

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D72/97

**Profits tax** – company incorporated to hold property – financial ability of the company – whether profits derived from the sale of a property assessable to profits tax – the lack of any documentary evidence of the property ever being put on the market or with estate agents – onus on the company to show its purpose.

Panel: Audrey Eu Yuet Mee SC (chairman), Michael Choy Wah Ying and Victor Hui Chun Fui.

Date of hearing: 7 October 1997.

Date of decision: 30 October 1997.

The taxpayer company was incorporated as a private company in Hong Kong on 28 February 1986 to hold property. Between December 1990 and August 1993, the taxpayer company purchased and sold two properties which are referred to as the smaller unit and the larger unit respectively. These two units were not yet completed. The subject property of this appeal was the larger unit. Before the completion of the smaller unit, the taxpayer company sold the smaller unit on March 1992. The net profit was included in the accounts of the taxpayer company for the year ended 31 March 1992 and was offered for profits tax assessment.

The larger unit was completed and assigned to the taxpayer company on 13 August 1992. The larger unit was left vacant for a whole year. On 5 July 1993, the taxpayer company sold it for a net gain which was treated in the accounts of the taxpayer company as an extraordinary item and was not offered for profits tax assessment. The Revenue assessed the net gain as trading profit because the Revenue considered that the smaller unit and the larger unit were acquired at the same time for trade. The taxpayer company appealed. It is the taxpayer company's case that the taxpayer company was meant to hold property of its directors as their long term investment. Having heard and observed the evidence given by a director of the taxpayer company, the Board accepted his evidence as to its intention towards the subject property at the time of acquisition.

Held:

- (1) Taxpayer company was incorporated merely a vehicle for its shareholders to hold company and was not meant to trade. It would be wrong to look at the financial ability of the taxpayer company separate from the two shareholders.

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- (2) Having some knowledge of how the estate agents operate in Hong Kong, it is not surprised that the taxpayer company did not have any documents to show for his contracts with them. No paper needed to be signed by the landlord until a successful deal.
- (3) The Board was satisfied that the taxpayer has discharged its onus to prove that the subject property was acquired for the purpose to long term investment in December 1990.

### **Appeal allowed.**

Yim Kwok Cheong for the Commissioner of Inland Revenue.  
Taxpayer represented by its director.

### **Decision:**

### **THE APPEAL**

1. The Taxpayer company ('the Company') appeals against the determination of the Commissioner of Inland Revenue dated 15 March 1997 assessing the Company to profits tax upon its disposal of a property. This is the usual dispute as to whether the property was acquired as a capital asset or for trade. Capital gain is not taxable, only profits are.

### **BACKGROUND**

2. The Company was incorporated as a private company in Hong Kong on 28 February 1986. At all material times, it had three directors, Mr A, his wife ('Mrs A') and her brother ('Mr B'). We have not been provided with a company search. But we were told that only Mr and Mrs A were the shareholders.

3. By two provisional agreements in December 1990, the Company purchased two units in District C. The smaller unit was of about 700 square feet with a price of \$1,153,100 ('the Smaller Unit'). The larger unit was of about 900 square feet and cost \$1,583,900 ('the Larger Unit'). The properties were not yet completed. There were two methods of payment. For cash payment or immediate mortgage, the developer offered a special price. In case of standard or stage payment, there was an additional 12-15% on the special price depending on the tower where the property was situated. The Company opted for immediate mortgage.

4. By an agreement for sub sale and sub purchase dated 2 March 1992, before the completion of the Smaller Unit, the Company sold it and made a net profit of \$1,055,531. The Company later completed the sale by acting as a confirmor when the property was assigned to the ultimate purchaser. The net profit of \$1,055,531 was included in the

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accounts of the Company for the year ended 31 March 1992 as 'gain from the disposal of fixed assets'. It was offered for tax assessment but due to previous losses and other tax adjustments, no demand note was sent and no tax was payable that year.

5. The Larger Unit was completed and assigned to the Company on 13 August 1992. It remained vacant. By a provisional sale and purchase agreement dated 5 July 1993, the Company sold it for \$3,845,000. The transaction was completed on 14 August 1993. This gave rise to a net gain of \$2,243,900 which was treated in the accounts as an extraordinary item and not offered for assessment.

