INLAND REVENUE BOARD OF REVIEW DECISIONS

**Case No. D69/87**

Profits tax – sale of land – business premises – whether profits were trading gains or realization of capital – evidential matters – s 14 of the Inland Revenue Ordinance.

Panel: H F G Hobson (chairman), Wilfred C W Lee and Francis G Martin.

Dates of hearing: 26 to 30 October; 2, 3 and 19 November 1987.
Date of decision: 21 March 1988.

The taxpayer company had carried on a fruit preserving business in certain premises from 1955 to 1977. The premises were no longer suitable for this purpose, but could not be redeveloped due to governmental plans to acquire part of the site for roadworks. Therefore, in 1977 the taxpayer arranged with the government to exchange the site for a second site which included part of the first site. The taxpayer planned to construct a multi-storey industrial building on the second site which could be used partly for its business and partly for leasing to third parties.

The taxpayer purchased a third site on which it intended to carry on its business during the development of the second site. However, such development was delayed because of unforeseen problems with encroaching electrical cables and squatters. There was no certain end to these problems.

In 1980, the taxpayer received an offer to buy the second site. Because of the problems which had been encountered with that site, the taxpayer agreed to sell.

The taxpayer had access to sufficient funds to hold on to the second site had it so desired. It had no prior history of dealing in properties.

At one stage, a director of the taxpayer had prepared figures comparing profits from the resale of the second site and rental income therefrom. Also, conflicting versions of board minutes existed.

The Commissioner assessed the taxpayer to profits tax, and argued that the taxpayer all along had intended to resell the second site.

Held:

The profits were not assessable.

The second site had been purchased as an investment asset and was sold due to the difficulties which were faced in developing it. The profits were therefore capital gains.

The director's calculation of profits from resale of the second site was neutral on the facts. The tampering of the minutes was of no weight as the false version could be disregarded.

Appeal allowed.

Cases referred to:

BR9/74, IRBRD, vol 1, 153
Balgownie Land Trust Ltd (The) v CIR (1929) 14 TC 684
Glenboig Union Fireclay Co Ltd (The) v CIR (1922) 12 TC 427
Hudson's Bay Co Ltd (The) v Stevens (1909) 5 TC 424
Iswera v CIR [1965] 1 WLR 663
Lionel Simmons Properties Ltd v CIR (1980) 53 TC 461
Royal Insurance Co Ltd (The) v Stephen (1928) 14 TC 22
Shadford v H Fairweather & Co Ltd (1966) 43 TC 291
Westminster Bank Ltd v Osler (1932) 17 TC 381
Wing Tai Development Co Ltd v CIR (1979) 1 HKTC 1115

Pauline Fan for the Commissioner of Inland Revenue.
John J Swaine QC with Benjamin Yu instructed by T S Tong and Co for the taxpayer.

Decision:

1. The Taxpayer Company sold certain property in January 1980. The Inland Revenue Department assessed the profit to tax, the Taxpayer objected and the Commissioner upheld the assessment with some modification. The Taxpayer appealed on the ground that the profit was simply a capital gain.

2. BACKGROUND

The following events were not in contention:

(a) The Taxpayer was incorporated in January 1941 and carried on business as a processor of preserved fruits, mainly plums, from a workshop in Kowloon.

(b) In December 1955 it acquired a site in the New Territories (the 'Old Site') where it built a four storey factory building which replaced the former Kowloon workshop.

(c) In January 1973 the Taxpayer's architects wrote to the District Office to enquire about the possibility of relocating its business to a more salubrious area and being permitted to redevelop the Old Site by substituting a multi-storey industrial building thereon. The architect was aware of a proposed new road which could affect the boundary of the Old Site. This letter also mentioned the possibility of acquiring an 'alternative/additional' site for carrying on the present trade. The response to this letter was to say that, as extensive road works were likely in the area, it was not possible at that stage to consider the grant of a new lot, in exchange for the old, to permit multi-storeyed development.

(d) The architects raised the subject again with the District Office (and the Highways Division) in May 1976. The response this time was an indication of a possibility of an exchange. The suggested substitute lot took in a part of the Old Site. This indication (being the nature of an informal offer to treat subject to government approval) included certain basic terms such as general industrial and/or godown use and a plot ratio of 9.5 maximum.

(e) In September 1976 the architects answered that the exchange proposal was acceptable in principle although a greater plot ratio was hoped for.

(f) In January 1977 the District Office confirmed the approval of the Government, in principle, and turned down the request for an increased plot ratio. The letter then raised a new issue, namely that the Old Site 'is required by Government not later than August 1977 for the implementation of road improvements ... Should your clients not be willing to surrender and vacate ... by August 1977 Government will resort to resumption proceedings ... and the offer of an exchange will be withdrawn.'

