

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D59/97

Profits tax – sale of property – whether the original intention of the acquisition was for long term investment.

Panel: Christopher Chan Cheuk (chairman), Edward Chow Kam Wah and David A Morris.

Dates of hearing: 22 May and 12 June 1997.

Date of decision: 25 September 1997.

The taxpayer was a private company incorporated in Hong Kong establishing an office and employing staff. It took a year for the taxpayer to study the market before acquiring the properties. The acquisition was financed partly by the parent company in another country controlled by a major shareholder and mainly by a bank loan. The major shareholder was the driving force behind the establishment of the company and office in Hong Kong as well as the acquisition. The major shareholder became ill and the business was taken over by his son who had to face the economic downturn of the foreign country and the bank pressure. The properties were sold.

Held:

- (a) If each of the following factors are taken in isolation without reference to other circumstances, they are neutral factors: the nature of the property acquired, the method of financing the acquisition and letting activities after acquisition.
- (b) The major shareholder's intention to acquire the properties for long term investment was established; and
- (c) The disposal of the properties was due to sudden change of circumstances.

Appeal allowed.

Cases referred to:

D34/92, IRBRD, vol 7, 356
D76/94, IRBRD, vol 9, 394
D32/95, IRBRD, vol 10, 195
D69/95, IRBRD, vol 11, 102
Simmons v CIR [1980] STC 350

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All Best Wishes Ltd v CIR 3 HKTC 750
D3/88, IRBRD, vol 3, 133
Chinachem Investment Co Ltd v CIR 2 HKTC 261

So Chau Chuen for the Commissioner of Inland Revenue.
Wong Mun Kit of Messrs Horwath & Company for the taxpayer.

Decision:

1. This is an appeal by Company A ('the Taxpayer') against the determination by the Commissioner of Inland Revenue, dated 8 June 1996 in respect of the profits tax assessment for the year of assessment of 1992/93 arising out of the two properties hereinafter described.

Facts of the Case

2. The Taxpayer was a private company incorporated in Hong Kong on 21 July 1989. On 16 July 1990 the property at District B ('Flat C') was assigned to the Taxpayer at a price of \$2,080,000.00. In October 1990 it purchased Shops A, B, C and D on Ground floor, the whole of First floor and the whole of Second floor, Building D, District E ('the District E Premises') at a consideration of \$45,000,000.

3. Flat C was purchased with vacant possession but was later let out at a monthly rent of \$20,000. The whole of the District E Premises was acquired subject to tenancies except part of First floor which was also subsequently let out after assignment.

4. The acquisition of Flat C was totally financed by Company A, the parent company in Country F ('Company G'). For the purchase of the District E Premises Company G made all the financial arrangement for the Taxpayer with Bank H.

5. By various agreements the Taxpayer first sold Flat C at a price of \$3,300,000.00 on 20 September 1991 and the District E Premises with a total consideration of \$60,280,000 on 21 December 1991. Tax was assessed on the profits.

Law

6. Parties referred to different cases covering various aspects of the issue. These include D34/92, IRBRD, vol 7, 356, D76/94, IRBRD, vol 9, 394, D32/95, IRBRD, vol 10, 195 and D69/95, IRBRD, vol 11, 102. Ms Wong for the Taxpayer also relied on a Malaysian decision Tebrau (Johore) Rubber Syndicate, Limited (in Liquidation) v Farmer (Surveyor of Taxes) in which we find little relevance. Both parties referred to various passages in the two leading cases: Simmons v CIR [1980] STC 350 and All Best Wishes Ltd v CIR 3 HKTC 750.

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7. We find no particular divergence on point law. Both sides agreed that the question whether a profit derived by a person from the sale of an asset is liable to profits tax depends very much on his intention at the time of acquisition.

