

Case No. D58/05

Property tax – whether or not an intention to hold property as capital investment – necessary to ascertain the intention at the time of acquisition.

Panel: Anna Chow Suk Han (chairman), Archie William Parnell and Wong Kwai Huen.

Dates of hearing: 23 November 2004, 20 December 2004, 21 April 2005, 1 June 2005 and 26 August 2005.

Date of decision: 18 November 2005.

Taxpayer is a company. Mr E is one of the directors of the company. It is the taxpayer's case that Property B was acquired as a long term investment to be let to related company, Company D ('the Firm'), upon expiration of the existing tenancy subject to which Property B was purchased. However, due to the subsequent expansion plan of the Firm, Property B was considered to be too small for the use of the Firm and thus Property B was sold.

The respondent challenges the taxpayer's stated intention mainly on the following points: (a) The taxpayer's departure from his normal practice suggested that Property B was a different type of property. It was intended as a trading stock instead of an investment property. (b) Property B was only held for 14 months. Mr E's properties for investment purpose were held for much long periods. (c) The firm was no haste to buy. Thus the acquisition must be for short-term gain. (d) It was unrealistic that Property B would be let to the Firm at a discounted rent. (e) The loans from Banks were on short term basis. (f) Neither the taxpayer nor Mr E had sufficient funds to hold Property B as a long term investment. (g) The respondent also attacks the reality of the expansion plan of the Firm, which was alleged to be the cause of the sale of Property B.

Held:

1. The intention of the taxpayer at the time of the acquisition of Property B is crucial in determining whether the property was capital asset or trading asset (Simmons v CIR (1980) 53 TC 461 followed).
2. An intention to hold property as capital investment must be definite. The stated intention of taxpayer is not decisive. Actual intention can only be determined objectively (All Best Wishes Ltd v CIR [1992] 3 HKTC 750 followed).

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

3. The legal principles in this kind of cases are well settled. To determine whether a property was acquired as a trading stock or an investment, it is necessary for the Board to ascertain the intention of the taxpayer at the time of acquisition of the property and the stated intention of the taxpayer had to be tested against objective facts, circumstances and the whole of the evidence.
4. Having carefully considered all the oral and documentary evidence before the Board in the present case, the Board is satisfied that the taxpayer has discharged the onus rested upon it to show that it did not embark on a trade in the acquisition of Property B.

Appeal allowed.

Cases referred to:

Lionel Simmons Properties Ltd (in liquidation) and others v Commissioners of
Inland Revenue [1980] 53 TC 461
All Best Wishes Ltd v CIR [1992] 3 HKTC 750
Marson (Inspector of Taxes) v Marton and related appeals [1986] STC 463
Simmons v CIR (1980) 53 TC 461
Board of Review Decision 54/98 dated 7 July 1998

Andrew Lam Ping Cheong of Messrs Andrew Lam & Company for the taxpayer.
Paul Leung H M Counsel instructed by Department of Justice for the Commissioner of Inland Revenue.

Decision:

1. **The appeal**

1.1 This is an appeal commenced by Company A ('the Taxpayer') against the determination of the Acting Deputy Commissioner of Inland Revenue dated 22 July 2004 whereby the Acting Deputy Commissioner confirmed the profits tax assessment for the year of assessment 1995/96 and the additional profits tax assessments for the years of assessment 1996/97 and 1997/98 raised on the Taxpayer.

2. **The issue**

- 2.1 The issue under the appeal is whether the profit derived by the Taxpayer from the sale of the property at Address C (‘Property B’) was trading profit chargeable to profits tax.

3. **The background facts**

- 3.1 There is an agreed statement of facts made between the parties. A copy of the same is annexed to this decision and marked ‘Agreed Statement of Facts’. This statement provides us with the background information of this appeal, information on the Taxpayer and also information gathered by the assessor during the investigation stage. Similar abbreviations will be used in this decision as in the Agreed Statement of Facts.

4. **The Taxpayer’s case**

- 4.1 It is the Taxpayer’s case that Property B was acquired as a long term investment to be let to a related company, Company D (‘the Firm’), upon expiration of the existing tenancy subject to which Property B was purchased. However, due to the subsequent expansion plan of the Firm, Property B was considered to be too small for the use of the Firm and thus Property B was sold.

5. **The Respondent’s case**

- 5.1 The Respondent challenges the Taxpayer’s stated intention mainly on the basis of the following points:
- (a) Unlike the present case, Mr E used Company F and the Taxpayer respectively to enter into agreements for sale and purchase of his residential and commercial investment properties. But in this case, he initially used a nominee company, Company G to enter into the provisional agreement for sale and purchase of Property B. This departure from his normal practice suggested that Property B was a different type of property. It was intended as a trading stock instead of an investment property.
 - (b) Property B was only held for 14 months. Mr E’s properties for investment purpose were held for much long periods.
 - (c) When property B was bought, the Firm only just entered into a new tenancy agreement. There was no haste to buy. Thus, the acquisition must be for short-term gain.

(d) It was unrealistic that Property B would be let to the Firm at a discounted rent because as Madam H gave evidence, the rate of return in an investment was a very important factor to Mr E.

(e) The loans from Bank I and Bank J were on short term basis.

5.2 The Respondent also contends that neither the Taxpayer nor Mr E had sufficient funds to hold Property B as a long term investment. The Respondent believes that Mr E bought Property B in a haste and his financial means had been stretched to a limit and thus when he was unable to obtain the intended loan amount from Bank I, he was forced to borrow the remaining amount from Bank J subject to the condition that he had to sell his other investment properties and to make repayment within one year. The Respondent also contends that Mr E's claim of repayment of Bank I's loan through the realization of Company K's investment was unrealistic since the listing plan of Company K was beyond the control of Mr E and furthermore, Bank I's loan was at the end repaid out of the proceeds of sale of Property B and not of Company K's investment.

5.3 The Respondent also attacks the reality of the expansion plan of the Firm which was alleged to be the cause of the sale of Property B. The Respondent claims that the expansion plan could not be real because there was no growth in the business of the Firm as to justify an expansion and the listing of Company L was only an isolated case. The Firm did not engage in any other IPO projects to warrant an expansion. We were also told that an increase in manpower as a part of the expansion plan was also not real since the number of employees employed by the Firm during the relevant times remained about the same. To engage in Company M ISO 9000 business was also alleged to be a part of the expansion plan, but Company M, the company to run this business, was not incorporated until 1999. Also there were neither merger of practices nor admission of new partners which were also claimed to be parts of the expansion plan.

5.4 The Respondent reminded us that even if there was an expansion plan, there was no necessity for the Taxpayer to sell Property B so soon, because it could be decided later if indeed a larger office was required by the Firm. Furthermore, the Firm had always used rented premises as its office which remained the case even up to the time of this appeal.

6. **The witnesses**

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

- 6.1 The Taxpayer called five witnesses, namely Mr E, Madam H the partners of the Firm, Mr N the accountant of the Firm and later of Company O, Miss P a company secretary of the Firm and later in Company O, and Miss Q an assistant manager of Company R, a client of the Firm and later of Company O.