(g) In January 1977 a meeting was held at the District Office between the District Officer, Mr S, the Taxpayer's architect, and Mr L, a director of the Taxpayer. Mr L made a minute of that meeting according to which he noted that the user would allow the new building to be used for a 'Preserved Fruit Factory', vacant possession was to be given by 15 August 1977 and the premium was to be HK$7,000,000, to be paid by instalments over 10 years of which the first of $700,000 was to be paid in June 1977.

(h) By a letter dated 15 January 1977, the architects confirmed the Taxpayer's readiness to vacate the Old Site. The letter went on to say that the Taxpayer would have difficulty in the time available to find a suitable place to carry on its trade and asked for indulgence by way of temporary use of a portion of the 'new site' as soon as possible.

(i) On 26 January 1977, the District Office set out in more formal terms the refined proposal, the area being increased beyond that minuted at (g) above, and the premium being set at $9,500,000. The terms were to be accepted within 28 days. This letter also dealt with the temporary accommodation request by saying that a 'Short Term Tenancy of the area to be regranted ... is acceptable in principle'.

(j) On 17 February 1977, the architects accepted the terms of the 26 January letter.

(k) On 2 March 1977, the District Office set out its proposals for the temporary accommodation.

(l) In March 1977, the Taxpayer entered into two Agreements to purchase two properties (the 'F Property') for $386,567 and $263,433 providing for completion in May 1977. Those properties were used as a food factory licensed by the Urban Services Department. The vendor/licensee transferred the licence to a nominee of the Taxpayer in April 1977 and the licence was renewed annually thereafter in the nominee's name. It permitted the property to be used as a preserved fruit factory, amongst other things.

(m) In May 1977, the architect advised the District Office that as the Taxpayer had obtained alternative premises it had no need to take up the offer at (k) above.

(n) In November 1977, the Taxpayer obtained a waiver of user provisions relating to the F Property (the Crown Lease of which had been lost) to permit it to be used for the purpose of 'soy sauce and fruit processing factory'.

(o) On 2 December 1977, the New Grant for the exchanged lot (the 'New Site') was executed.

(p) In July 1978, Jones Lang & Wootton, surveyors and estate agents, valued the New Site at $20,000,000.

(q) By 25 August 1978, the Old Site had been cleared of the old building and the Taxpayer's architects asked the District Office for a setting out plan of the New Site and possession. On 23 September 1978, the architects advised the Taxpayer that vacant possession could be expected on 3 October 1978. However in October 1978 the District Office wrote to say that China Light's cables encroached at a then unascertained location upon the New Site, with the result that the handing over of the New Site to the Taxpayer would be deferred. In May 1979, the architects protested and sought compensation for their clients for the delay and a change of plot ratio if the Taxpayer had to put up with the cable encroachment. Evidently there was no response to this letter so the architects wrote again but did not receive a reply until mid-November 1979

when the District Office cryptically explained 'possible solutions ... are being pursued and I shall be in touch with you again as soon as possible'.

(r) On 29 August 1978, Thomas Le C Kuen, Accountants, valued the Taxpayer's assets, including the New Site, at $18,955,945.

(s) In January 1980, an offer to purchase the New Site for $42,567,890 was made by G Company through its solicitors. An Agreement for the sale was executed in January 1980: we do not know the date of the Assignment but assume one was in due course executed.

(t) In February 1980, the architects billed the Taxpayer for services rendered since October 1978, amongst which were negotiations for temporary accommodation to facilitate the vacating of the Old Site.

## 3. TESTIMONY

Mr L testified to the following effect:

(a) At all relevant times the majority of the shares in the Taxpayer was held by directors of W Company, who were also directors of the Taxpayer, whereas 32% was held by his father and other members of the L and other families.

(b) The Taxpayer has all along carried on business of processing preserved fruits. Mr L's father had been personally instrumental in building up the business.

(c) The Taxpayer acquired a property in Hong Kong about 1955 where it maintained an office and a shop from which it retailed its preserved fruit products. The processing and sale of the preserved products was the sole business of the Taxpayer. Some produce was exported to the USA, the UK and Jamaica.

(c) The four storey building which the Taxpayer built on the Old Site after it was acquired in 1955 occupied only a small part of the site. The remainder was used, as were the roofs of the lower parts of the building, to lay out the fruit to expose it to sunlight.

