

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D38/92

Profits tax – intention of taxpayer at time of acquisition of property – whether capital assets.

Panel: Ronny Wong Fook Hum QC (chairman), Francis Jerome Law and Peter F Rhodes.

Dates of hearing: 30 September and 1 October 1992.

Date of decision: 25 November 1992.

The taxpayer was a company incorporated in Hong Kong. The taxpayer acquired certain commercial premises suitable for restaurant use. The taxpayer subsequently sold the premises at a profit. The taxpayer submitted that the acquisition of the premises was as a long term capital investment to be used as a restaurant and/or a billiard club. The profit was assessed to profits tax and the taxpayer appealed to the Board of Review.

Held:

The Board did not accept the evidence given on behalf of the taxpayer. It was necessary to establish the intention of the taxpayer when it acquired the property. The onus of proof was upon the taxpayer and the taxpayer had not discharged the onus of proof.

Appeal dismissed.

Cases referred to:

Simmons v Inland Revenue Commissioner [1980] 1 WLR 1196
Chinachem Investment Company Limited v CIR 2 HKTC 261

D J Gaskin for the Commissioner of Inland Revenue.
Liu Kwok Sang of K S Liu & Co Ltd for the taxpayer.

Decision:

THE BACKGROUND

1. The Taxpayer is a company incorporated in Hong Kong in mid-1985. Its authorised capital is \$10,000 divided into 10,000 shares of \$1 each.

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2. In 1985 Messrs A, B and C were appointed directors of the Taxpayer. On the same day, the Taxpayer approved transfer of the two subscriber shares to each of Messrs A and B and further resolved to allot 9,998 shares to Messrs A, B and C. The extent of each of Messrs A, B and C's interest in the Taxpayer was as follows:

<u>NAME</u>	<u>NO OF SHARES HELD</u>	<u>PERCENTAGE OF ISSUED SHARE CAPITAL</u>
Mr A	3,600	36%
Mr B	3,600	36%
Mr C	2,800	28%

3. (a) X Centre is a building completed in late 1983. According to an Occupation Permit of 1983, it has shops and 'restaurant and ancillary accommodation for non-domestic use'.
- (b) Various shop units in X Centre were offered for sale at a public auction held in mid-1985 under the auspices of property agent Y [Agent Y]. The auction was unsuccessful.
- (c) By a letter dated in June 1985, Agent Y offered to Mr A a number of shops in X Centre, which were said to be of '31,741 square feet gross approximately' for a price of \$3,520,000. This was accepted by Mr A who entered into a sale and purchase agreement in mid-1985.
- (d) In late 1985 Mr A executed a Deed of Nomination in favour of the Taxpayer. By an assignment issued a month later, the following premises were assigned in favour of the Taxpayer for \$3,520,000. The premises included:

'All those shops Nos 7, 8, 9, 10 and 11 on the UPPER GROUND FLOOR, RESTAURANT PREMISES (including the Entrance Hall on the Upper Ground Floor) on the FIRST FLOOR and RESTAURANT PREMISES on the SECOND FLOOR of the Building ...'

The assignment in favour of the Taxpayer therefore differed from Agent Y's offer of June 1985 in that Shop No 15 was omitted from the assignment. No explanation has been given to us for this discrepancy.

4. The proposal to acquire an interest in X Centre was first considered by Messrs A, B and C at a meeting in early 1985, some 2 months prior to the incorporation of the Taxpayer. According to the minutes of that meeting, Messrs A, B and C discussed two alternatives, namely, investment in property for rental income and investment in

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joint-venture project in servicing business. The minutes recorded Mr B pointing out that the project they were considering 'is for long-term and the least effect in demand for further cash-flow should be of utmost importance'. The latter alternative was therefore rejected as they 'would have to put further fund into the Company when there is business expansion or when cash-flow is tight'. X Centre was chosen as the rental expected (\$250 per square foot for shops and \$100 per square foot for restaurant) 'was favourable compared with the costs of finance'. Messrs A, B and C further resolved at that meeting to purchase a ready-made company 'T Co' – the Taxpayer before us.

