Case No. D49/07

Profits tax – property – interests acquired in two occasions – intention to trade – cost in calculating profits.

Panel: Benjamin Yu SC (chairman), Paul Mok Yun Lee and Erik Shum.

Dates of hearing: 14 and 17 December 2007.
Date of decision: 28 March 2008.

The taxpayer is a private company and belongs to a group of companies which carries on the business of redevelopment of properties. On or about 6 September 1994, the taxpayer bought half of the interests in a property, which was a pre-1950 five-storey building, at $47 millions. On and about 21 October 1994, the taxpayer bought the remaining half of the property at $96 millions.

In July 1996, the taxpayer caused the building to be in demolition. In October 1996, the taxpayer sold the property with redevelopment.

The main issue is whether when the taxpayer acquired the interests in the property, it did so with the intention to trade.

Held:

1. Having heard all the evidence, the Board accepted that when the taxpayer bought the 1st half share of the property, its intention was to hold it on a long term basis.

2. On the other hand, the Board found the taxpayer's intention at the time of buying the 2nd half share of the property was to redevelop it for sale.

3. Thus, the profit derived from the sale will be taxable but the cost of the 1st half of the property should be taken as the value of that one half at the date of the change of intention (i.e. on or about 21 October 1994).

Appeal allowed in part.

Case referred to:

Lionel Simmons Properties Ltd v Commissioner of Inland Revenue 53 TR 461

Taxpayer represented by its director.
Ng Yuk Chun and Leung To Shan for the Commissioner of Inland Revenue.

Decision:

Introduction

1. The taxpayer appeals against the determination by the Deputy Commissioner dated 31 August 2007 in relation to the tax liability of the taxpayer for the years of assessment 1996/97 and 1997/98. The issue which arises in the appeal is whether at the time the taxpayer acquired the interests in Address A ('the property'), it did so with the intention to trade: see Lionel Simmons Properties Ltd v Commissioner of Inland Revenue 53 TR 461, 491. Since the taxpayer acquired the interests in the property by first entering an agreement to acquire a one-half share from one of the tenants-in-common in September 1994 and the remaining one-half share from the other tenant-in-common in October 1994, the question of intention has to be considered separately in respect of each of the two one-half share. The question of whether the taxpayer acquired the said property with an intention to trade has consequences on three matters in the relevant years of assessment: (1) whether the profit it made in the subsequent disposition of the property was taxable under section 16 of the *Inland Revenue Ordinance*, (2) a claim for rebuilding allowance and (3) reimbursement of construction costs. There is no dispute as to quantum.

The Facts

2. The basic facts relevant to this appeal are set out below. These are not in dispute and we find them proved.

3. The taxpayer was incorporated in Hong Kong as a private company in June 1993. Its business was described as 'property investment' in the Directors' Reports for the years 1994/95 and 1995/96 and as 'property development and investment company' in the Directors' Report for 1996/97. The taxpayer belongs to a group of companies which carries on the business of redevelopment of properties.

4. At all relevant times, the controlling shareholder and director was Mr B. From about August 1994 to February 1996, Mr B held 6,000 shares (being at the time 60% of the issued shares) in the taxpayer. There was, during that period, only one other registered shareholder, Mr C, who held 4,000 shares that is, the remaining 40%. In February 1996, Mr C transferred his shares to Mr B. The annual return of the taxpayer as at 10 June 1996 shows that a company controlled by Mr B

was allotted 90,000 shares.

5. On or about 6 September 1994, the taxpayer entered into an agreement for the purchase of 1/2 of the interests in the property from one Madam D at the price of $47,000,000 subject to existing lettings and tenancies. The property was a five-storey building served by one staircase. A valuation report prepared by Company E gave the value of a one-half share of the property as $50,000,000.

6. On or about 21 October 1994, the taxpayer entered into another agreement for the purchase of the remaining 1/2 of the property from Madam F. The price was $96,000,000 subject to existing lettings and tenancies. At the time of the acquisition of the property, there was a pre-1950 5-storey building standing on the site. By an order issued by the Building Authority on 28 December 1995, the building was declared to be dangerous and the owners were ordered to carry out repair work. At the time, the total rental income from the existing tenancies totalled less than $100,000 per month.

7. In September 1994, the taxpayer appointed an authorized person to submit building plans for redevelopment of the property. In November 1994, the taxpayer obtained building plan approval from the Buildings Department for a 24-storey office building. Between 1994 and 1996, the taxpayer took steps to vacate the property. In 1996, it caused the 5-storey building standing on the property to be demolished. Demolition was completed in July 1996. The Directors' Report of the taxpayer for the year ended 31 March 1995 stated the principal activity of the taxpayer to be 'property investments'. Piling work commenced on 14 November 1996 and was completed on 11 December 1996.

