

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D38/87

Board of Review:

Andrew K. N. Li, *Chairman*, William L. Chen and Edmond T. C. Lau, *Members*.

30 September 1987.

Profits Tax—whether a property registered in the name of one of the partners was an asset of the firm, and if so whether the rents were chargeable to profits tax and expenses deductible in arriving at the chargeable income.

The assessments in question related to the income and expenses of a property which was included in the profits and loss accounts of the Appellant. Upon a review of the case the Revenue was of the opinion that income and expenses of the property should not be taken into account in the profits tax assessment because at all material times the property was registered in the name of one of the partners. Furthermore, the business of the firm was that of agent, manufacturer's representatives and quota dealers and there was no evidence that it had property investment or dealing business.

Held:

The property was an asset of the firm and one of the partners was holding the property on trust for the partnership. The rental income was not profits from its business of agent, manufacturers representatives etc. and the expenses claimed were not incurred or connected with such business. The rental income should be chargeable to property tax.

Appeal dismissed.

Jennifer Chan for the Commissioner of Inland Revenue.
Li Wai-chi of Messrs. Li Wai Chi & Co. for the Appellant.

Reasons:

This is an appeal by H against the 1983/84 profits tax assessment, the 1981/82 and 1982/83 additional profits tax assessments and the 1982/83 second additional profits tax assessments. We shall refer to them collectively as “the assessments in question”.

The assessments in question

The assessments in question related to the income and expenses of the property at M House, Hong Kong (“the Property”). They were included in H's profits and loss accounts supporting its profits tax returns. Particulars are set out in Schedule 1. Schedule 1 also sets out extracts from H's balance sheets showing the Property as a fixed asset and the mortgage loan as a liability.

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On 3 May 1983 the Assessor issued profits tax assessment for 1981/82 showing assessable profits of \$166,522 with tax of \$24,978 payable thereon. On 15 December 1983 the Assessor issued profits tax assessment for 1982/83 showing assessable profits of \$453,760 with tax of \$68,064 payable thereon. H did not object to these assessments. The computation of assessable profits in such assessments took into account the income and expenses of the Property.

On 3 August 1984, H's tax representative informed the assessor that the partnership in H had ceased as from 31 December 1983. After review, the Assessor was of the opinion that the income and expenses of the Property should not be taken into account in the profits tax assessments for 1981/82 and 1982/83.

On 6 November 1984 the Assessor issued additional assessments for 1981/82 and 1982/83 and also the profits tax assessment for 1983/84 excluding the income and expenses of the Property. Particulars are set out in Schedule 2. On 24 December 1984 the Assessor raised a second additional assessment for tax of \$1,182 for 1982/83 to withdraw the rebuilding allowance of \$7,886 granted in the original assessment. These are the assessments in question.

We note that the delay by the Revenue in making the additional assessments correcting errors in the original assessments is regrettable and H's dissatisfaction at this state of affairs is understandable.

Upon objection by H, the Deputy Commissioner of Inland Revenue, confirmed all the assessments in question save for the assessment for 1983/84 as to which assessable profits of \$1,208,214 with tax payable thereon of \$181,232 was increased to assessable profits of \$1,212,250 with tax payable thereon of \$181,837. The basis of the increase was that fixed deposit interest received of \$4,036 which was excluded in the 1983/84 assessment was brought into assessment.

The Issues

The appeal raises two issues: (1) Was the Property an asset of H the firm? (At all material times it was registered in the name of one of the partners) (2) Even if it was, are the expenses in question deductible?

Mr. Li Wai Chi representative of H submitted that the Property was an asset of H the firm and that the expenses in question are deductible and the income in question assessable. Mrs. Jennifer Chan for the Revenue submitted that it was not an asset of H but was an asset of Mr. Y personally and that in any event even if it were, the expenses are not deductible and the income in question not assessable to profits tax.

The Facts

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On the documentary evidence and the oral evidence of Mr. K we find the following facts. Most of them are not controversial.

H has carried on business in Hong Kong since 1 October 1975. In its profits tax returns for the years of assessment 1981/82 to 1983/84 it has described the nature of its business as "Agent, Manufacturers' representatives, Quota Dealers etc."

During the three years ended 30 September 1983 and the period from 1 October 1983 to 31 December 1983, the partners of H were Mr. Y and Mr. K. They shared profits and losses equally. With effect from 1 January 1984 Mr. Y retired as a partner and Mr. K continues as a sole proprietor.