7. **The authorities**

- 7.1 The Taxpayer produced the following authorities:

1. Lionel Simmons Properties Ltd (in liquidation) and Others v Commissioners of Inland Revenue [1980] 53 TC 461;
2. All Best Wishes Ltd and Commissioner of Inland Revenue [1992] HKTC 750; and
3. Marson (Inspector of Taxes) v Marton and related appeals [1986] STC 463.

- 7.2 The Respondent produced the following authorities:

4. Section 68, Inland Revenue Ordinance, Chapter 112;
5. Simmons v CIR (1980) 53 TC 461;
6. All Best Wishes Ltd v CIR (1992) 3 HKTC 750;
7. Board of Review Decision 54/98 dated 7 July 1998; and
8. Marson v Morton [1986] STC 463.

8. **The applicable legal principles**

- 8.1 The intention of the Appellant at the time of the acquisition of Property B is crucial in determining whether the property was capital asset or trading asset. As stated by Lord Wilberforce in Simmons v CIR (1980) 53 TC 461 at 491:

‘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?’

- 8.2 An intention to hold property as capital investment must be definite. The stated intention of the taxpayer is not decisive. Actual intention can only be determined objectively. In All Best Wishes Ltd v CIR (1992) 3 HKTC 750, Mortimer J gave the following guidance at 771:

‘The intention of the taxpayer, at the time of acquisition, and at the time when he is holding the asset is undoubtedly of very great weight. And if the intention is on the evidence, genuinely held, realistic and realizable, and if all the circumstances show that at the time of the acquisition of the asset, the taxpayer was investing in it, then I agree. But as it is a question of fact, no single test can produce the answer. In particular, the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of the evidence ... It is trite to say that intention can only be judged by considering the whole of the surrounding circumstances, including things said and done. Things said at the time, before and after, and things done at the time, before and after. Often it is rightly said that actions speak louder than words.’

9. **Our decision**

- 9.1 The legal principles in this kind of cases are well settled. To determine whether a property was acquired as a trading stock or an investment, it is necessary for the Board to ascertain the intention of the taxpayer at the time of acquisition of the property and the stated intention of the taxpayer had to be tested against objective facts, circumstances and the whole of the evidence.
- 9.2 Having carefully considered all the oral and documentary evidence before us in the present case, we are satisfied that the Taxpayer has discharged the onus rested upon it to show that it did not embark on a trade in the acquisition of Property B.
- 9.3 Five witnesses attended the hearing to give oral evidence on behalf of the Taxpayer. The important witnesses are Mr E and Madam H, the partners of the Firm. They are the relevant parties to give us an account of the matters and reasons leading to the purchase and sale of Property B. We had the benefit of seeing and hearing these two witnesses at the hearing and we are generally impressed by their demeanours and believe that they had been truthful with their evidence which were given with clarity.
- 9.4 Mr E had given us the impression that he was a very practical and cautious person. With his professional qualification and years of working experience behind him we believe he was also a wise and shrewd investor, unlikely to take

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

high risks. As to Madam H, she impressed upon us that she is a lady of intelligence and ability. We also believe that Mr E found her a valuable asset to the Firm thus rendering his explanation as to agreeing to a discounted rent in order to secure her as a partner on a long term basis, credible.

- 9.5 The Respondent essentially attacked the Taxpayer's evidence in three areas, namely its stated intention, the Taxpayer's or Mr E's financial ability to hold Property B as a long term investment and the reality of the expansion plan of the Firm.
- 9.6 Firstly, on the stated intention the Respondent contends that there are many advantages in using a nominee company to acquire a landed property which is to be a trading stock and since Company G being a nominee company was used to enter into the provisional agreement for sale and purchase of Property B, Property B must be intended as a trading stock. We do not find strength in this contention. The many advantages in using a nominee company do not apply in the present case because Company G was no ordinary nominee company. It was a company used by the Firm to provide nominee services to its clients. On the contrary, we believe that indeed by using it to enter into the provisional agreement of sale and purchase of Property B, Mr E was truly offering Madam H an opportunity to participate in the purchase and upon learning Madam H's lack of interest, Mr E thus used the Taxpayer, the company used by him to hold commercial investment property, to enter into the assignment of Property B. We take the view that if Property B was meant to be a trading asset, Mr E should have used a company without business operation and not Company G which was already running a business by providing services to the Firm's clients. In reality where one acquires a property through the purchase of shares of the company holding the property, one would usually avoid the shares of a company which is already running a business operation because such company may have liabilities which are not easily detectable. In the present case Company G had been carrying on business by providing nominee services to the clients of the Firm. It would be illogical for Mr E to use Company G to hold Property B and to sell it by disposing the shares of Company G. We accept Mr E's explanation that Company G was used in a hurry, pending Madam H's decision on his offer to her to participate in the purchase.
- 9.7 As to the Respondent's disbelief that Mr E would be prepared to grant a tenancy to the Firm at a discounted rent, having heard the evidence of both Mr E and Madam H, we accept their explanation in this regard. We accept Mr E's explanation that he was prepared to grant a tenancy at a reduced monthly rental in order to secure a long term business partnership with Madam H.

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

Since Mr E owned 70% of the business of the Firm, the loss in rent to him was not as significant as the Respondent put it to be. Also, had the Memorandum of tenancy been self-serving as the Respondent said it to be, there is no reason why the agreed rent was not the then market rent but a discounted rent. In fact, we believe the discounted rent reflects the truth of the matter that the discounted rent was a rent suggested by Madam H and agreed by Mr E. We accept Madam H's and Mr E's evidence that Property B was acquired for use as an office of the Firm; after Madam H did not wish to participate in the purchase, the terms of the proposed tenancy were discussed and Mr E accepted Madam H's suggested rental of \$68,000 per month; Madam H suggested \$68,000 because she believed that it was an amount affordable by the Firm; and Mr E agreed to it because he wished to maintain a long business relationship with Madam H. We also have evidence before us that after the fallen-through of the proposed tenancy of Property B, the Firm rented Property S as its office at the monthly rent of \$70,000 which was the kind of affordable rent Madam H told us. Also, we accept Mr E's explanation that because the Firm had only just entered into a new tenancy in respect of Property T, Mr E thus looked for an office with an existing tenancy and acquired Property B.

- 9.8 Furthermore, to fortify our aforesaid finding that the stated intention was or genuine one, we have also Bank J's facility letter of 26 September 1995, which mentioned that Property B was to be for use of Company F's related company after the expiry of the current tenancy in 1996.
- 9.9 The Respondent raised doubts on the Taxpayer's or Mr E's financial ability to hold Property B on a long term basis. In this regard, for practical purposes we only need to consider Mr E's financial position rather than that of the Taxpayer. Mr E was the alter-ego, the controlling mind of the Taxpayer and Company F. The evidence shows us that when Mr E decided to purchase Property B in July 1995, he had assets such as two residential properties at Private Estate U another residential property at Building V and a commercial property at Building W. All these properties were rented out save that the two Private Estate U properties were vacant shortly before they were sold. Mr E also owned a flat at Private Estate X which he occupied as his residence. All these properties were free from mortgages and their then market values amounted to about \$44,600,000. Save for the Private Estate X property, the rest of the properties were producing rental income for Mr E. He also had cash of \$5,000,000 at his disposal and an investment in Company K. Mr E explained to us that he intended to obtain a loan of about \$15,000,000 from Bank I and since Bank I was only prepared to lend him \$9,700,000, he borrowed the remaining amount from Bank J. As explained to us, both loans were on