5. The Taxpayer financed its purchase of the 5 shops, the entrance hall and the 2 floors as follows:

- (a) The Taxpayer obtained a loan of \$2,500,000 from F Ltd secured by the 5 shops, the entrance hall and the 2 floors. Interest payable by the Taxpayer for the loan was to be 'at such rate as shall from time to time be determined by [F Ltd]'. The principal of \$2,500,000 together with interest so determined were repayable by 120 equal monthly instalments of \$31,669 each commencing from 4 October 1985.
- (b) The balance of the purchase price of \$3,250,000 and the shortfalls in meeting the monthly repayment to F Ltd of \$31,669 were financed by loans extended by the Taxpayer's 3 directors in proportion to the extent of their interest. The loans from those directors amounted as follows:

<u>YEAR ENDED</u>	<u>Mr A [36%]</u>	<u>Mr B [36%]</u>	<u>Mr C [28%]</u>	<u>TOTAL</u>
31-12-1986	\$571,376	\$571,376	\$444,403	\$1,587,155
31-12-1987	\$685,676	\$685,676	\$533,303	\$1,904,655

6. (a) Shop No 7 was let by the Taxpayer under a tenancy agreement in late 1986 for two years at rental of \$2,000 per month.
 - (b) By a sale and purchase agreement made in mid-1987, the Taxpayer disposed of Shop No 7 for \$213,000. Such disposal was discussed at a meeting of the 3 directors of the Taxpayer held in June 1987. Two versions of the minutes of that meeting were tabled before us. Mr A was said to have been elected chairman of the meeting in one version whilst the other version recorded Mr B as the chairman. Both minutes indicated that the directors present discussed and rejected the suggestion of having further loans from them. Although it was pointed out at the meeting 'that the offer price [for Shop No 7] was not that attractive', the directors resolved to accept the same.
7. (a) Shop No 8 was let by a tenancy agreement made in late 1986 for 2 years at a monthly rental of \$1,500.

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- (b) By an instrument made in late 1986, Shop No 8 was sold by the Taxpayer for \$150,000. The proposed sale was discussed at a meeting of the Taxpayer's directors held in late 1986. Once again we have two versions of the minutes of that meeting with the same discrepancy. The minutes recorded an approach by a resident of the district where X Centre located for acquisition of Shop No. 8. The directors referred to the unsatisfactory rental income and the poor quality of the then tenant. 'In order to avoid further financial burden due to shortfall of rental income over interest outlay', the directors resolved to accept the offer.
8. (a) By a tenancy agreement made in late 1986, Shop No 9 was let for a term of 3 years at a monthly rental of \$3,000. This tenancy did not run its full term because by a further tenancy agreement made in early 1987, the Taxpayer let Shop No 9 to another tenant for a term of 2 years for the same rent of \$3,000 per month.
- (b) By an instrument made in early 1988, the Taxpayer disposed of Shop No 9 for \$300,000. This disposition was discussed at a directors' meeting held in April 1988. Once again we have two versions of the minutes for that meeting with the same discrepancy. Both minutes recorded an approach by the purchaser of Shop No 7 'asking if Shop No 9 could be available for sale'. It was pointed out at that meeting that 'the financial position of the company was still in the worse side'. The directors resolved to accept the offer for Shop No. 9.
9. (a) Shop No 10 was let for a period between August 1986 to December 1986. Rental derived from that letting amounted to \$14,070.
- (b) By a letter of June 1986, C Ltd informed the Taxpayer that they had considered the Taxpayer's offer of Shops No 10 and No 11 for their operation but regarded them as unsuitable.
- (c) Shop No 11 had therefore been left vacant from inception. We have no evidence as to the present fate of both Shops Nos 10 and 11.
10. The First floor (area 14,000 square fee) was utilised for the purpose of a billiard association. Two other companies, namely, P Ltd and M Ltd were involved in the operation of this billiard association. The relationship between P Ltd, M Ltd and the Taxpayer merits careful consideration.
11. (a) M Ltd is a company incorporated in February 1985. On incorporation, its authorised share capital was \$10,000 divided into 1,000 shares of \$10 each.
- (b) On 28 October 1985, M Ltd resolved to increase its authorised share capital to \$1,000,000 by creation of 99,000 ordinary shares of \$10 each. On the same day, 100,000 shares were allotted in favour of 10 shareholders amongst whom were Messrs A, B and C. Their respective shareholdings were as follows:

