INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D61/92

Profits tax – disposal of property – redevelopment and retention of part of property – whether capital gain or assessable profit.

Panel: William Turnbull (chairman), Kenneth Ku Shu Kay and Nigel A Rigg.

Dates of hearing: 11, 14 and 15 December 1992.
Date of decision: 12 March 1993.

The taxpayer acquired a site in the New Territories for redevelopment. The taxpayer entered into various joint development agreements for the development of the site. The taxpayer submitted that it was the alter ego of its shareholders and had acquired the site as a long term capital investment. The taxpayer submitted that the development was a symbolic investment and that the disposal of units in the development at a profit was caused by adverse circumstances.

Held:

It is necessary to ascertain the intention of the taxpayer at the date when it acquired the site. Based on the entirety of the evidence the Board found that it was not the intention of the taxpayer at the time when it acquired the site to develop the same and retain the entire development as a long term capital investment. On the contrary it was the intention of the taxpayer to proceed to sell residential units and carpark spaces and to retain only part of the redevelopment as a long term investment.

Appeal dismissed.

Cases referred to:

Simmons v IRC [1980] 1 WLR 1196
D83/89, IRBRD, vol 6, 300
D41/91, IRBRD, vol 6, 211
Hermann Gustav Erichsen v WH Last [1881] 4 TC 422
Marson v Morton [1986] STC 463
D9/74, IRBRD, vol 1, 153
Johnston v Heath [1970] 3 ALL ER 915
D37/89, IRBRD, vol 4, 425
D19/88, IRBRD, vol 3, 255
FC of T v Whitfords Beach Pty Ltd [1982] ATR 692

INLAND REVENUE BOARD OF REVIEW DECISIONS

All Best Wishes Ltd v CIR (Inland Revenue Appeal No. 1/1992)
Hillerns and Fowler v Murray 17 TC 77

D J Gaskin for the Commissioner of Inland Revenue.
Malcolm Merry instructed by Messrs Simmons & Simmons for the taxpayer.

Decision:

This is an appeal by a taxpayer against a profits tax assessment for the year of assessment 1986/87 wherein the assessor included as taxable profits gains which the Taxpayer made on the disposal of certain property. The facts are as follows:

1. The Taxpayer was incorporated in Hong Kong as a private company in 1981. At all relevant times the authorised and issued share capital of the Taxpayer was $1,000,000 made up of 1,000,000 shares of $1 each.

2. In its profits tax returns including that for the year of assessment 1986/87 the Taxpayer stated that the nature of the business which it carried on was 'property investment'.

3. The Taxpayer was a subsidiary of another company, X Limited.

4. X Limited was incorporated in Hong Kong in 1969 and was owned by Mr A and his wife Mrs A and members of their family. X Limited carried on the business of property investment and property sales.

5. Starting in 1969 Mr A decided that he would acquire letters B land exchange entitlements ('Letters B') and that X Limited would be used for this purpose. Between 1969 and 1981 X Limited acquired a large number of Letters B.

6. By conditions of exchange dated 9 March 1981 the Government granted to X Limited a site ('the site'). The consideration which X Limited gave to the Government for the site was a number of Letters B plus a premium of $37,160,365.

7. The conditions of exchange included the following terms:

(a) A requirement to expend not less than $62,500,000 on buildings to be erected on the site and to be completed within 48 calendar months.

(b) The buildings to be erected ('the development') would comprise a commercial and communal podium of 4 levels with residential blocks above the podium. The total number of residential units would not exceed 1,000.

(c) The podium would include walkways, foot bridges, sitting and children play areas and other amenities. No part of the podium was to be used for residential purposes and all buildings above the level of the podium were exclusively for residential purposes.

(d) There was a requirement to provide parking for motor vehicles at the rate of one space per two residential flats with 50% of such parking spaces reserved for use by residents of the residential units and 50% of the parking spaces to be available for members of the public.

(e) The commercial areas of the development including the car park spaces reserved for the public and the amenity areas were designated as a reserved portion ('reserved portion') and could not be sold except to a company approved by the Government whose principle business was estate management and which was a wholly owned and controlled subsidiary of the owner of the site. The effect of this term was to divide the development into two parts namely the commercial and communal areas on the one hand and the residential areas with associated car park spaces on the other. The commercial and communal areas could not be sold by the owner of the site other than to its own management company. On the other hand the owner of the site had the right, if it so wished, to sell to the public all of the residential units together with the associated car park spaces.