In December 1979 the Property was acquired in the name of Mr. Y. The Schedule of payment was:

	<i>HK\$</i>
(a) 5/12/79 deposit	50,000
(b) 12/12/79 instalment	351,700
(c) 1/3/80 instalment	200,850
(d) 1/6/80 instalment	200,850
(e) End of November 80 instalment	201,600
(f) Balance on completion on 5/6/81 after occupation permit	3,012,000
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	4,017,000

On completion on 5 June 1981, the Property was assigned to Mr. Y on payment of the balance of \$3,012,000. At all times he was the registered owner. Of this sum, \$3,000,000 was advanced by Wayfoong Credit Limited as a mortgage loan on the security of the Property. The monthly mortgage repayment was \$49,396 which was revised to \$54,105.65 due to a change in interest rate.

The Revenue at first disputed that H paid for the deposit, the instalments, the sum of \$12,000 on completion (the balance between the sum due of \$3,012,000 and the loan of \$3,000,000) and the mortgage repayments to Wayfoong Credit Ltd. from its funds. We gave an adjournment to give H the opportunity of adducing documentary evidence to prove that H made such payments. At the resumed hearing H produced its ledger and various bank statements. Having regard to such documents, the Revenue quite properly accepted that the payments in question were made by H from its bank account and that such payments were treated in H's accounting records as payments made by H as a firm. On the basis of the documents produced and the Revenue's concession, we find that the payments in question were made by H from its funds.

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During the years in question, the balance sheets of H showed the Property at cost as a fixed asset and the mortgage loan as a liability. Its profit and loss accounts showed various items as income and expenses of the Property. Particulars are set out in Schedule 1.

The Property which is a shop space had been vacant from completion in June 1981 until the end of September 1981. From 1 October 1981 a company called JB & Company occupied the Property. A varied sum of money representing 50% of the operating profits of JB & Company was paid to H each month by JB & Company for their use of the shop.

On 31 August 1983 Mr. Y entered into a tenancy agreement letting the Property to FA Limited for two years from 1 October 1983 to 30 September 1985 at a monthly rent of \$4,600.

Mr. Y retired as a partner of H with effect from 1 January 1984 and Mr. K continues as a sole proprietor. At that time they agreed that Mr. Y would take over the Property from H. He would take the benefit of the payments already made by H but thereafter he would be responsible for the mortgage repayments. At that time, the outstanding amount was about \$2.5 million and the market value of the Property was slightly below that amount.

Asset of the Firm?

We have found that H the firm paid for the deposit, the instalments the sum of \$12,000 on completion and the mortgage repayments from its funds. In our judgment it follows from this that the Property was an asset of H, the firm and that Mr. Y one of the partners was holding the Property on trust for the partnership.

The Revenue relied on the fact that (a) Mr. Y was the registered owner; (b) as the borrower from Wayfoong Credit Limited he was legally responsible for the mortgage repayments and (c) on dissolution Mr. Y took over the Property. As to (a), as H had paid for the Property, this meant that he was acting as the Firm's nominee. As to (b), Mr. Y was legally liable to Wayfoong Credit Limited but he was entitled to seek an indemnity from H the Firm for whom he was holding the Property. As to (c), this resulted from the agreement between the partners on dissolution of the partnership. It could not be inferred from this that Mr. Y owned the Property throughout when the firm had made the payments for the same.

Should the income and expenses of the Property be taken into account for profits tax?

The Revenue submitted that even if it were an asset of H the firm the expenses in question are not deductible and the income not assessable to profits tax. H's representative submitted the contrary. As can be seen from Schedule 1, the expenses consisted of property loan interest i.e. mortgage repayments, legal expenses for the mortgage, rates and professional charges in the letting of the Property.

In our judgment, the position is as follows as was submitted by the Revenue.

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The year ended 30 September 1981

There was no income from the Property during the year ended 30 September 1981. The expenses claimed for that year are not deductible as they were not incurred in the production of any profits.

The years ended 30 September 1982 and 30 September 1983

The income from the Property was \$7,747.08 and \$117.10 respectively. These sums represented 50% of the operating profits of JB & Company paid to H each month by JB & Company for the use of the shop. Substantial expenses were paid by H for the Property in respect of mortgage repayments and rates. On the evidence before us, the business of H was that of agent, manufacturers' representatives quota dealers. In its profits tax return, H described its business as such with the addition of the word "etc". In our judgment "etc" must have been intended to refer to business ancillary to or at least similar to that described. H had not discharged the onus of showing that it had a business of property investment or property dealing. There is no evidence that it had a property investment business. As to property dealing Mr. K told us in evidence that it was the intention at the time of purchase that if there was an increase in price then the property will be disposed of. But Mr. Li, the representative of H informed us on instructions that H had never dealt in property before. We are not satisfied that it had a business of property dealing.

