

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D39/88

Profits tax – sale of land – development of premises – original intention to hold for long-term leasing purposes – premises unsuitable – frustration of original purpose – whether profits were trading gains or realization of capital – s 14 of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Denis Evans and Woo Manuel Rosas.

Date of hearing: 14 July 1988.

Date of decision: 23 September 1988.

The taxpayer acquired land and entered into a joint venture agreement with a property developer under which the developer agreed to build a multi-storey industrial building on the land. On completion, the taxpayer would be entitled to five floors of the building.

The taxpayer's intention from the beginning was to lease his five floors as a godown to a joint venture company which was to be owned by him and a godown operator. During the construction of the building, he entered into a joint venture agreement with the godown operator to establish the joint venture company. Also during construction, amendments were made to the building plans in order to enable his floors to be more suitable for godown purposes.

The five floors were constructed to godown standards as to loading capacity and lifts. During construction, the taxpayer rejected an offer to purchase some of his floors.

Upon completion of the building, the premises turned out to be unsuitable in view of certain low-level structural beams in the premises. The taxpayer therefore sold three floors to the person who had previously offered to purchase them, and another floor to another person. He retained one floor for use by his manufacturing company.

The IRD assessed the taxpayer to profits tax with respect to his profits from the sale of the four floors. The taxpayer appealed, and argued that his original intention had been to hold the five floors as capital assets for the purpose of deriving rental income.

Held:

The gains were of a capital nature and not taxable. The taxpayer's original intention to retain the premises for long-term rental purpose had been frustrated by unforeseen problems with the design of the premises.

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Appeal allowed.

J G A Grady for the Commissioner of Inland Revenue.
Benjamin Chain instructed by Poon & Sum for the taxpayer.

Decision:

This case is an appeal by the Taxpayer against an assessment upon him of profits tax when he sold certain floors in an industrial building.

The relevant facts were as follows:

1. The Taxpayer was a private individual who acquired a piece of land ('the original land') from the Hong Kong Government in partnership with another private individual.
2. The partner of the Taxpayer died and it was not possible to proceed with the development of the original land. After some years of delay, the Taxpayer arranged with the personal representative of his deceased partner that the original land would be partitioned and part thereof ('the land') was transferred into his own name as the owner thereof.
3. Both the Taxpayer and the Commissioner agreed and confirmed at the hearing of the appeal that the facts prior to the Taxpayer obtaining title to the land were not relevant. Accordingly, the Board did not enquire into the earlier facts other than those set out above.
4. On 31 March 1976, which was a few days after the original land had been apportioned and the land had been transferred into the Taxpayer's name, the Taxpayer entered into an agreement ('the joint venture agreement') with a property development company ('the development company') for the development of the land.
5. The joint venture agreement provided, among other things, that the development company would construct on the land a multi-storey industrial building ('the building') and that, after completion, the second to sixth floors and five carparking spaces would belong to the Taxpayer.
6. At the Taxpayer's request, the development company agreed and there was included in the joint venture agreement a provision that the capacity of the two cargo lifts in the building would be not less than 4,000 lbs and 3,000 lbs

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respectively and that the floor loading of the second, third and fourth floors would be not less than 300 lbs per square feet.

7. In the course of the construction of the factory building, the development company proceeded to market and sell all of the floors and carparking spaces to which it would be entitled in the building when the same had been completed. The Taxpayer did not at any time attempt to market any of the floors or carparking spaces to which he was to be entitled.
8. The development company and the Taxpayer agreed upon a layout plan for the building which was signed by them when the joint venture agreement was signed or soon thereafter. Subsequently, at the request of the Taxpayer, the layout plan was amended and a supplemental agreement was entered into between the Taxpayer and the development company. The supplemental agreement provided that the Taxpayer would receive the first floor instead of the sixth floor and, in exchange, would give up one carpark space and would make a cash payment to the development company. The layout plan was amended to provide for direct access from the ground floor to the first floor by means of a cargo hoist and, to achieve this, it was necessary to move the toilets.
9. The building was completed and the occupation permit was issued in April 1978.
10. In July 1978, the Taxpayer sold the first, second and third floors and three carparking spaces to an unrelated textile company. Later, the Taxpayer sold the fifth floor and the remaining carparking space to another unrelated company.
11. The assessor assessed the Taxpayer to profits tax on the profit which arose from the sale by the Taxpayer of the four floors and the carparking spaces in the building.
12. The Taxpayer retained the fourth floor of the industrial building for occupation by a manufacturing company which he himself owned and which paid rent to him for the premises.

