INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D48/91

Profits tax – sale of properties – whether capital gain or trading profit – joint venture agreement – whether tax should be assessed on difference in value of acquisition price and value at date of joint venture agreement.

Panel: Anthony F Neoh QC (chairman), Robert G Kotewall QC and Lim Ken Y.

Dates of hearing: 6 and 7 May 1991.
Date of decision: 4 September 1991.

The taxpayer was a company which owned two properties. The taxpayer entered into a joint venture agreement with the owner of adjoining premises to redevelop the properties owned by the taxpayer. Separate tax returns were filed in respect of the joint venture. It was argued by the taxpayer that it had not purchased the two properties with a view to redevelopment and resale and that the gains were capital gains. Alternatively, if this was not the case, then the properties should be revalued as at the date when the joint venture agreement was made for the purpose of assessing tax on the taxpayer.

Held:

On the facts before it, it was clear that the taxpayer when purchasing the properties had the intention of redevelopment and resale and accordingly any profits were taxable. As the joint venture had filed separate tax returns in respect of the joint venture partnership, it was appropriate that a value should be placed on the two properties as at the date of the joint venture agreement and the properties should be revalued at that date and a notional profit subjected to salaries tax in the name of the taxpayer.

Appeal allowed in part.

Case referred to:

Sharkey v Wernher 36 TC 275

Doris Lee for the Commissioner of Inland Revenue.
Johnny Lau Kam Cheuk of S Y Leung & Co for the taxpayer.

Decision:

A taxpayer company ('the Taxpayer') appeals against the Commissioner's determination as to a profits tax assessment raised on it for the year of assessment 1982/83. The Commissioner determined that the assessment should be revised as follows:

	$	$
Loss for year as previously advised		(213,396)
Less: Value of properties at transfer	4,000,000	
Less: Cost	2,762,183	1,237,817
		$1,024,421
Less: Loss brought forward and set off		225,136
Assessable profits		$802,285*
Tax payable thereon		$132,377

[* arithmetical error of $3,000 (refer to paragraph 7(b) below.)]

2. The appeal revolves around the sum of $4,000,000 which the assessor maintains was income derived from the disposition by the Taxpayer of two properties ('the first property' and 'the second property') to a separate tax entity constituted by a joint venture between the Taxpayer and the owners of an adjoining premises ('the adjoining premises'), and which income was taxable under section 14 of the Inland Revenue Ordinance ('the Ordinance'). The Taxpayer maintains that at all material times the first and second properties were capital assets and their disposition should attract no profits tax. Futhermore, if the properties were trading assets, they were transferred on 1 September 1981 which was when they had to be valued. At the hearing, the Taxpayer's representative also suggested that the transfer date may have been in May 1983, and thus the proper year of assessment should be 1983/84.

Agreed Facts

3. The following facts were agreed:

(1) The Taxpayer was incorporated as a private company in Hong Kong in 1980. Until the year of assessment 1982/83 the Taxpayer's paid up capital was $5,000, but during that year of assessment it was increased to $500,000. At all material times the Taxpayer had four directors and four shareholders, each of whom held an equal number of shares in the Taxpayer.

(2) In October 1980 the Taxpayer purchased the first property at a consideration of $950,000.

(3) Two days later, the Taxpayer entered into an agreement ('the first agreement') with the owners of the adjoining premises. Under clause 4 of the first agreement the parties agreed to:

> '… redevelop [the first property] and [the adjoining premises] by a joint building venture by demolishing the existing buildings thereon and erecting in the place thereof two blocks of commercial buildings thirteen storeys each …'

(4) Clause 11 of the first agreement was in the following terms:

> 'During the course of construction of the new building and subject to the consent from the Registrar General and other government authority being obtained, each of the parties hereto shall be at liberty at any time to enter into agreements for sale and purchase of any parts of its or their interest in their respective premises subject also to the condition that completion of such sale and purchase shall take place when the occupation permit in respect of the new building has been issued by the Building Authority.'

(5) In mid-1981 the second property was assigned to the Taxpayer at a consideration of $1,700,000.