On the evidence before us, we are not satisfied that the income of \$7,747 and \$117 during the years ended 30 September 1982 and 30 September 1983 were profits from its business of agent, manufacturers' representative and quota dealers and that the expenses claimed for these years were incurred or connected with such business. There is in fact no evidence before us to support this. Accordingly, we hold that the expenses claimed are not deductible and the income should not be taken into account.

Period from 1 October 1983 to 31 December 1983

During this period, rent of \$13,800 was received. The letting to FA Limited had commenced on 1 October 1983. It is clear from the definition of "business" in the Inland Revenue Ordinance ("the Ordinance") that the mere letting of premises is not automatically a business. As stated above, we are not satisfied that H had a property investment business or a property dealing business. That being so, the rental received are not chargeable to profits tax and the expenses are not deductible. The rental should be chargeable to property tax.

It follows from the above conclusions that rebuilding allowance should not be granted as the Property was not used for the production of H's assessable profits for profits tax. See section 18F(1).

Accordingly, we dismiss the appeal and confirm the 1981/82 and 1982/83 additional assessment and the 1982/83 second additional assessment.

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As to the 1983/84 assessment we accept that fixed deposit interest received of \$4,036 which was excluded in the 1983/84 assessment should be assessable pursuant to section 15(1)(g) of the Ordinance. We therefore increase it as follows:

Profits previously assessed	\$1,208,214
Add: Fixed deposit interest received	4,036

Assessable profits	\$1,212,250
	=====
Tax payable thereon	\$181,837
	=====

Schedule 1

Balance Sheets

H's balance sheets show inter alia the following asset and liability.

	<i>Year ended</i> <i>30.9.81</i>	<i>Year ended</i> <i>30.9.82</i>	<i>Year ended</i> <i>30.9.83</i>	<i>Period from</i> <i>1.10.83 to</i> <i>31.12.83</i>
	\$	\$	\$	\$
<i>Fixed Asset</i>				
The Property at cost	4,205,850.00	4,205,850.00	4,205,850.00	4,205,850.00
	_____	_____	_____	_____
<i>Liability</i>				
Land and Building Loan	2,995,451.50	2,893,764.19	2,617,077.88	2,546,832.14
	_____	_____	_____	_____

Profit and Loss Accounts

H's profit and loss accounts show inter alia the following items of income and expenses.

	<i>Year ended</i> <i>30.9.81</i>	<i>Year ended</i> <i>30.9.82</i>	<i>Year ended</i> <i>30.9.83</i>	<i>Period from</i> <i>1.10.83 to</i> <i>31.12.83</i>
	\$	\$	\$	\$
<i>Income</i>				
Profits received from JB & Company for the use of the Property (included in Sundry Income)	—	7,747.08	117.10	—

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Rent received from the letting of the Property	—	—	—	13,800.00
	—	7,747.08	117.10	13,800.00
	—	7,747.08	117.10	13,800.00

	<i>Year ended</i>	<i>Year ended</i>	<i>Year ended</i>	<i>Period from</i>
	<i>30.9.81</i>	<i>30.9.82</i>	<i>30.9.83</i>	<i>1.10.83 to</i>
	<i>\$</i>	<i>\$</i>	<i>\$</i>	<i>31.12.83</i>

<i>Expenses</i>				
Property Loan Interest	242,431.50	533,451.54	372,581.49	146,176.86
Legal expenses in the Mortgage of the Property	15,330.00	—	—	—
Rates paid in respect of the Property	—	1,265.00	1,620.00	—
Professional charges in the letting of the Property	—	—	1,191.50	—
	257,761.50	534,716.54	375,392.99	146,176.86
	257,761.50	534,716.54	375,392.99	146,176.86

Schedule 2
Year of Assessment 1981/82
(Additional)

Additional Assessable Profits (See Schedule 1)	\$257,761
	\$257,761
Additional Tax Payable thereon	\$38,664
	\$38,664

Year of Assessment 1982/83
(Additional)

Additional Assessable Profits (\$534,716–7,747, see Schedule 1)	\$526,969
	\$526,969
Additional Tax Payable thereon	\$79,045
	\$79,045

Year of Assessment 1983/84
Basic Period: 1.10.1982 to 31.12.1983

Profit per computation for the year ended 30.9.1983	\$262,219
Profit per computation for the period ended 31.12.1983	442,379
	704,598

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<i>Add:</i> Property loan interest		
(\$372,581.49+\$146,176.86)	\$518,758	
Professional charges	1,191	
Rates	1,620	521,569
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		1,226,167
 <i>Less:</i> Profit sharing from JB & Co.	 117	
Rental income	13,800	
Fixed deposit interest received	4,036	17,953
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Assessable Profits		\$1,208,214
		=====
Tax Payable thereon		\$181,232
		=====