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<u>NAME</u>	<u>NO. OF SHARES</u>
Mr A	20,000
Mr B	25,000
Mr C	10,000
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	55,000 (55%)

Messrs A, B and C were all appointed directors of M Ltd in February 1986.

- (c) According to the business registration of M Ltd, it commenced a 'management' business in October 1985 at the First Floor of X Centre. According to its directors' report to its shareholders dated 26 February 1987, M Ltd 'has been carrying on the business of leasing of billiard tables'.
 - (d) The business was unsuccessful. As at 31 December 1986 M Ltd had a net loss of \$133,035. It ceased business in February 1988 with a net loss of \$446,498.
12. (a) P Ltd is a company incorporated in late 1985. Messrs A and B were both subscribers to the memorandum of P Ltd.
- (b) P Ltd is a company limited by guarantee without a share capital. Clause 3(1) of its memorandum provides as one of its objects:
- (i) to maintain, promote and cultivate friendship among the members of the Association and to provide club premises and other conveniences and generally to afford to members and their friends all the usual privileges, advantages, conveniences and accommodation of an association and to improve the welfare of its members.'
- (c) Clause 4 of P Ltd's memorandum further provides that the income and property of P Ltd 'shall be applied solely towards the promotion of the objects of the association as are herein specified and no portion thereof shall be paid or transferred directly or indirectly by way of dividend, bonus or otherwise howsoever by way of profit to its members.
- (d) Messrs B and A were appointed directors of P Ltd in late 1985. By a business registration dated late 1985 signed by Mr B, P Ltd was said to have commenced business in late 1985 on the First Floor of X Centre and the nature of business given was that of an 'Association'.

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- (e) By a tenancy agreement made in late 1985, the Taxpayer let the First Floor to P Ltd for 3 years from 1985 at a monthly rental of \$15,000. At around the same time, P Ltd engaged contractors to decorate the First Floor. P Ltd also took out insurance policies to cover various risks incidental to its operation. P Ltd further rented billiard tables from M Ltd.
- (f) P Ltd's operation was no better than that of M Ltd. Its loss for the period ending 31 December 1986 was \$27,981. When it ceased business in late 1987, its loss was \$84,742.

13. The question whether the Taxpayer should make direct investment in P Ltd was considered at a meeting of its directors held in late 1985. According to the minutes of that meeting, Mr B 'reported that the incorporation work of the investment company for a billiard association as agreed at the time acquiring the X Centre has been in progress and the incorporation of the investment company [P Ltd] has been done ...'. The 3 then proceeded to consider a proposal 'to have the investment 100% wholly owned by the [Taxpayer]' which would entail a capital outlay of \$1,500,000. This proposal was rejected in favour of personal investments by Messrs A and B in P Ltd.

14. As far as the Second Floor (area 20,000 square feet) is concerned, between October 1985 (date of purchase) and May 1988 (date of sale), the entire floor had been left vacate.

15. In early 1988, the Taxpayer received two offers for the purchase of the Ground Floor entrance, the First and Second Floors of X Centre. The first offer was from D Ltd. The consideration offered was \$10,000,000 but with a term imposing on the vendor an obligation to pay the purchaser a sum of \$3,000,000 for 'decoration and improvement'. The other offer was from a company called A Ltd signed by Mr M as its director. They offered to purchase the Ground Floor entrance, First Floor and Second Floor for \$7,000,000. Pursuant to this offer, by a sale and purchase agreement made in mid-1988, the Taxpayer sold the Ground Floor entrance, First Floor and Second Floor to S Ltd for \$7,000,000.

