Case No. D6/85

Board of Review:

H. F. G. Hobson, *Chairman*; Robert C. Kwok and D. V. Timmis, *Members.*

27 May 1985.

Profits tax—appellant undertook the completion of the building at its own cost in return for a 20 years lease—whether the cost of construction should be treated as an allowable deduction.

The Appellant made an agreement with the owners of a building site who agreed that if the appellant undertook the completion of the building on the site at its own cost the owners would grant it a 20 years lease of the building, save for the 3rd floor, at a nominal rent plus liability for rates and other charges (including those relating to the 3rd floor). The building was finished in mid 1971 and 80% of the rental receipts from the sublettings (the 3rd floor excepted) appeared in the appellant's account for tax years ending 31.3.72 and 31.3.73. The accounts for the year ended 31.3.74 showed 100% of such receipts because the appellant had then merged the affairs of a former partnership with his sole proprietorship business. The Inland Revenue Department investigated the affairs of the appellant and compiled an Assets Betterment Statement covering 9 years which formed the basis of certain assessments and additional assessment to which the appellant objected.

Held:

(1) The building was at all times owned by the owner and the appellant was not the beneficial owner. Its right was confined to that of a lessee of the greater part of the building for a period of 20 years. Such lease was purchased at the price it cost to complete the building. As such it was in the nature of capital and section 17(1)(*c*) applies.

(2) The property tax paid in respect of the third floor was in the nature of a contractual indemnification and treated as a deductible item.

(3) The appellant failed to attribute any or any given element of interest to any of the profit derived from the sublettings. Therefore the appellant is not entitled to a deduction for interest charges.

Appeal dismissed.

A. J. Halkyard for the Commissioner of Inland Revenue.
Mak Hing Cheung of Mak Hing Cheung & Co. for the Appellant.

Reasons:

The Taxpayer, an individual who carried on business as a building contractor under the style of CY Construction Co. entered into a partnership styled WY Enterprises Co. which made an unusual arrangement with TT Association, the owners of property on a certain

road. Prior to this arrangement that property was supposed to have been developed as an 18-storey building but the constructor failed to complete the construction. The owners therefore agreed with WY that if the latter undertook the completion of the building (modified to 12 floors) at its own cost the owners would grant WY a 20 years lease of the building, save for the 3rd floor, at a nominal rent of $1,000 per month plus liability for rates and other charges (including those relating to the 3rd floor).

This arrangement was embodied in an agreement dated the 10 March 1969 ("March Agreement"). On the 22 September 1969 the partners of WY agreed that the Taxpayer would be entitled to 80% of the "net income" of the partnership, which effectively meant of the completed building (less the 3rd floor) since the latter was the sole subject matter of the partnership.

The building was finished in mid 1971 and 80% of the rental receipts from the sublettings (the 3rd floor excepted) appeared in the Taxpayer's account for the tax years ended 31 March 1972 and 31 March 1973. However the accounts for the year ended 31 March 1974 showed 100% of such rental receipts because in February 1973 the Taxpayer had bought out the interests of the other partners and merged the affairs of WY with the Taxpayer's sole proprietorship business i.e. CY Construction Co.

The Inland Revenue Department (IRD) investigated the affairs of the Taxpayer and compiled an Assets Betterment Statement ("ABS") covering 9 years: this included financial activities in addition to those arising from the building. This and a revised ABS, formed the basis of certain assessments and additional assessments to which the Taxpayer objected. Having considered the objections, the Assessor raised Profits Tax Assessments and though the Assessor accepted that some of these required adjustment, they were largely maintained. The Taxpayer then appealed to the Commissioner of Inland Revenue (CIR), who variously annulled some, increased others and reduced the remainder. In arriving at his Determination the CIR dealt with the following 5 different propositions in the reference to him.

(*a*) The profits ascertained from the ABS failed to allow for adverse business conditions. This argument was rejected by the CIR because the ABS in fact could be said to have taken such factors into account in as much as it reflected incremental assets of the Taxpayer.

(*b*) A bad debt which the CIR explained had been taken into account.

(*c*) The setting off of property tax upon the 3rd floor of the building which the CIR found to be impermissible but which he had treated as rent for the building additional to the aforesaid $1,000 per month.

(*d*) The Taxpayer's contention that the costs of constructing the building were in the nature of revenue-making costs of which 1/20th part thereof (i.e. for each of the 20 years of the lease) should be deducted from the profits. The CIR rejected this argument because in his view the construction costs were in the nature of capital.