short-term basis because he intended to sell one or two of his residential premises to repay a part of the proposed loan amount of \$15,000,000 and to repay the balance of the loan by realization of his Company K investment. He also explained to us that the condition of Bank J that he should sell one or more of his residential premises to repay the loan on or before 31 October 1996 was not a condition stipulated by the bank and also the term of repayment upon expiration of one year was really a term offered by him to the bank as he had in mind to change investment. Mr E's evidence in this regard was challenged by the Respondent, in particular, since in responding to the enquiry made by the assessor, Company O on behalf of Company F replied that '..... properties were vacant after the expiration of the tenancy and our client has to keep looking for new tenants. At that time, [Company A] has entered into a memorandum for sale and purchase for acquiring a property located at [Address C] but cannot obtain sufficient loan amount from bank. So [Company F] was forced to borrow a bank loan from bank to cover in sufficient amount with the condition that [Company F] has to sell properties to repay the loan to bank before 31st October 1996.' Save for the part where it says 'our client has to keep looking for new tenants' which Mr E explained to us was not the case, we find the remaining of the statement was really not so far from the truth of the matter. As the evidence before us shows, it was a fact that the Taxpayer had entered into a memorandum for sale and purchase and it was also a fact that the Taxpayer could not obtain sufficient loan from Bank I and the Taxpayer under the circumstances had to borrow from Bank J and it was also a fact that there was a condition that Company F had to sell properties to repay the loan on or before 31 October 1996. As to whether Company F was looking for new tenants we accept Mr E's evidence that that statement was an error made by Madam H when she wrote the letter. We accept that it was possible that Mr E might not have read the letter before it was sent out. Mr E's evidence that he intended to change investment by replacing the Private Estate U properties with Property B, is credible. The tenancies of the two Private Estate U properties ended on 30 June 1995 and 6 July 1995 respectively. Bank J's offer of loan facilities was made on 26 September 1995. There was a long lapse of time between the ends of the two tenancies and the offer letter. Private Estate U is a popular development for self-use or letting purposes. If indeed Company F was truly looking for new tenants, we doubt if it had difficulties in finding them. The fact that the two properties were still vacant when Bank J's offer of loan was made suggests that the properties could have been left vacant by choice rather than by force of circumstances. Moreso, assuming that it was true that the condition to sell the properties was forced upon Mr E by the bank and Mr E had no wish to sell them, Mr E still had the option of not selling both Private Estate U properties since one of them already fetched \$5,480,000 which was sufficient to cover the bridging loan of

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

\$4,000,000 stipulated to be repaid on or before 30 October 1996. Also, the sale of the two Private Estate U properties were completed on 2 February 1996 and 3 May 1996 respectively. However, the loan of Bank J was only repaid on 25 October 1996. Again, this seems to suggest that it is more likely that the condition to sell the residential properties was self-imposed rather than a condition forced upon Company F by the bank. Had it been a condition insisted on by the bank, the bank ought to have also stipulated the repayment to be effected as and when the sale proceeds were received, for allowing it to be repaid later would defeat the purpose of the condition as a security for repayment. As it was, Mr E had a choice not to repay until 25 October 1996. Also, having regard to Mr E's past financial arrangements in respect of his investment properties, we accept that the loans from Bank I and Bank J were arranged short-term not because Property B was intended as a trading stock but because Mr E did not intend to borrow long term. Like his other investment properties, they were acquired either without mortgage or with mortgages but on short-term bases.

- 9.10 The Respondent contends that the realization of Company K's investment was an uncertainty which was beyond Mr E's control and thus Mr E's claim that he intended to repay Bank I's loan by realization of Company K's investment was an assertion only. However, as we surmise since the Firm and Madam H were involved in the flotation of the Company L, it would not be so difficult for Mr E to assess the timing of the flotation. As it was, Company K's investment was realized as expected and the proceeds of sale was received on 26 October 1996 and 28 January 1997. The Respondent criticized the Taxpayer's claim that Bank I's loan was intended to be paid through realization of Company K's investment but in fact it was repaid by means of the sale proceeds of Property B. In this regard, the sale of Company K's investment was completed on 28 January 1997 and Property B on 10 January 1997. Since these two dates were so close to each other, we find it matters not whether the loan was repaid out of the proceeds of sale of Company K's investment or that of Property B. As completion of the sale of Property B took place sooner than that of Company K's investment, it is understandable that the loan was repaid then.
- 9.11 The Respondent also reminds us that the Firm was not operating profitably and had Property B not been sold, the Taxpayer or Mr E would have difficulties in servicing the interest and principal repayment under the Bank I's loan. In this regard, we stand back and look at the whole picture and approach the matter with common sense. Mr E was the controlling mind behind the Taxpayer and other companies. At the relevant times, he owned both residential and commercial properties which were free of mortgages and were income producing. Mr E was also receiving income from his practices. We are

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

therefore satisfied that Mr E would have adequate financial ability to make interest payment or principal repayment enabling the Taxpayer to hold Property B on a long term basis.

- 9.12 As to the expansion plan which prompted the Taxpayer to sell Property B, we are also satisfied that such plan existed. We were told that the expansion plan came about in October 1996 after the new legislation enabling the incorporation of accounting and audit practices and the Company LIPO project when the Firm had in mind to expand the business in the area of IPO consultancy service and also to conduct ISO 9000 project. It was explained to us that as a part of the expansion plan, a bigger office of about 2,500 square feet was required and Property B being too small for the purpose was therefore sold; action was also immediately taken to incorporate the Firm and on 23 December 1996, Company O was incorporated. We were also told that another step of the expansion plan was to increase the manpower of the Firm and in December 1996 four trainees were recruited. The Respondent casts doubts on the intended expansion plan saying there was no significant growth in the turnovers of the Firm to justify an expansion and furthermore, despite the claim of increasing manpower, there was no noticeable change in the number of staff engaged at the relevant times and not until 1999, was Company M incorporated to deal with the anticipated Company M ISO 9000 business.
- 9.13 In considering Mr E's and Madam H's evidence on the expansion plan, we need to cast our minds back to the time in question. The expansion plan was said to be formulated by Mr E and Madam H in about October 1996. It was the time before the handover of sovereignty to China in July 1997, when Hong Kong's economy was flourishing. Stock and property markets were in an up-surge. Business of all kinds was booming. Hong Kong was then full of hopefuls. Mr E and Madam H were perhaps among them. Thus, we do accept that there was an expansion plan underway. As it is also history that after the handover of sovereignty to China in July 1997, with the descent of the Asian economic crisis, Hong Kong's economy suffered a severe setback. We accept so did the expansion plan. Nonetheless, true to their words, as a part of their expansion plan, Mr E and Madam H did move their practice to a larger office and they had since occupied an office space of 2,500 square feet. We also accept Mr E's explanation that after the sale of Property B, he did not acquire another office premises as a replacement as originally planned because after the sale of Property B the property market rose beyond his means.
- 9.14 In support of its stated intention and reason for the change of its stated intention, the Taxpayer produced various minutes of meeting and a Memorandum of

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

tenancy. The Respondent contends that those documents are self-serving and their veracity should be tested against contemporaneous documents and common sense. Having seen and heard the witnesses we have no reasons to doubt the accounts given by them as to how the Memorandum of tenancy and the minutes of meetings came to be prepared. Mr E told Bank J that Property B was acquired for use as the Firm's office after the expiry of the tenancy. This purpose was put in the bank's facility letter. We cannot speculate the reason why the bank did not ask for the Memorandum of tenancy before the drawdown but we are not surprised that the bank should ask for it even after the event because the Memorandum perhaps served the purpose of completing the record on its file. As to the minutes of the meeting on the incorporation of the CPA practice and the future expansion plan, even though the Firm was not in the practice of preparing minutes of the partners' meetings in the past, we do appreciate that the matters decided in this meeting called for special treatment since the proposed incorporation of the Firm's practice was indeed a major change to the Firm since its incorporation would alter the entire structure of the Firm.