The foregoing facts were undisputed by the parties. The fact which was disputed and which is the basis of this appeal relates to the claim by the Taxpayer that he did not intend to trade in any of the floors or carparking spaces to which he was entitled. He claimed that, at all material times, it was his intention to retain them for long-term rental purposes and that he proposed that the first to the fifth floors inclusive should be leased to a joint venture company which he was proposing to form with an unrelated godown operating company. He claimed that the proposed joint venture with the godown operating company fell through and that, shortly thereafter, he received an offer from a textile company to purchase three of the floors and three of the carpark spaces out of his entitlement. He claimed that he accepted this offer because the godown joint venture had fallen through, and

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because he considered the offer to purchase to be favourable. He claimed that he also received an attractive offer for one other floor out of his entitlement and his final carpark space, and he accepted this offer as he could no longer use the same for godown purposes.

This appeal depends entirely upon its facts and whether, on the evidence before the Board, we find that the Taxpayer did in fact intend to use the floors and carparking spaces to which he was entitled as godown premises or did in fact intend to sell his entitlement or part thereof for a profit.

We have no hesitation in finding in favour of the Taxpayer on the evidence before us. We find as a fact that it was at all material times the intention of the Taxpayer to retain the floors and carparking spaces in the building to which he was entitled for long-term rental purposes to be used as a godown and to be occupied by a joint venture company which he intended to form.

Both the Taxpayer and a senior representative from the development company appeared before us and gave evidence. Both were extensively and searchingly cross-examined by the representative for the Commissioner. We have no hesitation in saying that we found both of the witnesses to be truthful and frank in the evidence which they gave before us. Such inconsistencies as may have existed in the evidence which they gave can either be explained by the surrounding facts or because they were giving evidence of events which had occurred some ten or twelve years previously. However, there were very few inconsistencies. The important parts of the evidence given before us can be summarised as follows:

1. When the Taxpayer obtained title to the land following the death of his partner, it was his intention to develop the land in joint venture with a partner who had experience in constructing industrial buildings. It was his intention that he would retain the parts of the building to which he would be entitled for rental purposes.
2. He had been told by a third party that the business of operating a godown was very good. As he had no personal experience in operating a godown, he decided to enter into a joint venture with an experienced godown operator with whom he was already acquainted.
3. Pursuant to this intention, he entered a legally binding agreement with the development company for the joint development of the land. This agreement specified that he would be entitled to the lower floors and that the lower floors would have a higher floor loading (300 lbs/sq ft) than would be usual for industrial buildings. He subsequently found out that it was not practical to operate a godown unless there was direct access from street level, and accordingly he negotiated and agreed to pay to the development company financial compensation and to surrender a carparking space in exchange for his

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having the use of the first floor instead of the sixth floor and his having a custom-designed cargo hoist from the ground floor to the first floor.

4. The godown operating company by letter dated 2 March 1977 formally proposed to the Taxpayer a joint venture in the following terms:

‘Re: Proposal Godown Project

With reference to our discussion and consideration to the above project, we suggest the following terms as our developing scheme. Should there be no queries please sign the duplicate of this letter for confirmation. We will push our actions to this matter at once.