(*e*) Certain claims to expenses, including interest, which were rejected on the grounds that they were not supported by evidence or were of a personal nature.

The Taxpayer then appealed to the Board against the Determination of the CIR. His representatives, M & Co., filed grounds of appeal:— (1) to (7) and (9) and (11) of the said grounds dealt with (*c*) and (*d*) above and ground (8) dealth with (*e*) above. The said grounds were stated to cover the years of assessment 1966/81 inclusive. In the course of the hearing M of the said firm of accountants confirmed that the years of assessment with which the Board were really concerned with were the years 1970 to 1981 inclusive and he restated his grounds of appeal as follows:—

(1) the cost of construction of the new building is an allowable deduction.

(2) the 3rd floor is exempt from property tax, and

(3) "100% of the interest were not allowed which is unfair. Based on an asset backing method to add back the share of interest would be fair and consequently it is claimed. Such method is acceptable to the IRD in other cases too."

We now propose to deal with these 3 grounds:—

(1) *Should the cost of construction be treated as an allowable deduction?*

The answer lies in whether or not the 20 years lease is itself in the nature of a capital asset or the construction cost giving rise to lease should be treated as revenue producing, as though incurred at intervals over the period of the lease. M argued that although the March Agreement promised the lease when the building was finished no lease was in fact executed, accordingly the Taxpayer should be treated as through WY or the Taxpayer had built the building at its/his own expense as a "voluntary gesture", then when the building was complete it/he had leased 11 of the 12 floors from the owners at a rent of $1,000 per month. The voluntary expenditure, being motivated by commercial expediency, M argued should be treated as an allowable expense as though one twentieth part had been incurred during each year of the Lease. We experienced great difficulty in following this line of argument and consequently may not have done it justice in the foregoing precis. Be that as it may the argument rested on a submission which we considered groundless, namely that the absence of a signed lease of the 11 floors by the building owners i.e. TT Association, to the Taxpayer was fatal to the revenue's case. We do not agree, in our view at any time after the building was completed had the Taxpayer (or more accurately WY, whether in its original guise as a partnership or its final metamorphosis as a sole proprietorship) required the said association do so the association would have been obliged to issue the requisite lease. It would seem that the parties however were satisfied to treat the matter as though the lease had been issued. The Taxpayer sublet the 11 floor,

apparently without difficulty. Moreover we do not accept M's submission that the Taxpayer was the beneficial owner of the new building—we take the view that the building was at all times owned by TT Association, the Taxpayer's right being confined to that of a lessee of the greater part of the building for a period of 20 years. Such lease having been "purchased" at the price it cost to complete the building and we look upon such price as being in the nature of a capital investment. Having reached the conclusion that the consideration for the acquisition of the 22 floors was in the nature of capital, it seems to us that section 17(1)(*c*) applies and accordingly there is no case whatever for deeming for tax purposes such consideration to be spread over the length of the Lease.

(2) *Is the 3rd floor exempt from property tax?*

The Taxpayer is not directly liable for property tax in relation to the 3rd floor rather it is Tsung Tsin Association which is liable under section 5(1). No evidence was adduced to show that TT Association was exempt in any particular respect from such tax.

The arrangement with TT Association and the Taxpaper concerning such property tax was in the nature of a contractual indemnification. The CIR has been minded to treat it as an annual additional "rent" payable to the Association and hence a deductible item. We are content to follow this approach although we appreciate that it can be argued, with some force, that since the Taxpayer derived no profit from the 3rd floor the expense referrable to it does not achieve the character of a deductible.

(3) *Whether the Taxpayer is entitled to a deduction for interest charges?*

The relevant provision reads:—

S. 16 "(1) In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period, including—

(*a*) sums payable by such person by way of interest upon any money borrowed by him for the purpose of producing such profits, and sums payable by such person by way of legal fees, procuration fees, stamp duties and other expenses in connexion with such borrowing;"

M sought to show that certain interest which the Taxpayer had incurred was referable to the Taxpayer's profits. However his case was confusing and unconvincing since some of the interest appeared to have occurred in consequence of the Taxpayer himself drawing funds out of his account for his own personal

use. In short the Taxpayer failed in our view to be able to attribute any or any given element of interest to any of the profit derived from sub-lettings.

Accordingly for the foregoing reasons the appeal is dismissed in its entirety.