- 9.15 Having carefully considered the evidence for and on behalf of the Taxpayer and the overall circumstances of the case, we are satisfied that the Taxpayer has discharged the onus placed upon it to prove that it did not embark upon a trade in the acquisition of Property B. We hereby allow the appeal and dismiss the assessment.

Agreed Statement of Facts

- (1) Company A [‘ the Company’] has objected to the profits tax assessment for the year of assessment 1995/96 and additional profits tax assessments for the years of assessment 1996/97 and 1997/98 raised on it. The Company claims that the profit derived by it from the sale of a property is capital in nature and should not be subject to profits tax.
- (2)
 - (a) The Company was incorporated as a private company in Hong Kong on 29 July 1993.
 - (b) Its authorized share capital was \$10,000, divided into 10,000 ordinary shares of \$1 each. Prior to 16 May 1997, its paid up capital remained at \$2 with two shares issued, one to Madam Y and the other to Company Z. On 16 May 1997, the Company’ s issued share capital was increased to \$10,000 with 9,998 shares allotted to Company Z. On 22 May 1997, Madam Y transferred her only share in the Company to Company G and, on the same day, Company G by executing a Declaration of Trust declared that the one share was held on trust for Company Z.
 - (c) Mr E and Madam Y (both appointed on 18 October 1993) were the Company’ s only directors at all material times.
- (3) Mr E and Madam Y are husband and wife. Mr E has commenced his practice as a certified public accountant since 1981. During the period from 1 January 1994 to 31 December 1997, Mr E and Madam H carried on a partnership business under the name of Company D [‘ the Firm’] and sharing profit and loss in the ratio of 7 to 3. On 23 December 1996, Company O [‘ the CPA Limited’] was incorporated and Mr E and Madam H were appointed as its directors. The shareholdings of Mr E and Madam H in the CPA Limited were 70% and 30% respectively.
- (4) Company Z was a company wholly owned by Mr E prior to May 1997 and it was wholly owned by Mr E’ s family trust thereafter. Its address was Address AA.
- (5) In its directors’ reports for the period from 29 July 1993 (date of incorporation) to 31 December 1994 and for the years ended 31 December 1995 to 1997, the principal activities of the Company were described as ‘ property investment’ . At all relevant times, the Company’ s turnover represented rental income. The Company’ s balance

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

sheets at all the material times did not have any classification of 'trading stocks of properties for sale'.

(6) On 1 November 1993, the Company entered into an assignment to acquire a property at Address AB ['Property AC'] at a consideration of \$9,594,200.

(7) (a) On 15 July 1995, Company G entered into a Memorandum For Sale and Purchase to purchase a property at Address C ['Property B'] at a consideration of \$19,362,000. Company G agreed to pay the sum of \$19,362,000 as follows:

	Date	Amount (\$)
	On 15-7-1995	500,000
	On/before 29-7-1995	1,436,200
	On 29-9-1995	<u>17,425,800</u>
		<u>19,362,000</u>

(b) On 29 September 1995, Company G nominated the Company to complete the purchase of Property B.

(c) On 29 September 1995, Property B was assigned to the Company.

(8) (a) On 29 November 1996, the Company entered into a Provisional Agreement For Sale and Purchase to sell Property B at a consideration of \$34,344,500 to Company AD.

(b) On 21 December 1996, Company AD [Fact (8)(a)] acted as confirmor in the sub-sale of Property B to Company AE.

(c) On 10 January 1997, Property B was assigned to Company AE.

(9) Company G purchased Property B with existing tenancy. The lease period was three years from 1 January 1994 to 31 December 1996 and the monthly rent was \$105,056.

(10) (a) In its profits tax return for the year of assessment 1995/96, the Company declared an adjusted loss of \$112,087. In arriving at the adjusted loss, the Company deducted, inter alia, rebuilding allowance in the amount of \$129,080 in respect of Property B.

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

Copies of the Company's profits tax return, report and financial statements and tax computation for the year ended 31 December 1995 are attached as Appendices A, A1 and A2 respectively.

- (b) In its profits tax return for the year of assessment 1996/97, the Company declared assessable profits of \$118,221. In arriving at the assessable profits, the Company deducted, inter alia, rebuilding allowance in the amount of \$129,080 in respect of Property B.

Copies of the Company's profits tax return, report and financial statements and tax computation for the year ended 31 December 1996 are attached as Appendices B, B1 and B2 respectively.

- (c) In its profits tax return for the year of assessment 1997/98, the Company declared assessable profits of \$44,636. In arriving at the assessable profits, the Company did not include an amount of \$13,821,602 classified as exceptional item in the profits and loss account in relation to the gain it derived from the sale of Property B. The gain was arrived at as follows:

	\$	\$
Sale proceeds of Property B		34,344,500
<u>Less: Selling expenses</u>		
Legal fee	54,787	
Commission to estate agent	<u>343,445</u>	<u>398,232</u>
		33,946,268
Purchase cost	19,362,000	
Legal fee, stamp duty & commission	<u>762,666</u>	<u>20,124,666</u>
Gain on sale of Property B		<u><u>13,821,602</u></u>

Copies of the Company's profits tax return, report and financial statements and tax computation for the year ended 31 December 1997 are attached as Appendices C, C1 and C2 respectively.

- (11) The accounts submitted by the Company disclosed, inter alia, the following:

Balance sheet as at	31-12-1994	31-12-1995	31-12-1996	31-12-1997
	\$	\$	\$	\$
Fixed assets at cost	9,927,427	30,052,093	30,052,093	10,080,959
Current Liabilities				
Amount due to affiliated companies	-	208,577	3,240,000	-
Amount due to a shareholder	-	-	14,070,386	-
Amount due to a director	4,464,222	15,160,774	-	-

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

Bank loan (secured)	4,943,424	13,990,100	8,500,000	-
Non-current liabilities				
Amount due to holding company (Company Z)	-	-	-	7,342,233

- (12) In its tax computation for the year ended 31 December 1997, the Company gave the following reasons why it considered that the gain derived from the sale of Property B was capital in nature and should not be subject to profits tax:

‘(Property B) was purchased on 29 September 1995 together with tenant. Rental income was generated from the date of purchase to the expiration of the tenancy agreement on 31 December 1996.

The intention of acquiring (Property B) was for long-term investment purpose. It was originally intended that (Property B) would be let to (the Company’s) affiliated company and then the premise would be occupied by the Company’s group of affiliated companies after the vacation of the former tenant on 31 December 1996. However, owing to the unforeseeable blooming economy after purchasing (Property B), the area of (Property B) was considered to be too small to cope with the affiliated companies’ future operations in view of their expansion schemes. (Property B) was not suitable for the Company’s affiliated companies and therefore it was sold.’