6. The assessor considered that the net gain was a trading profit and, after taking into account the earlier losses and other adjustments, assessed the Company to tax of \$185,447 for the relevant year. The Commissioner upheld the assessment. The Company appealed.

### **THE RELEVANT LAW**

7. This is well established. We have to consider the whole of the surrounding circumstances. The onus is on the Company to satisfy us that the Commissioner was wrong and that, at the time of acquisition, the Company genuinely and realistically intended to purchase the asset for a long term investment.

### **THE REVENUE'S CASE**

8. The Revenue questioned the Company's ability to hold the two properties on a long term basis. The Company's balance sheets and profits and loss accounts for the years from 1990 to 1994 showed substantial losses which were only reduced by reason of the profits from the sale of the two properties. In 1990/91, the retained loss was \$428,974. This was turned into a retained profit of \$130,221 in the following year with the sale of the Smaller Unit. In 1992/93, the retained losses shot up again to \$485,046. The Company bounced back with a retained profit of \$1,234,198 in 1993/94 because of the extraordinary gain on the disposal of the Larger Unit. The substantial borrowings from the two directors ranged from \$1,000,000 odd to a high of over \$2,108,189 during those same years.

9. When the Revenue asked the Company for more information, the Company replied in a letter dated 22 December 1995 that its intention was to use one unit for the residence of Mr B, and to let the other for rental income. No decision was made as to which one would be used for which purpose. The Revenue said this meant the Company never held any firm intention.

10. The Revenue had other reasons to doubt that there was any genuine intention to use one of the units as Mr B's residence. Mr B's family had always resided in District D. Their earlier residence was held in the name of the wife. It was sold in 1993 and in the same year she purchased another property also in District D to which they moved. The Company said that Mr B would move to District C in order that his daughter could attend a good school in the area but the plan fell through because his daughter was not accepted by the

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school. However the Company was unable to produce any documentary evidence to show that Mr B's daughter had applied for the school. The information available showed that she had always studied in schools on the Kowloon side.

11. The two units were purchased at the same time, and allegedly for the same purpose. Yet when the Company sold the Smaller Unit in 1992, it did offer the gain for profits tax assessment. The Revenue naturally relied on this to show that the intention in purchasing the Larger Unit must also have been for trade.

12. The Larger Unit was left vacant for a whole year. It was located in a popular residential development and should have been let if the real intention was to hold the property for rental purpose. The Company had not been able to produce any documentary evidence of the property ever being put on the market or with estate agents.

13. One of the main reasons given for the sale of the property was that Mr A unexpectedly lost his job in January 1991. But the Revenue pointed out that this was 16 months before the Company purchased a third unit in District C and some two and half years before it sold the Larger Unit. Thus the loss of job could not be the real reason for the sale.

14. The Company stressed that if it had intended to trade, it would have opted for stage payment and saved some interest payments. The Revenue countered this by showing that the price would have been 12-15% more. At best, the factor was neutral.

### **THE TAXPAYER'S CASE**

15. The Company was represented by Mr A who gave evidence before us.

16. At all material times, Mr and Mrs A were living together in District E. They have no children. Mrs A is a teacher, Mr A an engineer. Mr A worked for a number of large companies until 1984 when he was head hunted by a foreign company to set up their regional headquarters in Asia. To use his own words, he 'baby sat' the company starting if from scratch in his own home and building it into a large Asian business with branch offices in Country F and Country G which he also helped to set up.

17. In 1986, they were advised by their accountant to set up the Company for tax purpose. Mr and Mrs A were the only shareholders. Mr B was added as an additional director because Mr A was out of town from time to time and Mr B might be needed as an additional signatory. The Company was meant as a vehicle to hold their property. It was not a trading company. It held their residence which was then in District H. Later they sold this and purchased their present residence which was also put into the Company. As they have no children and Mr A had no pension, they were keen to set up a nest egg for themselves when they retire. The Company was meant to hold their long term investments. They wanted to purchase three properties, one for their own residence, one for rental and one for reserve so that if they needed to sell one they could put the money in the bank for interest income.

