand the rental income of \$40,000 was no longer considered attractive.

22. C used funds derived from the proceeds of sale of the property in the purchase of properties in the United States of America and in Hong Kong as follows:

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- (a) In January 1980, a hotel and an apartment house in Los Angeles, USA were purchased by a company in which C and an associated company of A Ltd were shareholders, for US\$650,000. C's share was US\$260,000, equivalent to HK\$1,430,000. The properties were sold in June 1987.
- (b) In April 1980, 5.5 acres of vacant land in Napa, USA were purchased by the same company for US\$550,000, C's share being US\$220,000, equivalent to HK\$1,210,000.
- (c) In October 1979, 35.6 acres of agricultural land in the New Territories, Hong Kong were purchased by another company in which B Ltd and F Ltd, A Ltd's holding company, were shareholders for HK\$6,000,000. B Ltd's share was HK\$2,400,000.
- (d) In February 1980, C through a company purchased a piece of land in Ngau Chi Wan, Kowloon for HK\$6,500,000. It was registered as a New Kowloon Inland Lot, and its term was due to expire three days before the expiry of the New Territories Lease. It was sold in 1986.

23. In his testimony, C gave as the only reason for the sale of the Property the attractive price of \$15,000,000. This was the first time that such a reason had been advanced. The board resolution of B Ltd dated 2 November 1979 sets forth two reasons for deciding to sell the property: (1) that there was no prospect for redevelopment of the property either by itself or jointly with the adjacent sites and (2) that in view of the uncertainties facing the New Territories arising from the anticipated expiry of their lease, B Ltd should diversify its investments by purchasing a rental income producing property situated in Los Angeles. In their separate representations to the Inland Revenue Department, the Taxpayers' tax representatives, G Co and H Co, both referred to the impossibility of their redevelopment plans for the Property as the only reason for their decision to sell it.

24. In the circumstances, we find that the undoubtedly attractive price of \$15,000,000 was only a reason for the Taxpayers to sell to the particular party who offered that price, but that before the offer was received the Taxpayers had already made up their minds to sell anyway. We also find that the fact that they finally concluded that it was economically inadvisable to redevelop the property may well have affected the time of the sale, but we also find that that was not the point in time when the decision to sell was first formed. As for the desire to diversify investments by the purchase of a property in Los Angeles in view of the uncertainties surrounding the future of the New Territories, as referred to in the board resolution of B Ltd dated 2 November 1979, we do not think that that was a decisive factor in their decision to sell. The purchase price of the property in Los Angeles referred to in paragraph 22(a) above was only a fraction of the proceeds of sale of the property, whilst the greater part of the proceeds was spent in purchasing land in the New Territories and Ngau Chi Wan, Kowloon. In the light of the purchase and/or retention of

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investments in the New Territories, we are not persuaded that such uncertainties affected the position at all.

25. Neither the board resolution of B Ltd, nor the tax representatives' representations referred to in paragraph 23 above, gives any indication that the Taxpayers' decision to sell was influenced in any way by any price consideration. We find nothing extraordinary about this if, as we find, they made their decision to sell before they received the offer to purchase for \$15,000,000.

26. It was common ground that, if the Taxpayers originally intended to retain the property for rental income, they are entitled to succeed. On the other hand, if the original intention was always to resell at some stage whether after redevelopment or not, the Commissioner was correct. The crucial question therefore is: when did the Taxpayers form their intention to sell. The Taxpayers' case is that they acquired the property as a long term investment for rental income, that they acquired the property on the basis of an anticipated return of 12% after renovation, a return which they regarded as satisfactory, and that in fact it did yield 12% after renovation. C stated that the monthly rental income of \$40,000 was no longer attractive by the side of the offer of \$15,000,000 and therefore that the Taxpayers, at that point in time, decided to sell. But his testimony is inconsistent with the documentary evidence referred to above. It was accepted, correctly in our view, by counsel for the Taxpayers that the burden of persuading this Board that the Commissioner was wrong was on the Taxpayers. While the offer of \$15,000,000 was undoubtedly an attractive one, both in general terms and in the light of the original purchase price, we are not persuaded, having seen and heard the witnesses and considered the documents, that this offer caused a change of intention whereby the idea of continued retention of the building for rental income was abandoned. We are fortified in this conclusion by the fact that this reason had not previously been specifically relied upon. In any event, if value increased so would rent, and therefore long term investment was not precluded by increased value in a case such as the present, where tenancies were all short term. In our view, the eventual sale is only consistent with an original intention to resell, preferably after redevelopment, and we find that that was the intention with which the Taxpayers acquired the property.