(d) During the late 60s and early 70s, new towns became very built up and the high rise buildings going up around the Old Site were increasingly obscuring sunlight, so around 1973/74 the Taxpayer's directors began looking for alternative locations. The Taxpayer also made the approach referred to at 2(c) above, hoping that the Government would agree to an exchange in which case the Taxpayer would build a high rise on the alternative site, retain the roof for drying out the fruit, retain other contiguous floors for processing, dormitories and offices and let out the balance. The directors believed that at the top of a

ten storey building the roof would enjoy sufficient sunlight and be free from dust.

(f) With the indication from the District Office that an exchange was a decided probability, the directors began to look for some place, to buy or rent, where the Taxpayer's business could be carried on temporarily while the exchanged land was developed. The F Property was inspected but at that time thought to be unacceptable because of its poor access road and the presence of chicken and pig farms. At the same time, the question of temporary accommodation was put to the Government (2(h) above).

(g) In February 1977, the Taxpayer resolved to accept the Government's exchange offer which led to the formal acceptance letter at 2(j) above. However, due to the deadline of mid-August for vacant possession of the Old Site, the Directors revised their view of the unsuitability of the F Property and on 4 March 1977 resolved to buy it notwithstanding that it had a smaller usable area than the Old Site. By then the directors felt that any temporary location at the Old Site would not be acceptable because they would be bound to vacate it for several months whilst construction went ahead. Moreover the Urban Services Department had begun to control the pig and chicken farms. The F Property was then intended simply as an expedient pending development of the New Site when the business would be moved back to the top of the new building.

(h) A drawing prepared in 1977 of the layout of the F Property and a photograph of the former building on the Old Site were produced, both of which were helpful for comparison purposes. The latter was also instructive in showing the isolation of the Old Site back in the mid-1950s compared with the contemporary surroundings, and the large open areas used to dry fruit.

(i) The Taxpayer had sufficient funds to meet the instalments of premium and construction costs estimated at $6,000,000 for which it was anticipated a building mortgage could be obtained.

(j) The Taxpayer kept a Board Minute Book in Chinese and Mr L was referred to these, in particular a minute of 25 October 1977 wherein mention is made of approaching the X Group for a loan of $2,000,000. (Mr L explained that Mr K, the then General Manager of Bank, was a director of the Taxpayer – Mr K has since died.) The minute also mentioned a decision in principle 'to cooperate with other connected organizations in the development. The first step will be to employ a neutral valuer to ... value the lot so that detailed cooperation plans for the development may be drawn up.' Mr L explained that this was a reference to the X Group with whom it was hoped the Company could enter into a joint venture to develop the New Site. Indeed, a letter dated August 1977 from solicitors representing the X Group was produced in which an offer was made by it to acquire 51% of the shares in the Taxpayer. This offer was referred to in

a minute of 16 August 1978 by which time Jones Lang & Wootton had produced the valuation referred to at 2(p). It was resolved to accept the offer in principle. Mr L's proposal to revalue the Company's assets and issue new shares was adopted and three directors were appointed to study the legal procedures etc. Mr L said this led to the valuation by Thomas Le C Kuen (2(r) above). However, in the final result, the X Group offer was not accepted. The minority shareholders, of which Mr L was one, were afraid that, if the Taxpayer came under the control of the X Group, the decision to develop the New Site for the Taxpayer's own business might be jeopardized.

(k) Mr L gave detailed evidence concerning the Government's delay in handing over the New Site, which was occupied by squatters, and of the problems posed by the electric cables. These led to serious delays to which no solution was in sight even by mid-1979. Consequently the directors resolved on 24 December 1979 to sell the New Site. This decision led to the Agreement for Sale of 18 January 1980 (2(s) above).

(l) Mr L acknowledged that the minute concerning the decision to embark on the exchange of the Old Site for the New Site did not refer to the intention to use the top floors for its own business and to let out the remainder.

(m) Mr L was cross-examined meticulously and at great length. He categorically rejected the idea that the Taxpayer should have accepted Government compensation for resumption instead of negotiating an exchange, because the delays were notorious. On the whole, his testimony stood up well to cross-examination save for the two following exceptions.

(n) Amongst the papers before us were some computations done by Mr L about the time the negotiations for the New Site were becoming firm, in which he had calculated both the potential profit on resale of the developed property and potential rental income. Mr L said he made these calculations for his own benefit and they were not presented to the Board of Directors. He had made the calculations to see what benefits might accrue to others (which we took to mean the X Group).