8. On 11 October 1996, the taxpayer entered into an agreement to sell the property to Company G at the price of $160,000,000. A day later, on 12 October 1996, the taxpayer entered into a supplemental agreement with Company G to vary the terms of the agreement for sale and purchase of 11 October 1996 to make it conditional upon the successful purchase of all the units of the building on the adjacent site and delivery of vacant site to Company G on or before 10 October 1997. There are further terms in this supplemental agreement which included a right conferred on Company G to cancel the agreement for sale and purchase if it were unable to obtain vacant possession of the adjacent site; but that if it decided not to purchase all the units of the adjacent site but still elected to purchase the property, it would have to pay a revised consideration of $190,000,000. In the event, Company G was unable to acquire the adjacent site, but did purchase the property from the taxpayer at the price of $190,000,000. The sale was completed by an assignment dated 26 March 1997.

9. The taxpayer did not obtain outside financing for the acquisition of the property. In March 1995, it obtained the agreement of Bank H to provide banking facilities as to $40,000,000 to finance part of the purchase cost, as to $25,000,000 as building loan and a further $10,000,000 overdraft facility; to be secured by a legal charge over the property and repayable 24 months from

the date of execution of the charge. The loans were classified in the taxpayer's accounts as current liabilities.

10. The taxpayer did not prepare any feasibility report at the time of acquisition of the property. From November 1994 until December 1996, there were four reports prepared. All these were done by a company within the taxpayer's group. The first one did not contain any estimate on rental return.

Finding of the Taxpayer's intention

11. Mr B gave evidence before us. He stated that when the taxpayer decided to purchase the first one-half share of the property, its intention was to hold the same on a long term basis. The intention then was to acquire the second half and thereafter to develop the property. His evidence is that at the time of the acquisition of the first one-half share of the property, the taxpayer had no idea when it would be able to purchase the other half, if at all. In this regard, we note that the agreement to purchase the second half-share was entered into on or about 21 October 1994, some 1½ months after the agreement to purchase the first one-half. There was no evidence before the Board to suggest that at the time of the first purchase, it would be able to secure the purchase of the second one-half share. Mr B said that the intention at the time was that if the taxpayer was able to acquire the second half of the property, it would redevelop the property. The taxpayer belongs to a group of companies which has a record of redeveloping properties. As to how it would be developed, Mr B explained that this would depend on the state of the market at the time when the second half was acquired.

12. We accept Mr B's evidence as to the taxpayer's intention at the time of the acquisition of the first half of the property. We find what he stated to be inherently likely. We do so notwithstanding that Mr B's evidence is at variance with previous statements from the taxpayer. In particular, a statement in the note to the Reports and Financial Statements of the taxpayer for the year ended 31 March 1997 and a letter from the Finance Department of the taxpayer to the Commissioner, confirmed by another letter dated 24 December 2003 signed by Mr B himself suggested that the taxpayer's original intention was to acquire the property together with the adjacent site for development. Mr B explained, and we accept, that this could not have been the intention back in 1994 when the two halves of the property were acquired. We are also satisfied that the taxpayer had the financial ability to hold the first half of the property as a long term investment. We accept Mr B's evidence that although the rental yield at the time was low, this was probably in part due to neglect on the part of the previous owners and that as the property has a harbour frontage, advertising revenue could be generated from the property.

13. As noted above, the taxpayer's intention at the time of the acquisition of the second one-half of the property must be considered separately. Mr B pointed out that the acquisition price of the second one-half of the property was very high. The feasibility report prepared by a member of the group, Consultant I in November 1994, shortly after the acquisition, was predicated on

redevelopment for sale. Mr B frankly admitted that because of the high cost of the second half, computation on the basis of rental return may not be feasible. What Mr B frankly told the Board was tantamount to an admission that there had been a change of intention. In the circumstances, we find that the taxpayer has failed to discharge the burden upon it of showing that the acquisition of the second one-half was not for the purpose of trading. On the contrary, we find that at the time of the acquisition of the second one-half, the taxpayer has changed its intention with regard to the first one-half of the property, and has decided to treat the whole of the property as trading stock in its business of redevelopment. The consequence is that any profit derived from the purchase and disposition of the property is still taxable, but that, insofar as the first one-half is concerned, the cost should be taken as the value of that one-half at the date of the change of intention (namely on or about 21 October 1994), rather than the cost at the time of acquisition.

Conclusion

14. In the circumstances, this appeal succeeds in part. Pursuant to section 68(8) of the Inland Revenue Ordinance, we hereby remit the assessment to the Commissioner with the opinion of the Board that for the purpose of determining the profit of the taxpayer from the disposition of the property, the cost of the first one-half of the property should be taken as the open market value of that one-half on or about 21 October 1994.