8. After the case had been heard, without request for leave Ms Wong wrote to the Board and submitted two further cases without notifying the Revenue. It is unfair to the other side. Courts and tribunals in Hong Kong advocate for fair and open trial. Every party is given equal opportunity and there should not be private communication between a party and the Board. The Board decided not to refer to the two cases unless Mr So for the Revenue had the chance of making submission thereon. Except in exceptional circumstances the Board is not prepared to re-open any case after hearing. On point of law the Board should have the benefit of hearing the arguments from both sides. Ms Wong's practice of submission without leave from the Board and without informing the other side is, to say the least, not a practice that should be encouraged.

The Issue

9. The issue that the Board has to decide is very simple: whether the Taxpayer held the property for the purpose of trading or investment.

Submissions by both sides

10. Both sides have been very careful in analysing the documentary evidence. The Revenue grouped the facts under five different headings and tried to demonstrate to us that the properties purchased were for trading while Miss Wong drew our attention to the six 'badges of trade' and used them as tests against the evidence submitted to prove that the properties were not acquired for trading.

11. After considering the very able submission by Mr So for the Revenue we share his views on the following issues if each of them is considered in isolation without reference to other circumstances:

- (a) The nature of the assets acquired is neutral – it is consistent with an intention to trade as well as an intention to invest. Flat C was a vacant domestic unit at the time of purchase. Speculators on domestic units usually favour flats with vacant possession because they can be sold off much easier than flats with tenancies, except in cases where the rents give very high yield. However, commercial units can be sold easily with good tenancies. As one can argue either way we accept Mr So's view on this issue.
- (b) The letting activity is also a neutral factor. One can claim that letting is a strong sign of his intention to keep the property as investment but equally it can be argued that letting is a process of 'nursing' the property for subsequent sale. This point is well argued in D3/88, IRBRD, vol 3, 133 and Chinachem Investments Co. Ltd v CIR 2 HKTC 261, and we do not intend to elaborate on it.

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and (c) The fact that Company G fully financed the purchase of Flat C could hardly be used as an indication of the Company's intention; neither do we think that the structure of the subsequent bank loan can help to decide the intention of the Company in acquiring the District E Premises. Both facts can be interpreted either way.

12. We would like to make some comments on the following parts of Ms Wong's submissions:

(a) **Minutes and resolutions as proof of the Company's intention**

The Board always approach these documents with caution. They are nothing but self-declared intention. Upon close examination of the copy minutes (page 60 of Exhibit A) we find a fax record showing a date of 27 July 1993 from Company I. We do not want to draw any conclusion from this but suffice for us to say that we do not attach too much weight on this type of documents.

(b) **Rebuilding Allowances**

Ms Wong submitted that the Company's claim for Rebuilding Allowances in the various financial reports was a good indication of its intention. The Board notes that all the balance sheets were prepared and submitted to the Revenue after the properties were sold as set out below:

Year of Assessment	Filing Dates
1990/91	5 May 1992
1991/92	7 October 1992
1992/93	29 July 1993

There is no evidence to show that the Taxpayer made up the accounts for the purpose of this appeal but we are very cautious in taking this factor into account.

(c) **No previous record of sale**

Ms Wong raised the point that the Taxpayer had never sold any property before and neither had the parent company in Country F sold any property of significant value during the material period. This point was used to prove the negative: the Taxpayer was not a company trading in properties. We must bear in mind the following facts in evaluating the evidence. The Taxpayer was a newly formed company and the subject properties were its first acquisition. The main business of Company G was the operation of game shops. The properties were purchased mainly for their own use. This point could hardly be used as a proof of the Taxpayer's real intention.

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(d) Two separate legal entities

Ms Wong submitted that the Taxpayer and Company G were two separate legal entities and that the Board should restrict itself in considering the activities of Company A in Hong Kong and should not examine beyond that. This we cannot accept. The Taxpayer was completely controlled by Company G and to be more precise, by the president who at the time of purchase, was the founder. The real intention of the founder as well as that of the controlling company was most relevant. Similarly are their activities.

13. Mr So for the Revenue made very strong submissions in the following areas: (a) Short period of ownership, (b) the capital structure of Company G, (c) Reasons for sale and (d) Delay in remittance of sale proceeds to Country F. The Taxpayer must respond to these challenges before it could succeed in this appeal.