- (13) The assessor raised on the Company a loss computation for the year of assessment 1995/96 with adjusted loss of \$112,087 [Fact (10)(a)].

- (14) The assessor also raised on the Company the following profits tax assessments for the years of assessment 1996/97 and 1997/98:

	\$
(a) Year of assessment 1996/97	
Profits per return [Fact (10)(b)]	118,221
<u>Less: Loss brought forward and set off [Fact (13)]</u>	<u>112,087</u>
Net assessable profits	<u>6,134</u>
Tax payable thereon	<u>1,012</u>
(b) Year of assessment 1997/98	
Profits per return [Fact (10)(c)]	44,636
<u>Add: Adjustment not in dispute</u>	<u>44,481</u>

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

Assessable profits	<u>89,117</u>
Tax payable thereon (after taking into account tax rebate)	<u>13,233</u>

The Company did not object to the above assessments.

- (15) In reply to the assessor's enquiries, the CPA Limited, on behalf of the Company, accounted for the events giving rise to the purchase and sale of Property B as follows:
- (a) In April 1995, the Firm entered into a tenancy agreement to rent a property at Address AF [' Property T '] for a term of two years from 8 May 1995 to 7 May 1997 at a monthly rent of \$69,540. The saleable area of Property T was around 1,500 square feet.
 - (b) After moving into Property T, the partners of the Firm found that Building W was a suitable location for its long term development. In order to save time and cost spent in moving office every two or three years, the partners of the Firm decided to purchase an office nearby with floor area around 1,500 square feet.
 - (c) Mr E agreed to finance the purchase of a property and to let the property to the Firm ' for the purpose of own-use for his own practice ' .
 - (d) ' By considering office size (about 1613 sq. ft.) and handover date (December 31, 1996) of Property B was suitable for the firm, provisional purchases agreement for Property B was entered on July 15, 1995.'
 - (e) On 29 September 1995, the Firm as tenant entered into a Memorandum of Tenancy with the Company. By that memorandum, the Company agreed to let Property B to the Firm in the following terms:
 - (i) a period of five years from 1 January 1997 to 31 December 2001 at a monthly rent of \$68,000 with an option to lease for a further period of three years at prevailing market rent; and
 - (ii) a rent-free period of three months from 1 January 1997 to 31 March 1997 to the Firm for decoration purpose.
 - (f) ' Legislation enabling audit practice to incorporate was passed on August 2, 1996. Together with the blooming economy in 1996, the partners of (the Firm) decided to incorporate their practice on October 1, 1996, a Draft M & A and application was submitted to the Hong Kong Society of Accountants on

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

October 17, 1996 and (the CPA Limited) was incorporated on 23 December 1996.’

- (g) ‘Since the partners decided to incorporate their practice, the partners planned to expand their practice by expanding the existing business and to some other associate business, as a result more space is required. By considering the changes in (the Firm’ s) business plan, (the Firm) decided to cancel the memorandum of tenancy regarding (Property B) on October 1, 1996.’
- (h) As the original purpose of acquiring Property B was defeated, Mr E decided to sell it. Property B was offered for sale in early October 1996 through estate agents.
- (i) On 18 March 1997, the CPA Limited entered into a tenancy agreement to lease a property at Address AG [‘ Property S’] for a term of two years from 1 April 1997 to 31 March 1999 at a monthly rent of \$70,000 together with an option to renew the tenancy for a further term of one year. The gross floor area of Property S was around 2,500 square feet.

(16) In reply to the assessor’ s enquiries, the CPA Limited also stated the following:

- (a) The Company financed the purchase of Property B as follows:

	\$
Loan from Company Z	4,624,666
Loan from Company Z through Company F	5,800,000
Loan from Bank I	<u>9,700,000</u>
Fact (10)(c)	<u>20,124,666</u>

- (b) Company Z’ s fund came from its shareholder and Company F’ s fund came from a bank loan obtained from Bank J (for repayment of shareholder’ s loan from Company Z).
- (c) The Company had not entered into any agreement with Company Z in respect of the loan borrowed from them. And there was no fixed term of repayment agreed upon.
- (d) Property B was sold with vacant possession after expiry of the tenancy in January 1997 due to change of business plan of the Firm.
- (e) The sale proceeds derived from the sale of Property B was used to repay the balance of Bank I loan and the loans from Company Z.

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

(17) In support of its reply, the CPA Limited furnished copies of the following documents:

- (a) A letter of offer dated 29 April 1995 signed by Mr E for and on behalf of the Firm. By that letter, the Firm offered to rent Property T for the period from 8 May 1995 to 7 May 1997 at a monthly rent of \$69,540 with an option to renew for a further term of one year and rent free period of 31 days.
- (b) A tenancy agreement entered into on 10 July 1995 in respect of Property T on the terms offered by the Firm in the letter mentioned in Fact (17)(a) above.
- (c) A letter dated 1 September 1995 from Bank I to the Company [Appendix D]. By that letter, Bank I as lender offered the Company banking facilities under, inter alia, the following terms and conditions:

‘ Guarantor : (Mr E)

Facility : Short Term Loan Facility in 1, 2, 3 or 6 months for not more than HKD9,700,000.00 or 50% of Verbal Valuation/Formal Valuation whichever is lower. The facility amount is to be reduced by 10% (i.e. HKD970,000.00) at the end of anniversary of first drawdown.

Security : All monies first legal mortgage on (Property B) ...

Interest Rate : Hongkong Dollar Prime Rate plus 0.75% p.a. OR Hongkong Interbank Offered Rate (HIBOR) plus 3.5% p.a. over 1, 2, 3, 6 months whichever is higher.

Our HKD Prime Rate is subject to fluctuation at our discretion without notice, according to the prevailing market rate.

Repayment : Interest payment is to be made on the roll over date of the loan by debiting your account with us.

Guarantee : A continuing guarantee is to be provided by (Mr E) for HKD9,700,000.00.

:

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

- Conditions : 1. If requested by the Lender, (the Borrower) agrees to top-up with additional liquid collateral acceptable to the Bank within 14 days from demand date if the Loan-To-Value ratio exceeds 75% ...
2. The guarantor/borrower agrees to pledge HKD1,000,000.00 or equivalent deposit as additional collateral and condition under which this facility is granted ...'

The above banking facilities were subject to annual review and re-approval on or before 31 March 1996 and the bank's demand for repayment at any time.

- (d) Minutes of a meeting of the partners of the Firm, Mr E and Madam H. It was stated in the minutes that the meeting was held on 1 October 1996 and the matters discussed included, inter alia, the following:

'Future plan

After the incorporation of the CPA Limited, (the company) shall consider the followings for future growth. –

1. Possibilities of acquiring other CPA practice and locate suitable overseas associate.
 2. Planning to recruit salaried partner.
 3. Planning to conduct a new project, including ISO 9000.
 4. Locate for an office of around 2,000 to 2,500 square feet.'
- (e) A letter dated 10 October 1996 asking the Firm to advise whether it was prepared to renew the tenancy in relation to Property T.
- (f) A letter dated 18 April 1997 from the Firm which stated the following:
- '... we would handover (Property T) on May 8, 1997 with the existing condition ...'
- (g) A confirmation dated 7 May 1997 from the Firm which stated that 12 keys in respect of Property T were handed over to the landlord.