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18. In December 1988, he and his wife visited the site for District C. They liked the environment. There would be club facilities. They decided to buy two flats for long term investment. They thought they might live there on their retirement. He told his wife that he could fund the Larger Unit while she could fund the Smaller one. At the time, the wife was making \$18,000 or \$19,000 while the husband was making \$60,000 a month. They called up Mr B and suggested that he should also buy a unit there. Mr B said Mr and Mrs A should go ahead and when the units were ready for occupation, they could let one to him. It seemed that the discussion did not get much beyond that. The units were not yet built and there was never any discussion, let alone decision, as to which unit of the two units would be let to Mr B.

19. In January 1991, the unexpected happened. The senior management in the headquarters of Mr A's company changed. One morning, the senior vice president and the financial controller came in for a meeting with him. The next morning he had to announce that for personal reasons he was resigning from the company with immediate effect. That same evening he was given a farewell party and that ended his seven years service. He had no prior notice that this was coming. Just a few weeks before, he committed the Company to the purchase of the two units for his retirement plan, no doubt on the basis that he would continue to receive his \$60,000 a month.

20. Not unnaturally, Mr A felt disheartened about working as an employee. He set up his own company, I Limited. He dealt with industrial products. He got into trade of Country J, earning commission by helping state entities to make purchases overseas and later training staff for the companies from Country J. The market was tight because of the Gulf War and the economic policies of the Country J's government. But they had their savings and Mr A said he felt comfortable with his trading business in Country J.

21. Towards the end of 1991, they approached estate agents in District K hoping to get a feel of the rental market. They were advised by some estate agents that the tower where the Smaller Unit was situated was too close to the commercial complex fan coil. It would be quite noisy in the evening. So they drove to the site at six or seven in the evening. The construction was not yet complete. They assessed the situation and agreed with the advice. They instructed the estate agents to make a swap. In February 1992, they sold the Smaller Unit (the sale and purchase agreement was in early March). Shortly thereafter the estate agent recommended another flat in District C ('the Replacement Unit'). The sale and purchase agreement was signed on 15 May 1992 for \$2,600,000. As for offering the gain for tax assessment, Mr A explained that he left it to his friend who was the accountant for the Company. Because no tax was actually payable at the time, he did not realize that the gain had been treated as trading profit.

22. The Replacement Unit and the Larger Unit were completed at about the same time. The former was assigned to the Company on 27 July 1992 and the latter on 13 August 1992. Mr B did not move in. Mr A said it was because Mrs B did not want to do so. They could not locate any documentary evidence to prove that Mr B's daughter had at any time applied for any school in District C. Mr A explained that Mr B's family had moved house and this is borne out by the land searches in respect of the two residences in District D in

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Mrs B's name. Mr A had had very little contact with his brother in law since last year when Mr B separated with his wife.

23. The Replacement Unit was let out almost immediately for \$8,500 a month. The Company has continued to hold the Replacement Unit for rental income up to the time of the hearing. They were less fortunate with the Larger Unit. They wanted a monthly rental of at least \$10,000. It was 200 square feet bigger and it had two more rooms when compared with the Replacement Unit. They were offered \$9,000 but were unwilling to accept it. Some potential tenant said the windows of the Larger Unit looked out onto the cemetery. Although both units were in the same block, they had different views and faced different directions. The Larger Unit overlooked the edge of the bay. More importantly, it faced the west. It was thus very hot in the afternoon from the reflection of the sea. On the advice of the estate agent, Mr or Mrs A would go up to the flat forty-five minutes before to turn on the air conditioning so that the flat would be nice and cool when the potential tenant came to view it. Mr A said he made at least ten such trips. They had also done quite a bit with the interior, they polished the floor and the doors of the wardrobes. Unfortunately none of those efforts yielded a tenant who would pay the rent they demanded.

24. By 1993, the China business was getting worse. Mr A had over US\$100,000 trade credit which he was unable to collect. It affected his financial situation. In early July 1993, the estate agent told them that no one was willing to offer the rental they demanded but some one was willing to buy. With the business problem still unresolved and the difficulties in renting the Larger Unit, the final decision was to sell and wait for another opportunity to buy another replacement in future.