(6) The first and second properties which consisted of post-war four storeyed buildings were reflected under 'fixed assets' in the Taxpayer's balance sheets. Purchase thereof was financed by share capital, bank loans and overdraft, and advances from the directors, as indicated below:

As at 31 March	1981 $	1982 $	1983 $
Property at cost	992,639	2,762,183	2,762,183
Secured bank loan	550,000	550,000	1,000,000
Secured overdraft	-	982,513	151,709
Due to directors	480,000	1,506,775	1,731,775
Paid up capital	5,000	5,000	500,000

(7) The Taxpayer's profit and loss accounts for the years of assessment 1980/81 to 1982/83 were reflected in the following:

For the year Ended 31 March	1981 $	1982 $	1983 $
Rental income	20,153	45,648	37,181
Expenses			
Bank interest	24,114	149,109	197,052
Interest on mortgage	5,703	88,229	-
Ex-gratia payment to recover vacant possession	-	-	57,200
Legal & professional fees	-	-	46,994
Others	11,440	15,987	30,329
Total expenses	41,257	253,325	331,575
Loss for period	21,104	207,677	294,394

(8) In September 1981 the Taxpayer wrote to the owners of the adjoining premises in connection with a proposed joint redevelopment of the first and second properties together with the adjoining premises. This letter among other things stated that it was:

> '… subject to the detailed specifications in the legal contract …'

(9) In mid-1982, the Taxpayer entered into a formal cancellation of the first agreement. On the same day the same parties entered into another agreement ('the second agreement') to redevelop the first and second properties together with the adjoining premises.

The second agreement included, inter alia, the following terms:

(a) Clause 3 – a management committee would be formed to oversee the redevelopment including pre-selling and selling of the units in the development;

(b) Clause 5.1 – all costs and expenses to be shared and borne in the proportions; as to two-thirds by the Taxpayer and as to one-third by the other party;

(c) Clause 5.3 – a joint bank account to be set up and operated by the management committee;

(d) Clause 7.2 – the management committee had the power to pre-sell or sell, at any time, the new units;

(e) Clause 7.8 – 'All proceeds of such sales or pre-sales shall … be divided as net profits between the parties hereto in the following shares and proportions, namely, as to two-third to the first owner [the Taxpayer] and as the remaining one-third to the second owner [Mr X and Mr Y]';

(f) Clause 11.1 – 'Nothing herein contained shall be deemed to constitute a partnership between the parties hereto'.

(10) Redevelopment, as contemplated in the second agreement, was to be financed by way of a building mortgage. This was granted in September 1982 by a bank to secure advance of $5,500,000.

(11) The building plans, previously submitted in mid-1982, were approved by the Building Authority in September 1982. The redevelopment was carried through and the occupation permit in respect of the new building was issued in mid-1986. This described the new building as comprising:

(a) G/F: two shops for non-domestic use;

(b) 1/F to 3/F: two offices with two store rooms per floor for non-domestic use;

(c) 4/F to 20/F: two flats per floor for domestic use.

(12) The costs of redevelopment and the profits on sale of the new units were reflected in a profits tax file in the joint names of the owners of the adjoining premises and the Taxpayer in 'joint venture' submitted by the tax representatives pursuant to section 22 of the Ordinance. In computing the joint venture profits, the original costs of the three properties were not taken into account, such being replaced by valuations totalling $6,000,000 as at 1 September 1981 (based on a valuation carried out in early 1988 by a firm of chartered surveyors). This joint venture submitted its first tax return on 2 October 1986, when the aforesaid computations were also submitted.

(13) The Taxpayer had previously submitted its profits tax return for the year of assessment 1982/83 disclosing an allowable loss of $281,059. On 1 June 1984 the assessor issued the following loss computation in respect of the year of assessment 1982/83:

Profit per return	Nil

Statement of Losses	$	$	$
Balance brought forward			225,136
Add: 1982/83 loss as per return		281,059	
Less: Expenses to be capitalised to property development as agreed legal fees	10,463		
Ex-gratia payment	57,200	67,663	213,396
Balance carried forward			$438,532

(14) Subsequently, the assessor considered that, on the appointment of the Taxpayer's properties to the joint redevelopment by virtue of the second agreement, the difference between cost price and market value as at 3 May 1982 (the date of the second agreement) of the Taxpayer's properties should be taken to constitute an item of assessable profits under the principles established in Sharkey v Wernher 36 TC 275. On 10 March 1989 he issued the following profits tax assessment 1982/83:

Estimated assessable profits	$2,000,000
Tax payable thereon	$330,000

(15) Upon the Taxpayer's objection against the assessment as set out in fact (14) above, the Commissioner revised the assessment as set out in paragraph 1 above.