(o) The second matter of which we took a serious view was the presence of two hand written minutes (in Chinese) of a meeting of the Board on 24 December 1979. At the hearing, a photostat of a minute in Chinese (Version A) and an English translation were put before the Board but amongst the papers was another copy minute in Chinese (Version B) plus its English translation. The Minute Book itself was produced. That book was bound with string and at first sight the binding appeared to be in pristine condition.

The book contained Version A. The difference between the two versions was that Version A contained a long preamble cataloguing the problems the

Company had encountered and the reasons for sale; this preamble is absent from Version B, the version put before the Commissioner. It is clear from both photostats upon which appear parts of the adjacent pages that, on the two occasions photostating was done, the version being copied was actually in the Minute Book. It follows that at some stage Version A was substituted for Version B: we cannot accept the possibility suggested by Mr L (before the Revenue's representative did her Sherlock Holmes work) that Version B may merely have been a draft. It is also clear that Version B came to the Revenue (and hence was put before the Commissioner) under cover of a letter of 3 June 1982 from Thomas Le C Kuen. However we accept Junior Counsel's assurance that an inspection of the latter's files conducted during an adjournment did not disclose a copy of Version B – presumably because no copy was kept on the Accountant's file when it was sent to the Revenue. Mr L testified that the handwriting in the minute was that of a Mr A who acted as secretary and who is no longer with the Company, and that the signature was that of the deceased, Mr K.

(p) Mr L believed that the cable problem was resolved about one year after the Taxpayer sold the New Site.

## 4 THE REVENUE'S SUBMISSIONS

The Revenue's representative's submissions in essence were that the Company never intended to develop the New Site for its own use and for letting. She did this by attacking Mr L's evidence and at the same time equating the exchange to a purchase with a view to resale, as opposed to negotiating compensation from the Government for resumption. She referred to decisions and cases where the view had been taken that an asset acquired in the course of disposing of an investment could become trading stock (Wing Tai Development Co Ltd v CIR (1979) 1 HKTC 1115 and Royal Insurance Co Ltd (The) v Stephen (1928) 14 TC 22). She also challenged the financial ability of the Taxpayer to carry through the proposed development and referred us to BR9/74 IRBRD, vol 1, 153.

## 5. CONCLUSIONS

Having carefully considered all the evidence put before us and having seen Mr L and heard his evidence, we have reached the following conclusions which we find as matters of fact.

(a) The Old Site was a long term investment and had been used by the Taxpayer for 16 years prior to the exchange of the Old Site for the New Site, exclusively to carry on its own fruit preserve business. At all relevant times that business was profitable and not one which the Taxpayer (or more certainly Mr L's family interests) would wish to sacrifice for the sake of property speculation.

(b) The change in the surrounding environment was such that the Taxpayer realized that somehow it would have to relocate its plant and that redevelopment of the Old Site would enable this to be effected satisfactorily at the top of a multi-storey building on the Old Site, letting out the balance of the building. When it became clear that due to road planning the entirety of that site would not be available, they were prepared to exchange it for the New Site but with the same intention in mind. From the outset, compensation in lieu of an exchange was never contemplated as offering an acceptable alternative due to the probable four to five years' delay before the compensation would be forthcoming – which would mean the Taxpayer's business would have to close down, which the minority shareholders would not countenance.

(c) During redevelopment, a temporary site would be needed to house the business and eventually this was done by purchasing the F Property. Though not ideal, it was acceptable as a temporary location.

(d) The problems concerning the New Site were taking such an intolerable time to resolve, with no certain end in sight. The Taxpayer felt compelled to sell the New Site contrary to its original intentions. The consequential sale was that of a substituted investment and the profit thereon a capital gain.

(e) In reaching the above conclusions we have accepted that:

(i) the Taxpayer would have had no difficulty obtaining a building mortgage, particularly as its majority shareholders were connected with the X Group;

(ii) the minority became concerned that if they proceeded with their plans to admit X Company itself as a majority shareholder, that scheme would have diluted their own holdings and the Taxpayer as a subsidiary of X Company (a public company) would lose its independence perhaps to the detriment of the business;

(iii) the Taxpayer had never traded in other properties – its only other two properties being still in its ownership as occupiers and/or landlords;

(iv) Mr L's calculation (see 3(n)) was ambiguous but when viewed in the context of other evidence was no more than neutral.

We were most disturbed by the two versions of the 24 December 1979 minute, of which we take Version B to have been gilded to present a better picture to the Revenue. However, as it is impossible for us to establish who was responsible for tampering with the record (though we accept that neither Counsel had any prior knowledge of it), we can do no more than ignore Version B entirely and accordingly we have examined all other aspects before reaching the above conclusions.

This appeal is therefore allowed.