8. By an assignment dated 17 August 1981 the Taxpayer acquired the site from X Limited for the sum of $43,000,000 which was approximately equal to the total sum of money which X Limited had expended in acquiring the site from the Government. The small profit made by X Limited on the sale of the site to the Taxpayer was offered for assessment to profits tax and was duly assessed.

9. The acquisition of the site by the Taxpayer was financed by its paid up capital of $1,000,000 and an interest free loan of $42,000,000 from X Limited. In early 1982 the Taxpayer borrowed the sum of $30,000,000 from a bank and used the money to repay part of the interest free loan to X Limited. The interest rate payable to the bank was subject to market rates which at that time were 18.5% per annum and the loan was subject to repayment on demand by the bank.

10. By an agreement dated 26 August I982 the Taxpayer, entered into an agreement with a developer ('the first developer'). This agreement provided for a loan to the Taxpayer of the sum of $50,000,000. The first developer undertook to develop the site by the construction of a building to cost not less than $140,000,000. It was provided that between 50% to 60% of the domestic flats would be in the range of 500 to 600 square feet, between 10% to 15% should be in the range between 1,100 and 1,200 square feet and the remainder would be in the range between 700 to 800 square feet. The agreement further provided that all of the units in the development were for sale save and except only those units which comprised the reserved portion which would be let out and the rentals collected are shared between the Taxpayer and the first developer. The agreement went on to make

provision as to how the residential units were to be sold and how the proceeds of sale were to be distributed.

11. For unknown reasons the first developer did not proceed to develop the site as envisaged by the agreement dated 26 August 1982 and by a supplemental deed dated 3 June 1983 the Taxpayer and the first developer agreed to cancel the agreement which they had previously reached for the development of the site.

12. By an agreement dated 17 August I983 the Taxpayer agreed with another developer ('the second developer') for the development of the site. Under this agreement dated 17 August 1983 the Taxpayer agreed to make the site available for development by the second developer. The second developer undertook to develop the site to a minimum of 90% of its maximum development potential. The agreement provided that the Taxpayer would be entitled to 40% of all of the proceeds of sale of any units in the development which were sold and 40% of all unsold units which included the reserved portion. The agreement provided that unless it was otherwise agreed all units in the development would be offered for sale subject only to the conditions of exchange under which the land was held from the Government. The second developer was given the right to sell all of the units which could be sold through an associated company of the second developer. The second developer had the right to prepare a price list for such units and the Taxpayer had the right to acquire all or any of the units at the prices so listed. The agreement provided that the second developer would lend to the Taxpayer the sum of $36,000,000 with interest such loan to be repaid out of the proceeds of sale of the development to which the Taxpayer would be entitled. With regard to the reserved portion provision was made in the agreement the effect of which was that mutual offers would be made which placed a value on the reserved portion. If the Taxpayer placed the highest value on the reserved portion then the interest therein of the second developer would be sold to the Taxpayer. If the second developer placed the highest value on the reserved portion then X Limited would sell its shares in the Taxpayer whose only asset at that date would be the reserved portion. It was further provided that any unsold residential units would be distributed in specie between the Taxpayer and the second developer in the ratio of 40:60.

13. Subsequently by supplemental agreements between the Taxpayer and the second developer the Taxpayer agreed in exchange for cash payments to reduce its interest in the development first from 40% to 35% and subsequently from 35% to 32% with the second developer ultimately being entitled to 68% on the total development.

14. By a settlement agreement dated 8 August 1986 the Taxpayer and the second developer agreed to settle their respective entitlements in the total development. The effect of the settlement agreement was that the Taxpayer assigned to the second developer its 32% interest in certain of the unsold residential units and the second developer assigned to the Taxpayer its 68% interest in certain unsold car park spaces and the entirety of the reserved portion.

15. The Taxpayer proceeded to sell some of the car park spaces which it then owned but retained the entirety of the reserved portion of the development.

16. At some time between the acquisition of the site by the Taxpayer and the commencement of the development of the site by the second developer a dispute arose between the Taxpayer and a third party who claimed to have an interest in the site. The dispute was the subject matter of certain legal proceedings. By a deed dated 7 June 1986 to which the Taxpayer, the third party, the second developer, and others were parties the claim by the third party was settled. As the nature of the claim by the third party, the legal proceedings and the settlement thereof were complex and only partially relevant to these proceedings we do not set out the details in these facts but make reference thereto later in this decision.