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (18) The assessor was of the view that Property B was the Company's trading stock and thus it should not be entitled to rebuilding allowance in respect of the property and that the profits derived from the sale of Property B should be subject to profits tax. He therefore raised on the Company the following profits tax assessment for the year of assessment 1995/96 and additional profits tax assessments for the years of assessment 1996/97 and 1997/98:

	\$
(a) Year of assessment 1995/96	
Loss per return [Fact (10)(a)]	112,087
<u>Add: Rebuilding allowance in respect of Property B disallowed [Fact (10)(a)]</u>	<u>129,080</u>
	16,993
<u>Less: Adjustment not in dispute</u>	<u>1,699</u>
Assessable profits	<u>15,294</u>
Tax payable thereon	<u>2,523</u>
	\$
(b) Year of assessment 1996/97	
Profit per return [Fact (10)(b)]	118,221
<u>Add: Rebuilding allowance in respect of Property B disallowed [Fact (10)(b)]</u>	<u>129,080</u>
	247,301
<u>Less: Adjustment not in dispute</u>	<u>5,864</u>
Assessable profits	241,437
<u>Less: Profits already assessed [Fact (14)(a)]</u>	<u>6,134</u>
Additional assessable profits	<u>235,303</u>
Additional tax payable thereon	<u>38,825</u>
	\$
(c) Year of assessment 1997/98	
Profit per return [Fact (10)(c)]	44,636
<u>Add: Gain on disposal of Property B [Fact (10)(c)]</u>	<u>13,821,602</u>
	13,866,238
<u>Less: Adjustment not in dispute</u>	<u>54,199</u>
Assessable profits	13,812,039

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

<u>Less: Profits already assessed [Fact (14)(b)]</u>	<u>89,117</u>
Additional assessable profits	<u><u>13,722,922</u></u>
Additional tax payable thereon (after taking into account tax rebate)	<u><u>2,037,854</u></u>

(19) The CPA Limited, on behalf of the Company, objected to the assessments in Fact (18) above on the grounds that gain derived from the sale of Property B was capital in nature and should not be subject to profits tax in the year of assessment 1997/98 and that the Company should be entitled to rebuilding allowance in the years of assessment 1995/96 and 1996/97 in respect of Property B.

(20) In reply to the assessor's further enquiries, the CPA Limited stated as follows:

- (a) The ultimate shareholder of the Company, Mr E, had sufficient fund to finance the purchase of Property B.
- (b) Mr E planned to finance the purchase of Property B by two phases. For the first phase, part of the purchase consideration came from Mr E's deposit whereas part of it came from repayment of shareholder's loan by Company F. These amounted to a total of \$10,424,666 (that is, \$4,624,666 + \$5,800,000). For the second phase, Mr E planned to finance by realizing investment of shares in a company named Company K.

In relation to the loan from Company F

- (c) Company F was a company wholly owned by Company Z. Mr E and Madam Y were the directors of Company F.
- (d) The amount owed by Company F to Company Z as at 31 December 1994 was \$25,615,100.
- (e) On 28 September 1995, Company F drew a total of \$7,000,000 (including revolving loan and bridging loan) from Bank J. Out of this \$7,000,000, Company F paid \$5,800,000 to the Company.
- (f) On 25 October 1996, Company F repaid the \$7,000,000 loan by selling two properties as follows:

Location	Date of assignment	Sale proceeds (\$)
Property XX in Private Estate U	2-2-1996	5,480,000
Property YY in Private Estate U	3-5-1996	<u>4,600,000</u>
		<u><u>10,080,000</u></u>

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

In relation to investment in Company K

- (g) Mr E planned to repay the loan from Bank I [Fact (16)(a)] by realizing investment Company K.
- (h) In 1994, the controlling shareholder of Company K planned to list the share of its group in the Hong Kong Stock Exchange. However, the plan was deferred to 1995 due to change of market condition.
- (i) There was an understanding amongst the shareholders of Company K that their investments in Company K would be realized at the time of the listing.
- (j) Madam H was seconded to Company L group of companies as financial controller in September 1995 for preparation of listing. Holdings Company AH was the holding company of the Company L group of companies in which Company K was a member. Holdings Company AH was listed on 30 September 1996.
- (k) Mr E' s investment in Company K was realized at a consideration of around \$13,000,000 in September 1996.

(21) The CPA Limited furnished copies of the following documents:

- (a) Five witness statements signed by Madam H, Mr N, Miss P, Miss Q and Mr AI respectively [Appendices E, E1, E2, E3 and E4]. Attached with the witness statement signed by Madam H were Memorandum of Tenancy mentioned in Fact (15)(e) and the Minutes mentioned in Fact (17)(d).
- (b) A letter dated 26 September 1995 [Appendix F] issued by Bank J for the attention of Mr E confirming the availability of the following banking facilities to Company F:
 - (i) A revolving loan in the amount of \$5,000,000 for refinancing.
 - (ii) An overdraft in the amount of \$5,000,000 for occasional investment purposes.
 - (iii) A bridging loan of \$4,000,000 for purchasing Property B for use by Company F' s related company after expiry of the existing tenancy in 1996. The loan had to be repaid on or before 31 October 1996 by selling one or more of the following properties: -

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (1) Property ZZ in Building V
- (2) Property XX in Private Estate U
- (3) Property YY in Private Estate U

In the letter, it was also stated that the combined outstanding amount under the overdraft facility and the revolving loan should not exceed \$5,000,000 and that a personal guarantee had to be provided by Mr E and it was to be limited to the principal sum of \$9,000,000 plus interest.

- (c) A bank statement of Company F showing, inter alia, the following withdrawals:

Date	Amount (\$)
13-9-1995	28,170
28-9-1995	<u>5,800,000</u>
	<u>5,828,170</u>

- (d) Bank statements of Mr E &/or Madam Y showing, inter alia, the following withdrawals:

Date	Amount (\$)
17-7-1995	500,000
28-7-1995	1,436,200
1-9-1995	57,625
29-9-1995	2,586,796
26-10-1995	<u>57,625</u>
	<u>4,638,246</u>

- (e) A schedule and 13 billing advices issued by Bank I to the Company showing, inter alia, the following:

Date	Due Date	Principal (\$)	Interest (\$)	Total (\$)
15-12-1995	29-12-1995	9,700,000	235,789.73	9,935,789.73
15-3-1996	29-3-1996	9,700,000	229,743.84	9,929,743.84
16-4-1996	30-4-1996	⁽¹⁾ 8,500,000	68,931.51	8,568,931.51
17-5-1996	31-5-1996	8,500,000	66,777.40	8,566,777.40
14-6-1996	28-6-1996	8,500,000	60,315.07	8,560,315.07
17-7-1996	31-7-1996	8,500,000	71,085.62	8,571,085.62
16-8-1996	30-8-1996	8,500,000	64,623.29	8,564,623.29
16-9-1996	30-9-1996	8,500,000	66,777.40	8,566,777.40
17-10-1996	31-10-1996	8,500,000	66,777.40	8,566,777.40
15-11-1996	29-11-1996	8,500,000	62,469.18	8,562,469.18
17-12-1996	31-12-1996	8,500,000	68,931.51	8,568,931.51