16. The Taxpayer submitted its profits tax return for the year of assessment 1986/87 and supporting accounts for the period from June 1985 (the date of incorporation) to December 1986. The Taxpayer declared a loss of \$208,427 which was arrived at after excluding the profit of \$87,940 on sale of Shop No 8.

17. The assessor considered that the profit derived from disposal of Shop No 8 should be chargeable to profits tax and issued to the Taxpayer the following computation of loss for the year of assessment 1986/87:

Basic Period: Year ended 31-12-1986

Loss per Return	\$208,427
<u>LESS: Profits on disposal of Shop No 8</u>	<u>87,940</u>

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Loss carried forward	\$120,487
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The Taxpayer did not dispute the computation of loss issued to it.

18. The Taxpayer submitted its profits tax return for the year of assessment 1987/88 showing a loss of \$108,233 and supporting accounts for the year ended late 1987. In the proposed tax computation, the profit on sale of Shop No 7 in the amount of \$116,186 was not offered for assessment.

19. The assessor issued to the Taxpayer the following computation of loss for the year of assessment 1987/88:

Basic Period: Year ended 31-12-1987

Loss per Return	\$108,233
<u>LESS: Profit on disposal of Land and Buildings</u>	<u>116,186</u>
Assessable Profits	7,953
<u>LESS: loss brought forward</u>	<u>7,953</u>
Net Assessable Profits	NIL =====

STATEMENT OF LOSS

Loss brought forward	\$120,487
<u>LESS: Loss set off as above</u>	<u>7,953</u>
Loss carried forward	\$112,534 =====

20. The Taxpayer, through its former representative (the Former Representative) disagreed with the assessor's computation of loss for the year of assessment 1987/88 and claimed that: 'the add back of profit on Disposal of Land & Building is incorrect. In fact the profits of \$116,186 is a capital profit and it should not be subject to profits tax for that year of assessment.'

21. Upon the failure by the Taxpayer to submit its profits tax return for the year of assessment 1988/89, the assessor raised on the Taxpayer the following profits tax assessment:

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Estimated Assessable Profits under Section 59(3)	\$200,000
<u>LESS:</u> Loss set off	<u>112,524</u>
Net Assessable Profits	\$87,466 =====

STATEMENT OF LOSS

Loss brought forward	\$112,534
<u>Less:</u> Loss set off as above	<u>112,534</u>
Loss carried forward	NIL =====

22. The Former Representative, on behalf of the Taxpayer, objected to the profits tax assessment for the year of assessment 1988/89 on the ground that the amount so assessed is excessive.

23. The profits tax return for the year of assessment 1988/89 filed by the Taxpayer in support of its objection against the assessment showed a loss of \$289,644. In arriving at this loss, the Taxpayer excluded the profits totalling \$4,222,893 on disposal of Shop No 9 and the Restaurant Premises on the First Floor and Second Floor.

24. The assessor did not accept that the profits derived by the Taxpayer on disposal of Shop No 9 and the Restaurant Premises on the First Floor and Second Floor were not chargeable to tax and raised an additional profits tax assessment for the year of assessment 1988/89 on the Taxpayer as follows:

Loss per computation	\$ 289,644
<u>LESS:</u> Profit on Sale of Properties	<u>4,222,893</u>
Assessable Profits	\$3,933,249
<u>LESS:</u> Loss brought forward	<u>112,534</u>
Net Assessable Profits	\$3,820,715
<u>LESS:</u> profits originally assessed	<u>87,466</u>
Additional Assessable Profits	\$3,733,249 =====

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Tax Payable thereon	\$634,652 =====
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25. The Former Representative objected to the additional profits tax assessment for the year of assessment 1988/89 in the following terms:

‘The profit on sale of properties in the amount of \$4,222,893 is a capital gain and it is not subject to profits tax. The properties in question were acquired for long-term investment. However, they were disposed off under force and coincidentally the price of the property market rised and eventually the Taxpayer made a capital profit.’