17. An estimated assessment for the year of assessment 1986/87 was issued to the Taxpayer on 2 September 1987 in which estimated net assessable profits of $20,000,000 were assessed to tax with tax payable thereon of $3,700,000. Subsequent thereto the Taxpayer through its advisers made representations to the assessor and answered queries raised by the assessor. The assessor was of the opinion that the Taxpayer should be assessed to tax on the profits or gains which were made by the Taxpayer on the sale of units in the development. The Taxpayer submitted that such profits or gains were of a capital nature and not trading profits and accordingly should not be subject to tax. The assessor did not agree with this submission and was of the opinion that the whole of the profit made by the Taxpayer on the sale of units in the development amounting to $33,283,111 should be assessed to tax with tax payable thereon of $6,157,375.

18. The matter was referred to the Commissioner of Inland Revenue who by his determination dated 10 August 1992 agreed with the assessor and increased the estimated assessment of $20,000,000 to an assessable profit of $33,283,111 with tax payable thereon of $6,157,375.

19. The Taxpayer duly appealed to this Board of Review.

At the hearing of the appeal the Taxpayer was represented by Counsel and Mr A who was also the managing director of the Taxpayer was called to give evidence and was cross-examined. The Counsel for the Taxpayer submitted and Mr A gave evidence to the effect that it was the wish of Mr A to create a property investment in the form of a commercial cum residential complex which would be retained as a long-term capital investment asset, which would produce income, and which would bear a symbol of himself and his wife. With that objective Mr A started to acquire Letters B with a view to accumulating them in the hope that one day he would be able to exchange the Letters B for building land in the New Territories upon which he could erect his proposed commercial cum residential complex.

By 1980 he had accumulated a significant quantity of Letters B and he considered that X Limited had sufficient financial resources to carry out his plan. He conducted an informal survey of the property market and decided that the site was a suitable area and he had confidence that the rental returns in that area would justify the commercial cum residential complex which he proposed.

In making his estimate of the feasibility he took a conservative view which was to value the Letters B at their original acquisition cost and not their then market value. Mr A said that in order to distinguish his proposed symbolic investment from the rest of his property investment activities which were carried on in the name of X Limited he incorporated the Taxpayer and arranged for the Taxpayer to acquire the site from X Limited as set out in the facts which we have found above.

He said that after he had acquired the site he began to move ahead to build the development which was to bear the name of himself and his wife. Architects were instructed to prepare plans which they proceeded to do with large size residential flats which he considered were suitable for rental purposes.

In late 1981 misfortunes set in and he encountered cash difficulties and found himself unable to proceed on his own with the proposed development. In the desperate circumstances then confronting him he had to move speedily because of the time limit on the building convenant relating to the site. He made various approaches to large property consortia and property dealing companies but met with no success because political confidence in Hong Kong was at its lowest ebb and the money situation was very tight. With time running out he decided to begin earnest discussions with the second developer. He was in a weak bargaining position but was able to negotiate the deal to which we have referred in the facts above. He said that his financial situation forced him to surrender complete control of the project to the second developer. By the time that the project was coming to fruition he was in a stronger financial position and he said that he was able to follow his original objective of having a symbol for himself and his wife by retaining the reserved portion of the development which he still retained.

Mr A said that the original residential units were much larger than those which were eventually built by the second developer because the second developer wanted and insisted on selling the units. He said that he thought that the larger units which he originally envisaged were more suitable for long-term rental purposes as opposed to the smaller residential units which the second developer built for the purpose of sale.

Counsel for the Taxpayer submitted that on the basis of the evidence of Mr A there was a clear intention on the part of the Taxpayer to acquire the site for development as a long-term investment for rental purposes. He submitted that because of adverse financial circumstances a change of intention had been forced upon the Taxpayer. The Taxpayer had no alternative but to join with the second developer with the result that the residential units had been sold but the reserved portion had been retained by the Taxpayer in accordance with the original intention of Mr A.

Counsel for the Taxpayer submitted that the law was simple and that it was the intention of the Taxpayer at the time of acquisition of the site which was all important. He said that the intention of the Taxpayer was the same as the intention of Mr A, its managing director and the person who controlled it and made all the decisions. Counsel for the Taxpayer referred us to the following cases:

Simmons v IRC [1980] 1 WLR 1196
D83/89, IRBRD, vol 6, 300
D41/91, IRBRD, vol 6, 211
Hermann Gustav Erichsen v WH Last [l88l] 4 TC 422
Marson v Morton [1986] STC 463
D9/74, IRBRD, vol 1, 153
Johnston v Heath [1970] 3 ALL ER 915
D37/89, IRBRD, vol 4, 425
D19/88, IRBRD, vol 3, 255
FC of T v Whitfords Beach Pty Ltd [1982] ATR 692