4. The Board heard evidence from two of the shareholders and directors of the Taxpayer, Mr A and Mr B. The Board also had the benefit of submissions made by Mr Lau from the tax representative and Miss Lee representing the Revenue.

Findings of fact

5. Having heard the evidence and submissions made by representatives of the respective parties and having considered the documents placed before us, the Board makes the following findings of fact:

(1) That the Taxpayer had at the time of acquisition of the first property intended to redevelop the same for sale and it was acquired for the purposes of trade.

We base these findings upon the following matters:

(a) That the first property was an old four storeyed building with low rental income, which was in fact only $20,135 for the year ended 31 March 1981.

(b) That the Taxpayer originally only had a capital of $5,000 but had to finance a purchase price of $950,000, $750,000 of which was payable in November 1980. In order to finance the purchase, the Taxpayer had had to borrow from a bank with the sum of $550,000. Bank interest alone exceeded the rental of $20,135.

(c) That only three days from the time of acquisition, the Taxpayer entered into a joint venture agreement with the owners of the adjoining premises to redevelop the first property into a commercial building. This agreement envisages freedom for either party to sell.

(d) That despite protestations by Mr A and Mr B that the first property had been bought for long term investment in mind, that was an intention which was totally inconsistent with the realities at the time. The Taxpayer simply could not afford to maintain a property deriving such low rental income, without envisaging a sale at some stage. Indeed, both Mr A and Mr B admitted in cross-examination that if the Taxpayer made a profit, it would certainly sell the first property.

(2) That the Taxpayer had acquired the second property in mid-1981 also for the purposes of redevelopment, resale and trade.

We base this finding upon the following matters:

(a) That by 1981, the Taxpayer already had a joint venture agreement with the owners of the adjoining premises to redevelop the first property into a commercial building.

(b) That acquiring the second property would enable all three properties to be redeveloped at the same time.

(c) That the letter of 1 September 1981 from the Taxpayer to Mr Y, one of the owners of the adjoining premises, clearly indicated such intention.

(d) That in the absence of evidence to the contrary, the Taxpayer must be taken to have formed such intention in mid-1981 when the second property was acquired.

(e) That in September 1981, while the Taxpayer was still capitalised at $5,000, it had to acquire the second property with shareholders' loans

and bank finance. However, for the year of assessment 1981/82 rental income was $45,648. Interest expenditure for that year alone was $149,109.66. Therefore it was unrealistic for the Taxpayer to expect to hold the second property for long term investment purposes.

(3) That the letter of 1 September 1981 signed by the Taxpayer and the owner of the adjoining premises was not intended to be a binding agreement.

We base this finding upon the following matters:

(a) That it was stated in the letter that the parties were only 'basically agreed to redevelop the whole site of [address of the three properties including the adjoining premises cited] together and subject to the detail specification in the legal contract'.

(b) That important terms, such as the scale of the redevelopment, the precise amount to be expended, the choice of architects and contractors, were not present and thus it was not an agreement which could be implemented unless and until further terms are agreed.

(c) That the letter of 1 September 1981, was no more than at that stage, a 'letter of intent'.

(4) That the first occasion when the first and second properties became irrevocably committed to the joint venture for redevelopment of the three properties was the date of the second agreement, namely, in mid-1982, on which date, the second agreement, by terms, took effect. We accordingly reject the submissions by the Taxpayer's representative that the first and second properties were only transferred to the joint venture upon vacant possession by operation of clause 1.6, which reads as follows:

> 'In the event that vacant possession of either the first or the second premises or any part thereof cannot be obtained by the expiration of eighteen months from the date hereof then this agreement shall be cancelled null and void as if the same has never been entered into saved that either owner who shall have so failed to deliver vacant possession of the relevant premises shall pay and bear all legal fees incurred by the other owner in preparing and approving this agreement as well as all architectural fees incurred hereunder up to and including the said expiration date.'

