INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D62/91

Profits tax – whether profits arising on sale of two properties were subject to profits tax – intention of taxpayer at date of acquisition of property.

Panel: William Turnbull (chairman), Maxine Kwok Li Yuen Kwan and Raymond A Zala.

Dates of hearing: 9 and 10 October 1991.
Date of decision: 9 January 1992.

The taxpayer was a private limited company which purchased two properties. One of which was sold soon after acquisitions and one of which was still retained at the date of the hearing. The taxpayer claimed that both properties had been acquired as long term investments and that there had been a change of intention with regard to the property which was sold soon after acquisitions. With regard to the property which was retained the taxpayer claimed depreciation allowance on the basis that the property was a long term capital asset. The assessor assessed to profits tax the profit made on the sale of the first property and declined to grant depreciation allowances in respect of the second property. The taxpayer appealed to the Board of Review.

Held:

On the evidence before it the Board did not accept that the property had been acquired for long-term investment purposes, and that therefore there was no change of intention with regard to the first property. With regard to the second property on the evidence before it the Board held that it was the intention of the taxpayer to trade and not to acquire the property as a long term capital investment.

Appeal dismissed.

Cases referred to:

Lionel Simmons Properties Ltd v CIR 53 TC 461
Beautiland Company Limited v CIR [1991] STC 467
Harvey v Caulcott 31 TC 159
D16/88, IRBRD, vol 3, 225
Chinachem Investment Company Limited v CIR [1987] 2 HKTC 261

H Bale for the Commissioner of Inland Revenue.
Sara McGrath of Deloitte Ross Tohmatsu for the taxpayer.

Decision:

This is an appeal by a private limited company against a profits tax assessment for the year of assessment 1988/89 wherein the assessor assessed to profits tax the gain or profit which was made by the Taxpayer when it sold two real estate properties in Hong Kong. The facts are as follows:

1. The Taxpayer is a private limited company incorporated in Hong Kong in early 1987.

2. In its provisional profits tax return for the year of assessment 1987/88 the Taxpayer stated that it had commenced business on 13 March 1987, being the date of its first investment in property. It further stated that the nature of its business was 'Property Investment for resale'.

3. In its profits tax returns for the years of assessment 1986/87 and 1987/88, the Taxpayer described the nature of its business as 'property dealing' and in respect of the year of assessment 1988/89, described the nature of its business as 'property investment'.

4. In default of receiving a profits tax return for the year of assessment 1988/89 within the stipulated time, the assessor raised an estimated assessment on the Taxpayer wherein he estimated the profits of the Taxpayer at $280,000 with tax payable thereon of $47,600.

5. By letter dated 19 December 1989 the tax representatives for the Taxpayer lodged objection against the estimated assessment and claimed that the Taxpayer had actually made a profit of only $243,517 in respect of the year of assessment 1988/89. To validate the objection, a profits tax return was filed together with supporting documents including the accounts for the Taxpayer for the year ended 31 March 1989. These accounts stated that the Taxpayer had received a surplus on disposal of investment properties in the amount of $2,078,946. This surplus was treated as an extraordinary item in the accounts of the Taxpayer and was not offered for assessment to profits tax.

6. The surplus arose from the sale of a property in Hong Kong ('the X property') which the Taxpayer had acquired in four separate lots in September 1987 and had sold in September 1988. The surplus was calculated as follows:

		$	$
Sale Proceeds			9,000,000
Less:	Purchase price	6,500,000	
	Agency and legal fee	237,700	
	Stamp duty	175,263	
	Sundry	4,586	
	Advertisement	756	
	Valuation fee	2,750	6,921,055
			$2,078,945

7. The assessor made enquiries of the Taxpayer through its tax representative with regard to the nature of and circumstances leading to the surplus. Representations were made and information was provided to the assessor claiming that the surplus was a capital gain and not a trading profit.

8. In addition to the X property, the Taxpayer also owned another property in Kowloon ('the Y property'). The Taxpayer had entered into a sale and purchase agreement to acquire this property in early 1987 and completion of the purchase took place a month later.

9. The Y property was shown in the audited accounts of the Taxpayer for the year ending 31 March 1987 under the heading 'current assets'. Both the Y property and the X property were shown in the audited accounts of the Taxpayer for the year ending 31 March 1988 under the heading 'current assets'. No rebuilding allowances were claimed in respect of either of the two properties.

10. In the audited accounts of the Taxpayer for the year ending 31 March 1989 the Y property was shown under the heading 'fixed assets'. A rebuilding allowance was claimed in respect of the Y property for the year of assessment 1988/89.

11. The auditors and tax representatives originally appointed by the Taxpayer were replaced by a new firm of auditors and tax representatives for and with effect from the year ended 31 March 1989 and the year of assessment 1988/89.