26. By its determination dated 23 June 1992, the Commissioner rejected this contention of the Taxpayer. The Taxpayer now appeals before us.

ORAL EVIDENCE ON BEHALF OF THE TAXPAYER

27. The Taxpayer called its director Mr B. He is a garment merchant with no knowledge of the English language. At the date of purchase of the units in X Centre in 1985:

- (a) His principal business interest was in two garment companies. The turnover of one of these companies in 1987 was US\$10,000,000.
- (b) He had been operating a restaurant in Kowloon called X restaurant for 9 years with his friends.
- (c) He had no experience in property rental in the district where X Centre located.
- (d) He had developed an interest in playing billiard and made attempts to locate premises in two other districts.

28. Mr B told us that together with Messrs A and C, he found the premises in X Centre which were designed for opening a restaurant. They intended to open a restaurant there. Afterwards they found the premises unsuitable for a restaurant as the area was too large and there was no customer from outside that district. They then enlisted a well-known billiard player and started operating a billiard association. He accepted that there was no reference to a billiard association in the minutes of the April 1985 meeting and explained that at that juncture they ‘had plans to invest but had not made up their mind on any kind’.

29. He was cross-examined on the discrepancies in the minutes kept by the Taxpayer. He pointed out that those minutes were prepared by the Taxpayer’s employees and the affairs of the Taxpayer were not handled as systematic as the garment business of its shareholders. The employees would determine which director was acting as chairman of the meeting. That issue did not make any difference to Messrs A, C or to B himself.

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30. Mr B explained why the Taxpayer did not dispute assessment of the profit derived from disposal of Shop No 8. He pointed out that he entrusted the matter to the Former Representative. He was told by the Former Representative that the Taxpayer did not have to pay tax and he therefore accepted the position.

31. Mr B told us that Mr M of A Ltd was introduced by his brother to the Taxpayer. He accepted that he himself participated with Mr M in a company called T Ltd in mid-1987. T Ltd engaged in a venture involving the purchase and sale of shop spaces. Mr B withdrew from that company in late 1987 because of the mode whereby Mr M was running its business.

32. Mr B accepted that in late 1988, he together with others in the garment trade entered into an agreement for the purchase of C Building for \$131,000,000. This was subsequently resold at a profit which was reported to tax.

ARGUMENTS OF THE TAXPAYER

33. The Taxpayer contends as follows:

- (a) The Taxpayer intended to acquire the properties for long-term rental income as well as for opening of a billiard association for business income. M Ltd and P Ltd were genuinely formed and operated for this purpose.
- (b) The business of the billiard association was unexpectedly poor and the directors of the Taxpayer decided to cease business in order to cut loss.
- (c) 'Frustration of the plan due to financial difficulties which had hindered the directors to go further with the investment and the uncertainty in future business income has blocked the decision to run further business for the investment.'
- (d) It was at that juncture that S Ltd approached the Taxpayer. Given the cessation of P Ltd and M Ltd and the difficulties encountered in the leasing business, the Taxpayer found that it was more beneficial to realise than to retain the investment.

ARGUMENTS OF THE REVENUE

34. The Revenue contends as follows:

- (a) The evidential value of an expression of intention is minimal unless the Taxpayer has acted in a way compatible or in line with the intention so professed.
- (b) Intention connotes an ability to carry it into effect. It is idle to speak of 'intention' if the person so intending did not have the means to bring it about or

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had made no arrangements or taken any steps to enable such intention to be implemented.

- (c) The minutes of meeting held in April 1985 made no reference to any billiard 'project' and there was no evidence of any detailed consideration of the manner of financing the project and the costs thereof.
- (d) There is no evidence of the ability of the property to generate, on a long-term basis, rental sufficient to finance repayments in favour of F Ltd.
- (e) In just over two and half years the Taxpayer had sold the vast majority of its property interest at substantial profits which would suggest that the Taxpayer was 'dealing in real estate'.