The representative for the Commissioner agreed that it was the intention of the Taxpayer at the date when it acquired the site which was the important fact. He referred us to two cases:

All Best Wishes Ltd v CIR (Inland Revenue Appeal No. 1/1992)
Hillerns and Fowler v Murray 17 TC 77

He submitted that to ascertain the intention of the Taxpayer at the relevant date it was necessary to consider all of the surrounding facts. He referred us in some detail to the legal proceedings and settlement which had taken place when the third party made a claim to which we have referred in fact 16 above. He then took us through the evidence of Mr A and his cross examination and drew our attention to a number of points which he considered to be important. He said that the Commissioner readily agreed and accepted that the reserved portion which the Taxpayer still retained was a capital asset but pointed out that it was a very common situation for a developer to develop a property for resale of the residential units and retention of the commercial portion as a long-term investment.

The representative for the Commissioner spent some time drawing our attention to other facts which related to X Limited and which he submitted were material. He tabled before us a decision of another Board in relation to an appeal which had been made by X Limited regarding another site which it had acquired at Place X contemporaneously with the acquisition by X Limited and the Taxpayer of the site. He indicated to us and it was not contested on behalf of the Taxpayer that X Limited was currently appealing the decision of the earlier Board with regard to the Place X property and that X Limited maintained that the Place X property was also a long-term investment. The representative for the Commissioner pointed out that X Limited was entitled to 54% of the Place X property which was also a significant development which had required the surrender of Letters B, the payment of a premium of $21,500,000 and the fulfilment of a building convenant of not less than $52,000,000. He submitted that it was not financially possible for Mr A through X Limited and the Taxpayer to develop and retain as long-term investments simultaneously both the Place X property and the property in the site.

The representative for the Commissioner drew our attention to correspondence which had taken place between the architect of the Taxpayer and the Government in which

the architects at an early stage had indicated that it was the intention of the Taxpayer to develop the site for sale of the residential units. He further submitted that the change in size of the residential units to which Mr A had placed great importance was in reality to meet the requirements of the market which had changed. He also drew our attention to the joint venture development agreement with the first developer to which Mr A had made no reference in his early evidence and which was something which the Commissioner had raised. He submitted that there was clear evidence before us to prove that it was the intention of the Taxpayer from the outset to develop the site with a view to the sale of the residential units and the car park spaces which were permitted to be sold. He said that all of the objective facts were consistent with this intention and gave no support to what Mr A had alleged in his evidence.

The evidence before us in this case is comprehensive and it is impossible and not necessary for us to try to record all of it in this decision. Suffice to say that we have carefully studied all of the evidence and the fact that we do not make reference to each and every piece of evidence given or placed before us does not mean that we have not taken them carefully into consideration in reaching the decision which we have done.

There is little evidence with regard to the intention of the Taxpayer at or prior to the date when it acquired the site. However there is extensive evidence as to what happened subsequent thereto. We have the evidence of Mr A to the effect that it was his long-term intention to acquire Letters B, exchange them for a site in the New Territories, develop the site with a building or buildings which would bear the name of himself and his wife and retain the same for long-term investment purposes. This is the subjective evidence of Mr A given on behalf of the Taxpayer but before we are able to accept it we have to look at the surrounding facts and evidence. Such subjective and self-serving statements must be tested against the other facts and evidence. This we have done and unfortunately for the Taxpayer we find that all of the objective and other evidence and facts are either equivocable or support the proposition that in reality the Taxpayer and Mr A had no such intention at that time as now claimed by Mr A. We will now refer to a number of major points which are not intended to be exhaustive.

Mr A said that in 1969 he started to acquire Letters B with a view to accumulating them with the hope that one day he would be able to exchange them for land on which he could build a long-term commercial cum residential complex which would bear a symbol of himself and his wife. However in reality what he did was to acquire large amounts of Letters B in the name of X Limited with a view to X Limited exchanging the same with the Hong Kong Government for land suitable for development in the New Territories. He acquired Letters B far in excess of the requirement for his symbolic building and proceeded with two projects one in Place X and one in the site. On the evidence before us we are unable to find as a fact that Mr A and X Limited were doing what Mr A said they were doing.