12. The assessor indicated to the representatives for the Taxpayer that he did not accept that either of the two properties were capital assets. Prior to the matter being referred to the Commissioner of Inland Revenue for his determination, the representatives for the Taxpayer wrote to the assessor by letter dated 9 July 1991 making the following statement which summarises the representations made by them to the assessor:

> ‘ Both of the company’s properties were acquired with an intention to be held for long-term investment purposes as evidenced by copies of the relevant directors’ minutes submitted to your department earlier. The company’s nature of business has been erroneously put down as property dealing in the profits tax returns for 1986/87 and 1987/88 whereas the correct description should be property investment. Similarly, both properties at [X] and [Y] were mistakenly grouped under current assets in the company’s balance sheet as at 31 March 1987 and 1988 and no rebuilding allowance were claimed for these years. However, such errors were corrected in the year ended 31 March 1989 in accordance with the provisions of the Statement of the Standard Accounting Practice No 13 “Accounting for Investment Properties” as issued by the Hong Kong Society of Accountants. The company is still holding the [Y property] because the return from this investment is more in line with the expectation of the directors than that from the [X property].’

13. The Commissioner by his determination dated 3 August 1991 determined that the profits tax assessment for the year of assessment 1988/89 should be increased from net assessable profits of $280,000 with tax payable thereon of $47,600 to net assessable profits of $2,341,345 with tax payable thereon of $398,028. He accepted the view of the assessor that the two properties in question were trading assets and that accordingly the surplus arising on the disposal of the X property was subject to profits tax and that the Y property was not entitled to the benefit of a rebuilding allowance.

14. The Taxpayer duly appealed against this determination of the Commissioner to the Board of Review.

15. At the hearing of the appeal copies of a number of letters were tabled which proved in relation to the Y property that in 1988 and 1991 offers had been received and negotiations carried on with regard to the possible sale of the Y property but that no sale had been concluded.

At the hearing of the appeal, a director of the Taxpayer was called to give evidence on behalf of the Taxpayer. He gave evidence in chief to the effect that when the two properties had been acquired by the Taxpayer, it was the intention of the Taxpayer to acquire the same as long-term investments. He said that board meetings had been held to approve the two acquisitions and he had been present at the board meetings. Copies of minutes of two meetings were tabled before the Board of Review. At the first of the two meetings stated to be held in May 1987 it was resolved to purchase the Y property ‘as a long-term investment for recurring rental revenue’. The second meeting was stated to have been held in December 1987 when it was resolved to purchase four properties which collectively comprised the X property ‘for the purpose of investment holding’.

The director went on to say that when purchasing the properties, warranties had been included in the sale and purchase agreements with regard to the rental income of the properties. He said that before the properties were purchased, simple calculations of the expected yields had been made. He said that the expected yield on both properties was about 8%. The actual yield which the Taxpayer received was about 6% to 7% for the X property and initially 8% rising to 18% for the Y property.

With regard to the accounts, the director said that prior to the year in question they had been audited by a different firm of auditors. He said that there had been a change in the auditors of the Taxpayer because the Taxpayer had not been satisfied with the services of the original auditors. He said that he had informed both firms of auditors that both of the properties were purchased for long-term investment purposes.

He said that the reason for selling the X property was because the actual rental yield was only between 6% and 7% whereas it had been expected that it would be 8%.

We comment below on the acceptability of the evidence of the director.

When the original minute book of the Taxpayer was inspected, there appeared to be some discrepancies. These cast some doubt on the validity of the board minutes which had been tabled before us. However, even if we accept the two board minutes at their face value, it is not conclusive. The board minutes are self-serving documents created by the Taxpayer which on their own are of limited evidentiary value. If supported by surrounding facts, contemporaneous minutes can be of the greatest importance, but in the present case they stand out in stark contrast to the other facts and little weight can be placed upon them.

In the course of hearing, the following cases were referred. The representative of the Taxpayer cited:

Lionel Simmons Properties Ltd v CIR 53 TC 461
Beautiland Company Limited v CIR
Harvey v Caulcott 31 TC 159
D16/88, IRBRD, vol 3, 225

The representative for the Commissioner cited:

Chinachem Investment Company Limited v CIR [1987] 2 HKTC 261

The starting point in any trading/non-trading case is to look at the uncontrovertible facts. In the present case, the Taxpayer filed profits tax returns in previous years stating that its business was 'property investment for resale' and 'property dealing'. The first property which the Taxpayer purchased was the Y property and the date of purchase of this property was used as the date of commencement of business of the Taxpayer which business was stated to be 'property investment for resale'. The Taxpayer is still the owner of the Y property. The Taxpayer then purchased some four separate

properties which collectively made the X property and which it sold as one property within twelve months of its acquisition. There is no evidence before us of the Taxpayer obtaining a survey report for any of the buildings which it was purchasing nor any information showing the features of the properties which made them desirable for long-term rental purposes. The X property was not a new building and it was only five storeys high. A recent valuation of the Y property was tabled before the Board. It showed that the Y property, comprised a thirty-two year old building six storeys in height. The rentals collected in respect of the Y property have increased substantially. With the possible exception of the continued ownership of the Y property, all of these facts suggest that the intention of the Taxpayer when it acquired each of the two properties was for trading purposes.