25. Mr A gave an account of the properties he purchased in the past. Apart from a small apartment they held for rental for some years, the others were mostly their own residences. The Revenue pointed out that Mrs A had once purchased three units in District K. Mr A said that she had a lot of problem with the tenant and eventually sold them offering the profits for tax. But the intention for the properties in District C were very different and he repeatedly expressed his grievance at being disbelieved by the Commissioner.

### **REASONS FOR DECISION**

26. The Commissioner had good reasons to disbelieve the Company. There was very little documentary evidence in support of the Company's contentions. There was no reason to believe that Mr B was really interested in moving to District C. There was no document to show that his daughter ever applied to any school in that neighbourhood. There was not a scrap of paper to show that the Company had ever placed the Larger Unit on the market and one year was an unusually long period of time if the landlord was determined to let out the property. The distance of time from the lay off and to the disposal of the Larger Unit does not show any immediate connection between the two.

27. But the Commissioner did not have the benefit of the additional evidence before us. Mr A impressed us as a very direct, honest and forthright witness. He was spontaneous with his answers. We also find the logic and reasoning of his actions

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understandable. It would be wrong for us to look at the financial ability of the Company separate from the two shareholders. It was merely a vehicle for them. It was not meant to trade. The indebtedness was essentially made up of the mortgage payments and they were saving for their retirement. We do not think properties in District K purchased by the wife affected the picture. They were treated differently. When a wife as in the case of Mrs A had purchased properties for trade, it does not mean that the couple would never have any intention to purchase properties for long term investment. This couple had no children. Mr A had no pension. It was quite understandable for them to think of holding long term investments for their future retirement. And it is only natural for Hong Kong couples like Mr and Mrs A to wish to invest in real properties for rental income for their old age. They liked District C. Even after they sold the Smaller Unit for reasons given, they immediately got a replacement and are still renting out the Replacement Unit even up to today.

28. We believe they were a bit optimistic in thinking that Mr B ever seriously intended to move into one of the units. Mr and Mrs A were no doubt showing a lot of enthusiasm for the development. Instead of pouring cold water, Mr B went along by saying they could rent one to him after the units were ready. There was no commitment from him. No doubt Mr and Mrs A would have welcomed Mr B's family if they would take up one of the units because they would have been guaranteed the rental income from a reliable source. There was no evidence that it ever went further than a possibility mentioned. Indeed even if Mr B's daughter did apply for a school in District C that still did not mean Mr B's family who had been living on the Kowloon side would necessarily move or change school for their daughter. It is always prudent to keep all your options open. Thus it is hardly surprising that no decision was ever made as to which unit would be for Mr B's family and which unit would be rented to outsiders. That does not mean that there was no fixed intention. There was a fixed intention to hold both units for long term rental income. It was just the identity of the tenant that remained unfixed.

29. Having some knowledge of how the estate agents operate in Hong Kong, we are not surprised that Mr A does not have any documents to show for his contacts with them. No paper needed to be signed by the landlord until a successful deal. But we have no hesitation in believing Mr A that he and his wife did put a lot of effort into letting the Larger Unit. We also accept his reason for not agreeing to a lower rent. It is important to bear in mind that the Company could have sold the Larger Unit at any time but Mr and Mrs A kept up with the mortgage payment since December 1990. Interest rate was at some 11%. They could have reaped a profit from the rising market instead of paying the mortgage instalments and leaving the property vacant. But they stuck at it until July 1993.

30. The Larger Unit was not sold until more than two years after Mr A was laid off. Mr A started his own business. No doubt, in the beginning, times were not always all bad or all good. We accept that he was doing alright and felt comfortable with his progress. The fact that they did not immediately sell the units in District C when Mr A was laid off is equally consistent with their determination to keep them long term. We find that in July 1993 it was a combination of their frustration in failing after a year's effort, to let the Larger Unit for their desired rental and Mr A's difficulty in failing to collect the trade credits that they finally decided to sell it.

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31. We also accept the explanation Mr A gave for having offered the gain from the Smaller Unit as trading profit.

32. For reasons given, the Taxpayer Company has discharged its onus and we allow the appeal accordingly.