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

31-12-1996	10-1-1997	8,500,000	21,541.10	8,521,541.10
10-1-1997	13-1-1997	8,500,000	6,462.33	⁽²⁾ 8,506,462.33

(1) repayment made by Mr E in the sum of \$1,200,000

(2) repayment made from proceeds of sale

- (f) Two bank statements showing that amounts of \$1,188,399.97 and \$11,600.03 (total \$1,200,000) were transferred from Mr E and Mr E &/or Madam Y's accounts on 29 March 1996 for partial settlement of Bank I loan of the Company.
- (g) Memorandum of Understanding dated 11 September 1996 whereby Company F as the beneficial owner holding 20 out of 82 shares of Company K agreed with the other shareholders to set up an optimal group structure for future flotation of the shares of Company L.
- (h) An extract of an accountant's report dated 17 September 1996 prepared for the purpose of incorporation in the prospectus of Company L disclosing that Company K was one of subsidiaries/associates of Company L.
- (i) The profits and loss accounts of the Firm for the period from 1 January 1994 (Date of Commencement) to 31 March 1995, for the year ended 31 March 1996 and for the year ended 31 March 1997 and the accounts of the CPA Limited for the period from 23 December 1996 (Date of Incorporation) to 31 December 1998. The accounts showed, inter alia, the following:

	For the period/year ended	Service Income/Turnover (\$)	Staff Salary (\$)	Rental (\$)	Provident fund (\$)	^(*) One-off Expense (\$)	Profit/(Loss) before taxation (\$)
The Firm	1-1-1994 – 31-3-1995 year ended	5,231,552	2,180,170	1,194,756	90,690	-	495,372
	31-3-1996 year ended	4,931,253	2,063,675	1,068,633	286,152	469,497	(364,652)
	31-3-1997	4,423,406	2,118,339	960,060	111,623	-	47,396
The CPA Limited	23-12-1996 – 31-12-1998 (business was commenced on 1-7-1997)	7,742,140	3,648,113	1,330,000	154,140	-	(53,087)

(*) Fact (22)(o) below refer

- (j) Detailed profit and loss accounts of the Firm for each month for the period from 1 April 1996 to 31 March 1997 [Appendix G].

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (k) Detailed profit and loss accounts of the CPA Limited breaking down into the period from 23 December 1996 to 31 December 1997 and the period from 1 January 1998 to 31 December 1998. The account showed, inter alia the following:

For the period/year ended	Service Income/Turnover (\$)	Staff Salary (\$)	Rental (\$)	Provident fund (\$)	Profit/(Loss) before taxation (\$)
23-12-1996 – 31-12-1997	2,782,219	1,165,354	495,317	112,417	(202,298)
1-1-1998 – 31-12-1998	<u>4,959,921</u>	<u>2,482,759</u>	<u>834,683</u>	<u>41,723</u>	<u>149,211</u>
23-12-1996 – 31-12-1998	<u>7,742,140</u>	<u>3,648,113</u>	<u>1,330,000</u>	<u>154,140</u>	<u>(53,087)</u>

- (l) Detailed profit and loss accounts of the CPA Limited and Consultants Company AJ [‘the Consultant’] for each month for the period from 1 April 1995 to 31 March 1996 and for the period from 1 April 1996 to 31 March 1997 [Appendix H].

- (22) In correspondence with the assessor, the CPA Limited had on divers dates put forth the following contentions:

- (a) The partners of the Firm considered that Property AC was not suitable for use as its office as the saleable area was only 872 square feet.
- (b) The Company planned to use the sale proceeds derived from selling Property B to purchase a larger office for investment or for use as office by the Firm. However, the Company could not find a suitable property at a suitable price as the property price at that moment increased dramatically.
- (c) All the properties held by Mr E were for investment and the Company still held Property AC up till the present.
- (d) The intention of acquiring Property B was for use as office by the Firm. Whether the Firm moved to Property B is irrelevant.

In relation to the Memorandum of Tenancy at Fact (15)(e)

- (e) The monthly rent of \$68,000 was based on the rent that the Firm was paying (that is, \$69,540) [Fact (17)(a)] at the time the Memorandum of Tenancy was entered into.

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (f) According to the experience of the partners of the Firm, moving office involved significant amount of set up cost and a lot of effort such as time spent in looking for suitable location, preparation of tenancy documents, office decoration planning. Thus, the Firm signed a memorandum with the Company for a lease period of five years. In fact, the CPA Limited had moved to Property S [Fact (15)(i)] on 1 April 1997 and had been staying there for almost five years up till the date of the reply letter (16 October 2001).
- (g) The lease period was fixed at five years in the Memorandum of Tenancy. Thus, once the Firm moved to Property B, its location would be fixed for five years and this would restrict the Firm's expansion. This explained why when the partners of the Firm changed their business plan, they decided to move to a bigger office immediately.

In relation to the Firm's change of business plan

- (h) The partners conducted feasibility study on the turnover trend of the Firm according to their experience. The partners believed that the business of the Firm was quite stable. Once they could control the cost (of which rental and staff salaries were the key components), additional profit would be expected from new business and business growth.
- (i) The partners of the Firm believed that, based on its client portfolio, with the return of sovereignty in 1997, there would be an increase of clients from the Mainland in addition to local clients in Hong Kong.
- (j) The partners of the Firm knew that there were some accountants who decided to sell their practices before the handover in July 1997. The partners believed that there were good opportunities to acquire practices. During the relevant times, through referral from friends and business connections, the partners had approached some intended sellers. However, as the meetings were at the introductory stage, the partners did not obtain detailed information such as registration number from the intended sellers.
- (k) 'In 1996, ISO was a hot and popular topics in the market, especially for manufacturing business. The partners believed that there would be a trend for most of the business to obtain an ISO approval in the future. As there should be annual audit for ISO, the partners considered that ISO business was quite stable and would be recurring. In addition, the partners also believed that ISO and audit business could share their client network and there would be synergy effect for the two business. Feasibility was carried out by making direct enquiries with the existing client who had ISO approval and who planned to

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

have ISO approval. In addition, the partners also had discussion with relevant parties for possible business cooperation. And a company named [Company M] (which was associated with Bureau AL in [Country AK]), of which [Mr E] was a director, was established in 1999 for providing ISO service.'

- (l) ISO projects were not conducted under the name of the Firm because the partners of ISO business insisted to establish a company with a name similar to the certified body in order to have a better image and because of marketing tactics. The party who issued certificate was named as Bureau AL in Country AK and thus Company M was established. However, Company M carried business at the address of CPA Limited.

In relation to the accounts of the Firm, the CPA Limited and the Consultant

- (m) The breakdown at Appendix G showed that the total service income of the Firm for the period from April 1996 to September 1996 was \$2,316,821. When comparing this figure with that for the period from April 1995 to September 1995 that is, \$2,204,450, the Partners considered there was upward trend in turnover of the Firm.
- (n) In October 1996 when the partners of the Firm had the meeting, they based on the sales figure for the period from April 1995 to September 1995 (that is, \$2,204,450) and that for the period from April 1996 to September 1996 (that is, \$2,316,821) and believed that there would be an upward trend in terms of both turnover and profitability of the Firm.
- (o) The loss of the Firm for the year ended 31 March 1996 in the amount of \$364,652 was mainly resulted from some one-off expenses including:

	Amount (\$)
Consultancy fee	300,000
Loss on disposal of fixed asset	88,587
Claims arose from removal of office	25,000
Commission	34,770
Legal fee on tenancy agreement	<u>21,140</u>
	<u>469,497</u>

After adjusting the above expenses, it would result in a profit of \$104,845.