OUR FINDINGS AND DECISION

35. We accept that our task is as directed by Lord Wilberforce in Simmons v Inland Revenue Commissioner [1980] 1 WLR 1196 at 1199A:

'One must ask, first, what the commissioners were required or entitled to find. Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment?'

36. In discharging this task, we are guided by Sir Alan Huggins VP's succinct statement of principle in Chinachem Investment Company Limited v CIR 2 HKTC 261 at page 305:

'There is no dispute what the test is. What was the subjective intention of the taxpayer at the time each parcel was acquired, that intention being viewed in the light of the objective circumstances.'

37. The primary evidence as to the Taxpayer's intention is the minutes of meeting in April 1985. Because of the following factors, we have reservations concerning the contemporaneous nature of the minutes:

- (a) The very loose manner whereby the Taxpayer's minutes were kept. The explanation given by Mr B is insufficient to dispel our general disquietness.
- (b) The timing of the meeting: this meeting allegedly took place in April 1985, over a month before the scheduled auction date for various units in X Centre in May 1985. No explanation was given as to why no bid was made by Messrs A, B or C at the auction if the intention to invest had crystallised in the meeting in April 1985.

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- (c) That document is inconsistent with the general flavour of Mr B's evidence. Instead of a settled intention, Mr B accepted in cross-examination that as in July 1985 various possibilities were opened to him: billiard association was one, restaurant another and he candidly admitted that he and his associates were basically interested in any business that would make profit.

For these reasons, we would approach the minutes of the meeting in April 1985 with caution.

38. The backbone in the Taxpayer's attempt to bolster up the investment intention as depicted in the April 1985 minutes rests on the deliberate formation of P Ltd and M Ltd. The Taxpayer suggested that the efforts devoted in their formation are supportive of an intention to hold the properties as an investment. We are of the view that this contention is considerably weakened by the directors' meeting held in late 1985. The Taxpayer's direct participation in P Ltd was specifically raised but rejected in view of the capital outlay of \$1,500,000. Two of the directors were to make personal investment instead. Consequently, the only relationship between the Taxpayer and the two companies that made up the billiard association was the tenancy between the Taxpayer and P Ltd for 3 years. Had the Taxpayer intended to acquire these properties as an investment by virtue of its alleged intention to run a billiard association we would have expected active participation by the Taxpayer in both M Ltd and P Ltd.

39. We find the evidence in relation to the Taxpayer's attempt to let out the premises in question sketchy. The only documentary evidence relates to offer of the two shops (Nos 10 and 11) to C Ltd in mid-1986. Mr B said in evidence that Mr A contacted Agent Y and he approached estate agents in the vicinity. Had these efforts been made, we would have expected evidence from Agent Y and the local estate agents.

40. Whilst we have general evidence as to the turnover of Mr B's garment business, we do not have any evidence as to any long-term plan on the part of the Taxpayer to meet the monthly repayments to F Ltd. On each of the occasions when the question of disposal of the relevant shop unit was raised, there was a general reluctance on the part of the directors to make further advances in support of the investment. Shop No 8 was sold in late 1986. No attempt was made to call the Former Representative for explanation as to inclusion of the profits arising from that disposal in the Taxpayer's computation.

41. We have considered but decided to place no weight on Messrs A, C and B's participation in T Ltd and in the disposition of C Building. The Taxpayer did not participate in those transactions which took place well after the purchase in question in 1985. We also take the view that the circumstances surrounding the approach by Mr M for the purchase of the First and Second Floors of little relevance in shedding light on the Taxpayer's intention in 1985. On this issue, we are inclined to accept the Revenue's submission that bearing in mind the relationship between the parties in T Ltd and the convoluted nature of the two offers in early 1988, the probabilities are against the Taxpayer's contention that the approach by A Ltd was fortuitous.

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42. For these reasons, we hold that the Taxpayer failed to discharge the onus on them and we would dismiss the Taxpayer's appeal. We so order.