We base these findings upon the following matters:

(a) That the terms of the second agreement in mid-1982 were clearly intended to be immediately binding between the parties.

(b) That clause 1.6 of the second agreement does no more than to declare that the contract shall be null and void if vacant possession could not be obtained within eighteen months within the date of the agreement. Vacant possession was in fact obtained within this period and the parties in fact proceeded with the redevelopment.

(c) That as the rights and obligations of the parties began from the date of the agreement, the first and second properties could not be dealt with by the Taxpayer in a way inconsistent with its terms as from mid-1982.

(5) That notwithstanding clause 11.1 of the second agreement which states that nothing in the agreement shall be deemed to constitute a partnership between the parties, the filing of a tax return under section 22 of the Ordinance by the Taxpayer jointly with the owners of the adjoining premises indicated in the clearest terms that they regard themselves as constituting a separate entity as if they were a partnership to be taxed as such under section 22 of the Ordinance. Whatever the position of the joint venture in partnership law is therefore irrelevant for present purposes.

We base this finding on the fact that the tax return was filed pursuant to section 22 of the Ordinance.

(6) That the separate tax entity constituted by the joint venture, took a transfer of the first and second properties in mid-1982, the date when the second agreement took effect.

This finding follows from our findings in sub-paragraphs (4) and (5) above.

(7) That the separate tax entity constituted by the joint venture, took a transfer of the first and second properties at a cost which included the market valuation of the properties applicable to September 1981 together with acquisition costs comprising legal fees and stamp duty.

We base this on the tax return filed by this separate tax entity.

(8) That accordingly, the Taxpayer must be taken to have disposed of the first and second properties to the joint venture in mid-1982 at the price of $4,000,000 together with acquisition costs comprising legal fees and stamp duty.

Conclusions

6. We therefore conclude as follows:

(1) That the first and second properties were acquired for the purposes of trade.

(2) That the first and second properties were in fact disposed of by the Taxpayer to the separate tax entity constituted by the joint venture for the redevelopment of the three properties.

(3) That such disposition took place in mid-1982 when the second agreement took effect.

(4) That the disposition was for the price of $4,000,000 plus acquisition costs comprising legal fees and stamp duty.

(5) Such disposition was clearly evidenced in the tax return of the separate tax entity constituted by the joint venture.

(6) That as the Taxpayer had in fact made a disposition to the separate tax entity constituted by the joint venture, it must show at least, a corresponding receipt in its accounts. There is no difference in principle between the disposal to the joint venture entity and a sale to an unconnected party for cash.

(7) That in the absence of an expert opinion of market value in mid-1982, the Board had no alternative but to take the sum of $4,000,000 as the market value. The Board noted that the Commissioner was in fact content to adopt this valuation and indeed even it had been a higher valuation, the joint venture would pay lesser the tax while the Taxpayer will pay more. That would result in neither gain nor loss to the Revenue. The higher the base cost of the properties to the joint venture, the lesser the tax it will have to pay on any profits it makes from the redevelopment.

(8) That, accordingly, the sum arising out of and upon this disposition of the first and second properties to the joint venture was trading income which should attract profits tax under section 14 of the Ordinance.

(9) That furthermore, the development expenses incurred by the Taxpayer in the year of assessment 1983/84 and which were included in the Taxpayer's account for the year of assessment 1983/84 are expenses incurred for the account of the joint venture. This should therefore be claimed under the joint venture account and not by the Taxpayer after disposition of the first and second properties in mid-1982.

7. Finally, we note that the Commissioner had in the proceedings before us made the following concessions:

(a) That the following expenses incurred by the Taxpayer in the year of assessment 1982/83 should be deductible from the Taxpayer's income;

(i) the sum of $10,463 representing legal fees,

(ii) the sum of $27,500 representing expenses for the construction loan.

(b) That due to arithmetical error the sum of $3,000 should also be deducted from the 1982/83 income; and furthermore, certain adjustments arising from deduction for the property tax which had been paid should be made, the quantum of which may be agreed between the parties.

8. We therefore remit the matter to the Commissioner for a new assessment to be raised in accordance with our conclusions and observations set out above.

9. In conclusion we would like to thank representatives of both sides for their assistance.