27. We cannot derive any assistance from the joint venture agreement or the board resolutions of B Ltd and A Ltd dated 3 and 5 August 1977 respectively for the following reasons:

- (1) The documents are all self-serving.
- (2) The agreement and the board resolution of B Ltd were drafted by B Ltd's auditors and tax representatives, and the board resolution of A Ltd was copied from B Ltd's board resolution.
- (3) C does not read English and simply signed the agreement and the board minute.

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- (4) The board minute of B Ltd was prepared by its auditors/tax representatives with the date and time in blank. D, the senior book-keeper of B Ltd, typed in the date and time and took the minute to C for his signature. There is no evidence that the board meeting referred to in the minute was in fact held.
- (5) In the board minute of A Ltd (referred to in the Commissioner's determination), the date and time of the meeting are stated to be 5 August 1977 at 10 a.m. At the hearing, Mr Richmond produced a document purporting to be another board minute of A Ltd relating to a directors' meeting held on 4 May 1979 at 11 a.m. which passed a resolution in identical items with the one dated 5 August 1977. Both minutes appear to have been signed by the same three directors including E. It is admitted by the Taxpayers through their solicitors that the board minute dated 4 May 1979 was enclosed with a letter dated 11 January 1983 from H Co, the Taxpayers' then tax representatives, to the Inland Revenue Department. However, the contents of the minute are not admitted. There is thus a grave doubt as to whether any meeting was held on 5 August 1977, or indeed at any other time, to pass the resolution.
- (6) We are therefore unable to accept any of these documents as evidencing the Taxpayers' intention to acquire the property as a long term investment for rental income.

28. As for ground 4 of the notice of appeal, we think that the circumstances surrounding the matters raised therein should be taken into consideration. At the time of the purchase, the property was subject to tenancies, the expiry dates of which extended into 1980 or 1982. The redecoration and improvements, which were clearly not expensive or extensive, resulted in a substantial increase in rental income as expected after renewing old tenancies and granting new tenancies, all for short terms. The negotiations for joint redevelopment with adjacent owners which the Taxpayers started almost as soon as they had acquired the property, and the drawing of building plans and obtaining the approval of the Building Authority, were all matters which could and did take time. In the light of all these considerations, we are of the view that the carrying out of the works and the grant of new tenancies were steps as consistent with nursing the property pending redevelopment for resale as with maintaining a long term investment.

29. The letter dated 17 May 1979 from A Ltd to the owners of the adjoining property, mentioned in paragraph 15 above, refers to the Property as 'standing on a valuable piece of land that deserves more intensive development to generate a higher income'. Mr Yu, counsel for the Taxpayers, submitted that those words showed that their intention was to hold the property as a long term investment. With respect, we do not think so. The words certainly do not preclude an intention to resell after the property has acquired a capacity for higher income through redevelopment.

30. The main point of E's affirmation (referred to in paragraph 4 above) is that, at the time of acquiring the property, the Taxpayers' intention was to purchase it as a long term

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investment to provide rental income with a view to redeveloping the property in perhaps three to five years' time to generate more rental income, that the offer to purchase the property at a price of \$15,000,000 was one which they could not reasonably refuse, and therefore that they agreed to abandon the original intention of holding on to the property and to re-invest part of the money on a long term basis in property overseas. E was authorized by A Ltd to make the affirmation on its behalf. The affirmation was admitted in evidence on the ground that E, the maker of the affirmation, was beyond the seas. However, the question of weight to be given to the statements contained in the affirmation remains to be considered. No explanation was offered as to why E was not made available as a witness for the Taxpayers. If the evidence contained in the affirmation is important, it is also important that it should be tested by cross-examination. Furthermore, in his affirmation, E referred to the board minute of A Ltd dated 5 August 1977 (referred to in paragraph 27(5) above) as evidencing the Taxpayers' intention to hold the property as a long term investment. He signed the board minute as a director. On the other hand, he also appears to have signed the board minute dated 4 May 1979 which is in identical terms. Whilst agreeing that the 1979 board minute was sent by H Co, the Taxpayers' tax representatives, to the Inland Revenue Department in the course of their correspondence, the Taxpayers would not admit any part of the contents of that document. If it was not an authentic or truthful document, how was it that it was sent by H Co to the Inland Revenue Department? The Taxpayers have not chosen to throw any more light on the matter. Their lack of candour does not enhance the credibility of E. In the circumstances we have decided to give no weight to E's affirmation.

31. For all these reasons, we have come to the conclusion that the profits arising from the sale of the property in December 1979 are assessable to profits tax. This appeal is therefore dismissed and the profits tax assessments as revised for the years of assessment 1978/79 and 1979/80 are hereby confirmed.