1. The developing industrial building from first floor to fifth floor (approximate 39,800 square feet) including five car parks are reserved for the proposal godown purpose.
2. Shareholders will be half and half. (Our groups or our nominee parties hold 50% shares and you hold the rest 50% shares.)
3. Capital is \$750,000 only.
4. We pay all expenditures at the first stage. The rent of the first year will be collected and put into the account of the new company as the capital of your shares.
5. Calculation of rent is \$31,840 per month (39,800 square feet at \$0.8 per each foot) exclusive of rates (Crown rent and property tax only excepted).
6. We are going to prepare the articles and memorandum of the company. When the occupation permit is issued, we will arrange and sign the tenancy agreement and the articles and memorandum of the company in due course.

Please sign and return the duplicate at your convenience.’

5. The Taxpayer formally accepted the foregoing proposal by signing the copy of the letter, and dated his acceptance 4 March 1976.
6. Subsequent to signing this letter, it was discovered by the Taxpayer it was found out by the godown operating company that the premises were unsuitable for use as a godown because the height between the floor and the bottom part of the structural beams was insufficient to allow the efficient moving and storage of goods.

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7. A textile company which occupied an adjoining building wished to purchase adjoining floors in the building. These were the floors to which the Taxpayer was entitled. During the course of construction of the building, the neighbouring textile company had made enquiries of the development company to see if they could purchase the floors in question. As the development company was not entitled to these floors, the enquiry was referred to the Taxpayer and the Taxpayer declined to sell the floors to which he was entitled.
8. Subsequently, when it was found that it was not possible to proceed with the godown joint venture proposal, the neighbouring textile company again approached the Taxpayer to see if he would agree to sell the floors which adjoined their own premises. As it was not practical for the Taxpayer to proceed with his original intention of using the floors for godown purposes, and as the price offered by the adjoining textile factory was attractive, the Taxpayer agreed to sell the first to third floors and three carparking spaces to the textile company. At the same time, the Taxpayer was approached with a view to selling the fifth floor and remaining carparking space which likewise he no longer required. He agreed to the sale of the same. With regard to the fourth floor, he declined to sell the same because he wished to use the same for rental purposes to be occupied by his own manufacturing company.

Based on the foregoing summary of evidence which we accept as being true and correct, it is clear that, at the time when the Taxpayer obtained title to the land, it was his intention to retain the premises to which he would be entitled for long-term rental purposes and not for resale. As his objective was frustrated because the premises were unsuitable for use as a godown, he decided to sell the same when he received unsolicited offers for their sale, which offers he considered to be attractive.

The representative for the Commissioner cross-examined at some length and submitted that the evidence of the Taxpayer and of the representative of the development company should be rejected. He said it was not reasonable to believe that the Taxpayer would have agreed to the design of the building when it was apparent, or should have been apparent, that the design of the building was unsuitable for use as a godown. The explanation given (which we accept) was that it was more economical to design a building for general industrial purposes which could include use as a godown rather than to design a building specifically for use as a godown. Apparently, Government regulations would make it more complicated if the floors in question had been specified as being for godown use as opposed to general industrial use. The Taxpayer had specified the floor loading and the lift loading to accommodate his plan to use the premises as a godown. Subsequently, he negotiated for ground floor access (including exchanging the sixth floor for the first floor) to overcome a problem regarding access to the premises if they were to be used as a godown. He did not foresee the problem which would arise because of the structural beams which could not be subsequently altered.

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As stated, we accept the Taxpayer's explanation regarding this.

This is not a case where a taxpayer is simply making self-serving statements in order to avoid a liability to tax. Not only did the Taxpayer give evidence before us but also a senior representative of the development company, and there was documentary evidence produced before us with regard to the capacity of the lifts and the floor loading together with the amendments to the building plans. In addition, we had before us the letter dated 2 March 1977 from the godown operating company which was precise in its content and which was signed by both the Taxpayer and the godown operating company. There was no suggestion that the document was anything other than genuine, and it clearly supports the Taxpayer's evidence and contention that it was his intention to use the floors as a godown.

As stated above, on the facts before us it is clear that the Taxpayer did not intend to sell the floors and carparking spaces in the building when he entered into the joint venture agreement for the development of the building. Accordingly, we allow this appeal. We direct that the profits tax assessment appealed against be annulled.