Mr A said that after hard negotiations with the Government he was successful in arranging for X Limited to acquire the site and subsequently decided that the site would be transferred to the Taxpayer in order to distinguish his proposed symbolic investment

from the rest of his property investment activities. Here again we have tested what Mr A told us with other objective facts. We have the benefit of having seen the pleadings and papers relating to the claim made by the third party in relation to the site. In those proceedings Mr A made very different statements as what he told us were his intentions when he gave evidence before us. In summary it appears that he had a close relationship with the third party who was a solicitor. That close relationship turned sour. It was the contention of Mr A in 1986 that the third party was his joint venture partner in the site and it is clear from the papers that at that time a sale was envisaged of units in the development. The explanation which was given to us on behalf of the Taxpayer was that what Mr A had told this third party at that time was not his real intention. His real intention at that time had been to buy out his partner but if his partner knew this it would be too expensive for him. With due respect we totally reject this explanation and it clearly casts doubt on the veracity of the evidence of Mr A.

We now come to the first joint venture agreement with the first developer. We have little evidence from the Taxpayer or Mr A with regard to the circumstances surrounding this agreement. It was executed within twelve months of the acquisition of the site by the Taxpayer and clearly must have been the result of prior negotiations. We find it difficult to accept that it was the intention of the Taxpayer to build a symbolic building for Mr A and his wife and that within a few months they were negotiating with the first developer and ultimately were successful in coming to an agreement with that developer. We note one particular term in that agreement which relates to the name of the building. Much of the case of the Taxpayer hangs or falls on the statement of Mr A relating to a symbolic commercial cum residential complex which would bear the name of Mr A and his wife. It is somewhat surprising to find in the agreement with the first developer a statement that the new building shall bear the name of X Limited and not the joint names of Mr A and his wife. No explanation whatsoever was given with regard to this.

The agreement with the first developer envisaged the sale of all of the residential units and the retention of the reserved portion as a long-term investment. Once again we note that this does not support the evidence of Mr A. His explanation regarding the second developer was that adverse financial circumstances forced him to change his intention. To what extent this explanation could apply to the first developer was not made clear to us. However it is clear that long before the second developer come on the scene it was the intention of Mr A to dispose of everything except the reserved portion and we find no evidence that there was any change of intention.

We have then tested the evidence of Mr A with regard to the change in size of the residential units. Only Mr A gave evidence regarding this. Numerous other persons could have come forward and given evidence to support or refute what Mr A said. This is particularly the case with the architect, the first developer and the second developer. Mr A tells us that he instructed the architect to prepare plans for large residential units and subsequently changed the instructions because of a change of intention. However what we find is that the architect was writing letters to the Government complaining to the Government that because of delays on the part of the Government it would be more difficult for the Taxpayer to sell the residential units. We also find statements that the reduction in

the size of the residential units was to meet with changing market conditions. There is no mention anywhere of a change of intention by the Taxpayer. We would assume that if there was such a momentous change of intention on the part of the Taxpayer this would have been reflected in the correspondence. We find no evidence to support the proposition that instructions were given to the architect to prepare plans for large residential units for rental purposes and then to change the size of the units because of a change of intention forced upon the Taxpayer.

The representative for the Taxpayer and Mr A would like us to believe that the change of intention was forced upon the Taxpayer as a result of a dramatic deterioration in the political situation in Hong Kong and the property market. With due respect we again find that the evidence does not support this. Whilst it may well be true that the market situation in Hong Kong did dramatically change we do not accept that X Limited and its subsidiary, the Taxpayer, had the financial ability to develop and retain as long-term investments the entire development of the site and the 54% of the development of Place X at the time when the Taxpayer acquired the site. Evidence was given to the effect that X Limited owned extensive Letters B which were very valuable and more than sufficient to support the development of the site as a long-term investment. However no adequate explanation was given with regard to how much of the Letters B was committed to other investments including the development of Place X. It appears to us that the Taxpayer would have had great difficulty in financially supporting the development of the site in its entirety without resorting to a joint venture arrangement. The Taxpayer was totally dependent upon X Limited for financial support with regard to the development of the site and we are not satisfied that X Limited had the financial ability to proceed with the development of the site.

We have highlighted some of the inconsistencies between the evidence of Mr A and the objective facts before us. Based upon the entirety of the evidence before us we find as a fact that it was not the intention of the Taxpayer at the time when it acquired the site to develop the same and retain the entire development as a long-term capital investment. We find as a fact that it was the intention of the Taxpayer when it acquired the site to proceed with the development as envisaged by the conditions of exchange and then proceed to sell the residential units and such car park spaces as it was allowed to do and to retain the reserved portion as a long-term capital investment which it was required to do under the conditions of exchange.

For the reasons given we dismiss this appeal and confirm the determination of the Commissioner.