- (p) The Firm had to pay additional provident fund in the amount of \$200,000 during the year 1995. After adjusting this one-off expense, the profit for the

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

year ended 31 March 1996 was more or less the same as that for the year ended 31 March 1995.

- (q) The breakdown at Appendix H showed that the total service income of the Firm and the Consultant for the period from April 1995 to September 1995 was \$3,722,678. When comparing this figure with that for the period from April 1996 to September 1996 that is, \$5,240,513, it showed that there was 'a significant growth in business'.
- (r) The sales of the Consultant for the period from April 1995 to September 1995 and for the period from April 1996 to September 1996 were \$787,795 and \$3,096,366 respectively. The Consultant was a company (using the same office as the Firm) providing secretarial service, consultancy, management and accountancy service. This showed that there was a 'significant growth of business'.

(23) The assessor has ascertained the following:

- (a) The Firm and the CPA Limited furnished the following employer's returns for respective years ended 31 March as follows:

	For the year ended	Sheets of employer's returns furnished
(i) The Firm	31-3-1995	22
	31-3-1996	16
	31-3-1997	23
	31-3-1998*	15
(ii) The CPA Limited	31-3-1998#	21
	31-3-1999	20
	31-3-2000	20

* up to 30 June 1997

from 1 July 1997

- (b) Mr N and Miss P [Fact (21)(a)] were employed by the Firm during respective years in the following capacities:

For the year ended	Mr N	Miss P
31-3-1995	Account Assistant	Secretary
31-3-1996	Account Assistant	Company Secretary Manager
31-3-1997	Accountant	Company Secretary Manager
31-3-1998	Accountant	Company Secretary Manager

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (c) Mr N and Miss P have been the shareholders of Company G [Fact (7)(a)] since 21 February 1994. The shares were transferred to them from Madam Y and Mr E respectively on 21 February 1994. At all relevant times, Mr N and Miss P were the directors of Company G.
 - (d) The landlord of Property T, acted through its solicitors, served the Firm a Notice of Termination of Tenancy on 17 December 1996. At the same time, the Firm was informed that the notice dated 10 October 1996 [Fact (17)(e)] was superseded.
 - (e) Company M [Fact (22)(k)] was incorporated on 20 September 1999 but had applied for deregistration in June 2003. On 18 September 2000, Company G disposed of all its 6,000 shares in Company M.
- (24) When asked by the assessor to comment on a draft statement of facts and supply further information and documents, the CPA Limited, by a letter dated 27 November 2003, stated the following:
- (a) Company Z nominated Company G to enter into the Memorandum For Sale and Purchase to purchase Property B. Company Z had also nominated the Company to enter into the 'formal sale and purchase agreement and to complete the purchase of Property B on July 28, 1995 and September 29, 1995 respectively'.
 - (b) The Company did not have any relationship with Company AD [Fact (8)(a)]. It was not involved in the sale between Company AD and Company AE [Fact 8(b)&(c)].
 - (c) The directors and shareholders of Company G did not have any relationship with the Company. Company G did not have any business or investment. It only acted as a vehicle for nominee.
 - (d) 'As there was always fluctuation (the may be up or down), in market rental, the rental of HK\$105,056 per month just represented a market rental at specific time. By considering there would be any credit risk for letting of Property B to a related company (the Firm). And there was further cost saving effect, such as saving of time and cost (including giving of rent free period) to locate suitable tenant every 2 to 3 years and saving of commission to property agents. (The Company) considered monthly rental of HK\$68,000 was a reasonable and acceptable return on long term basis for investment in Property B.'

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (e) The return for all properties held by Mr E through Company F and the Company at the relevant times ranged from 4.35% to 5.89% as follows:

	Property location	Cost	Annual rental	Rate of return
(i)	Held through Company F			
	- Property ZZ in Building V	\$8,561,570	\$462,000	5.39%
	- Property XX in Private Estate U	\$4,136,380	\$180,000	4.35%
	- Property YY in Private Estate U	\$2,957,455	\$129,600	4.38%
(ii)	Held through the Company			
	- Property AC	\$9,927,427	\$586,620	5.89%
	- Property B	\$20,124,666	(*) \$816,000	4.05%

* based on rental income of \$68,000 per month

- (f) The average savings deposit rate in the years 1993 to 1995 was around 2.72%. The rate of return from investing in Property B which was 4.05% was optimistic on a long term basis.
- (g) The Company sent a notice of termination of tenancy to the tenant of Property B in June 1996. After receiving the notice, the tenant phoned the Company and asked whether the tenancy could be renewed. The Company replied verbally that it did not have any intention to renew the tenancy.
- (h) Mr E did not have any intention 'to further let' Property B when the Memorandum of Tenancy was cancelled as he had already got another Property AC in his investment portfolio. In order to avoid duplication of investment in Building W, Mr E decided to sell Property B. Mr E then nominated the Company to put up Property B for sale in October 1996 (which was two months before the expiry of the tenancy).
- (i) Property T was handed over to the Firm on 7 May 1995. The Firm moved to Property T on 16 June 1995.
- (j) The Firm when asked, by the letter dated 10 October 1996, whether it was prepared to renew the tenancy in relation to Property T [Fact (17)(e)], it advised the landlord verbally that it did not renew the tenancy because it had

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

decided to expand its business and was looking for a bigger office (with 2,000 square feet to 2,500 square feet).

- (k) The loan in Fact (17)(c) was repaid in January 1997 'due to realization of investment in 1996'.
- (l) The facilities [Appendix F, supra] were regarded as temporary measures. Mr E planned to repay the bank loan by realizing certain investments to replace Property B.
- (m) The financial position of Mr E at the relevant times was as follows:

	Prior to acquisition of Property B	After acquisition of Property B	Proforma position after realization of investments in two properties at Private Estate U and Company K
Total assets held by Mr E (A)	\$53,606,631	\$70,674,001	\$51,130,166
Total bank borrowings (B)	\$4,943,424	\$23,643,424	\$2,193,424
Gearing ratio (B)/(A)	9.22%	33.45%	4.28%

- (n) Mr E had sufficient financial ability for all his investment. He had planned to finance the acquisition of Property B by replacing other investments as follows:

	\$
Disposal of two properties at Private Estate U held by Company F	10,080,000
Realization of investment in Company K	<u>13,000,000</u>
	<u>23,080,000</u>

- (o) The office at Address AM [paragraph 4 of Appendix E] had an area of approximately of 1,600 square feet.

(25) When asked to supply copies of all minutes of the Firm from 1 July 1993 to 31 December 1997 (date of cessation of business), the CPA Limited replied as follows:

'As the Firm is not a limited company, no minutes was maintained for the daily operation (which was managed by the only 2 partners, [Mr E] and [Madam H]. The

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

only minutes was just for recording the Memorandum of Tenancy and the change of the Firm's business plan.'