We will now proceed to consider each of the two properties separately starting with the X property.

It was submitted that the four sale and purchase agreements for the X property included warranties with regard to the existing tenancies and rental income which supported the proposition that the property was purchased as a long-term investment. We do not accept this submission. If the reason for the warranties regarding tenancies and rental income was to protect the Taxpayer against income loss, then we would expect to see some claims for compensation when the actual income was not up to expectations but there was none. It is accepted conveyancing practice when buying property to set out details of any tenancies and indeed all other encumbrances. At best this is a neutral factor because it is also common knowledge that if premises ripe for redevelopment are being acquired, warranties are included in the sale and purchase agreement with regard to existing tenancies. If the Taxpayer had taken steps to enforce the warranties because of the alleged loss of rent, the situation would have been totally different.

It was submitted for the Taxpayer that the reason for the sale of the X property was that the actual rental return of 6% to 7% did not reach the anticipated 8%. This was in accordance with the evidence given by the director of the Taxpayer. We do not accept this evidence. It would be most unusual for a long-term investor to decide to sell property which he has just purchased because of a 1% to 2% difference in the immediate percentage yield. We do not find this credible. We also note that the actual figures given before us were an anticipated yield of 7.9%, an actual yield of 6.1% for the first five months with part of the ground floor vacant and an actual yield of 7.4% thereafter with the ground floor fully let. Furthermore if we were to believe what the director said, it would mean disregarding all of the other evidence including earlier tax returns, earlier audited accounts and the fact of the sale at a substantial profit within twelve months. If the value of the X property lay in its rental potential then the value should have declined. It is clear to us on the evidence before us that the Taxpayer, when purchasing the X property did so with a view to trading and not for rental income.

The case for the Taxpayer with regard to the Y property would appear at first sight to be much stronger than the X property. We again have a self-serving statement in a board resolution but this time it is supported by the fact that the Taxpayer still at the date of

the hearing of the appeal owned the Y property and was receiving rental income thereform. Evidence was given that the anticipated yield of 8% had increased to approximately 17%. If these were the only facts before us they would favour the Taxpayer, but there are a number of other facts which clearly point in the opposite direction. The doubts that we have about the authenticity of the board minutes do not apply to the provisional tax return filed by the Taxpayer for the year of assessment 1987/88 dated 11 December 1987 and received by the Inland Revenue Department on 17 December 1987. This document speaks for itself and contains a declaration of truthfulness signed by a director of the Taxpayer who did not appear to give evidence. It states that there are heavy penalties for making an incorrect return. In relation to the Y property which was the first property purchased, it states that the nature of business is 'Property Investment for resale'. Nothing could be clearer. The director who did give evidence said that he told the original auditors that the Y property was a long-term capital investment. If this was correct it would mean that not only were the original auditors negligent but also were the directors, including the director giving evidence, when the audited accounts for the first two years were approved. We do not accept the evidence given by the director without corroboration from the original auditors and the other directors.

The premises comprising the Y property are over thirty years old. No evidence was given that the Taxpayer obtained any survey report as to the state of repair of the premises and no evidence was given to show that the premises were suitable for long-term rental income investment purposes. Once again we have the suggestion that warranties in sale and purchase agreements were there to ensure that the level of rental income expected would be realised. However as we have pointed out above, such warranties can have the opposite meaning when given in respect of old premises ripe for redevelopment. At best they are a neutral fact.

The final fact which reaffirms to us that the Y property is a trading property is the number of written offers made by various potential purchasers. The offers were tabled on behalf of the Taxpayer to show that the Taxpayer had no intention of selling the Y property even though many offers had been received. However, in our opinion, the offers show the opposite. They demonstrate to us that throughout the period during which the Taxpayer had owned the Y property, it has been offered for sale, either with the knowledge of or on the instructions of the Taxpayer. We have no evidence with regard to how these various offers came into existence but it is clear from their wording that they are not just vague indications from third parties of an interest in purchasing the Y property. The first one tabled before us is from a firm of solicitors representing an intended purchaser which states that they understand that a property consultancy company acts for the vendor. It is unlikely that such a letter would come into existence without some prior negotiations or indication that the 'vendor' who was the Taxpayer might be interested in selling the property. The next offer for a significantly higher price again suggests prior negotiations. The next offer tabled before us refers to discussions with an agency company which was an associated company of the Taxpayer. The director who gave evidence before us was the son of the founder of the group of companies of which the Taxpayer formed part. When asked about the relationship between the Taxpayer and its associated company he was unable to

give any satisfactory answer other than to say that the associated company had been appointed to manage the Y property for the Taxpayer. We cannot accept that the director who gave evidence before us had no knowledge of what had taken place. It appears clear to us that the associated company was actively offering the Y property in the market place to see whether there were any potential purchasers and if so what price could be obtained for the property.

As in the case of the X property we find as a fact that when the Taxpayer acquired the Y property it did so with the intention of trading.

For the reasons given we dismiss this appeal and confirm the assessment as increased by the determination of the Commissioner dated 3 August 1991.