14. For both properties the length of ownership (from the date of acquisition to the date of sale) was about fourteen months. It is very unusual for investments of this size (both premises together having a total value of about \$47,000,000 to be disposed of within such a short period except under special circumstances and it is difficult to argue that the original intention was for investment unless something unexpected happened. It was Ms Wong's case that Company A had to sell the properties because Company G wanted to open more game shops. Mr So for the Revenue demonstrated to us that the money was not needed for the expansion itself. The Board accepts Mr So's view. He also commented on the capital structure of Company G itself. He submitted that in view of the heavy short term borrowings the declared intention of Company G (and therefore that of the Taxpayer) is unlikely to be 'genuinely held, realistic and realisable'. But, he did not appreciate the business nature of Company G, and the effect of the founder's death upon the whole game shop business and its expansion plan. The latter was the ground that clearly emerged from the witness' evidence and was also adopted by Ms Wong. Mr So for the Revenue had also made full and detail submission on this point. We do not think that this reason is a new invention by the Taxpayer for the purpose of this appeal.

The Founder's Death

15. The Board finds that Mr J, the only witness called by the Taxpayer, was a truthful and honest witness. Having heard what Mr J had said and having had the opportunity of seeing his demeanour we generally accept his evidence.

16. According to the testimony by Mr J, the founder (and after his death his son, Mr K) was the master mind behind the whole business empire of Company G. The founder recruited Mr J and instructed him to set up the Taxpayer company in Hong Kong which he did. They had known each other for about fifteen years and had very good relationship. At that time Country F was having its economic boom which made the founder plan for some real estate investment in Hong Kong. He had no difficulty in obtaining finance for any acquisition as the banks with which he had business dealings trusted him and were prepared

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to offer assistance. Most of them were small banks who had granted short term loans because of the business nature of Company G. It operated game shops which received nothing but cash. The game machines had an average life span of about one year and kept changing. It is understandable that it had only short term loans. This should not be construed that long term investment is beyond Company G's ability.

17. The founder had to find some one he trusted in Hong Kong to handle the real estate business for him; Mr J was a logical choice. Mr J did not know much about Hong Kong real estate and he did not rush into the market. He learnt his way through by making enquiries and analysis; it took him nearly a year before he came up with the first recommendation which was accepted by the founder, that is, Flat C. A few months later, another recommendation which was also accepted was the subject property of the District E premises. The purchase of Flat C was fully financed by Company G while that of the one in District E was covered by bank loan.

18. The founder passed away on 16 October 1991 after having stayed in hospital for six to eight months. We were not told of the details of his illness. During that time his son took over the control of the company. It is understandable that the pressure fell upon him. The banks with which Company G had dealings were mostly small banks; they were not as generous as before in dealing with his father. Most of the loans were short-term loans. Adding to this the economic recession. It was only prudent for a person facing such situation to crystallise all the assets which did not form part of its main business – operation of game shop. The decision to sell the Hong Kong properties was made three months before the founder's death. Although, as Mr So pointed out, no one could anticipate the founder's death, however, it is not unreasonable to assume that his successor wanted to get in as much cash as possible. The money was not immediately remitted back to Country F because financial arrangement for new shops had been made some time ago and also because there was foreign remittance restriction, at least, this was what Mr J honestly believed. The Board accepts Mr J's explanation that the main reasons for the sale of the subject properties were the economic recession in Country F and the founder's death.

19. The Board also believes that the Company's original intention to acquire the property was for investment. The founder deliberately recruited Mr J to station in Hong Kong and set up the Company in Hong Kong. Mr J rented an office premises and employed staff. Mr J had no other duty in Hong Kong but to look for investment opportunity. It took him nearly a year before the first investment was made. All these circumstances lead us to believe that the founder's real intention was to invest for long term purpose in Hong Kong rather than to make some quick profit.

Decision

20. The Board is of the opinion that the subject properties were acquired for the purpose of investment. They were sold because of the special circumstances outlined above. The Taxpayer has discharged its burden of proof. Accordingly we allow the appeal and set aside the profits tax assessment.