Case No. D76/97

Profits tax – whether profits realized from sale of property assessable to profit tax – whether the purchase and sale of the property amounted to an adventure in the nature of trade – whether building allowance should be granted in respect of the property – section 2, 14 of the Inland Revenue Ordinance, Chapter 112.

Panel: Terence Tai Chun To (chairman), Andrew Mak Yip Shing and Alexander Woo Chung Ho.

Date of hearing: 26 August 1997.
Date of decision: 31 October 1997.

The taxpayer was registered as a money lender with the Money Lenders Registry. The taxpayer described the nature of its business as 'financing business.' On 21 August 1991 the taxpayer made an application to its parent company to purchase a property. In the application the taxpayer pointed out that there was a possibility of a rise in price in the future and that the property was undervalued by 8.6%.

Approval was granted by the parent company and the purchase was completed on 24 September 1991. In all of the financial statements of the taxpayer during the ownership of the property, the property was classified as investment properties under fixed assets. In the tax computation, the taxpayer stated that the property acquired in that year of assessment was investment property.

The Commissioner came to the view that the property had been acquired by the taxpayer as its trading stock and determined that the gain arising from the disposal of the property was chargeable to profits tax.

The taxpayer appealed against the Commissioner's determination on the grounds, inter alia, that:

(1) the principal activity of the taxpayer was provision of loans to corporate borrowers. The taxpayer emphasized that trading in property was not within the objects of the memorandum of association of the taxpayer;

(2) the intention of the taxpayer to acquire the property was for long-term purpose and to hold it for rental income;

(3) the disposal of the property was due to unexpected worsening in the financial position of the parent company.

Held:

(1) In determining whether a property was purchased for trading/dealing purposes or is a capital asset the intention at the time of purchase has been held to be of very great weight (All Best Wishes Limited v CIR [1992] 3 HKTC 750, at 771 per Mortimer J; Lionel Simmons Properties Limited (In Liquidation) and others v Commissioners of Inland Revenue [1980] 2 AER 798, at 800 per Lord Wilberforce applied.)

(2) On the evidence, the Board found that the purchase of the property was not for long term investment.

  (i) The parent company in approving the application did not have a set of long term cash flow projections to examine nor did it mention that the property was to be acquired on a long term basis.

  (ii) The evidence regarding Grade A office market rental was that it would go down in the next two years, making the property a less attractive investment in the long term. It is difficult to accept that the parent company had approved the purchase of the property on the basis of a long term investment.

  (iii) The purchase of the property was to be financed by short term loans.

(3) It might well be that it was not the usual business of the taxpayer to deal in property but this fact by itself does not lead to the conclusion that profits made are not assessable to tax. On must look at all the evidence to decide on the taxpayer's intention and the taxpayer's declared and subjective intention is not enough. (FCT v Myer Emporium Limited 18 ATC 693 at 697 applied).

(4) Further, Clause (u) of the memorandum did not preclude the taxpayer from trading in property.

(5) The taxpayer has failed to give a reasonable explanation for the quick resale of the property.

(6) The purchase and sale of the property by the taxpayer amounted to an adventure in the nature of the trade. It follows that any gain on the disposal of the property should be chargeable to profits tax and no building allowance should be granted in respect of the property.

Appeal dismissed.

Cases referred to:

All Best Wishes Limited v CIR [1992] 3 HKTC 750
Lionel Simmons Properties Limited (In Liquidation) and Others v CIR [1980] 2 AER 798
FCT v Myer Emporium Limited 18 ATC 693

K A Lancaster for the Commissioner of Inland Revenue.
Victor Lim Toong Yen of Messrs F S Li & Co for the taxpayer.

Decision:

BACKGROUND

1. This appeal is brought by the Taxpayer against the determination of the Commissioner of Inland Revenue dated 3 February 1997 in respect of the second additional profits tax assessment for the year of assessment 1991/92 and the additional profits tax assessment for the year of assessment 1992/93. The Taxpayer claims that the gain arose from the disposal of a property should not be chargeable to profits tax and rebuilding allowance should be granted in respect of the property.

2. The Taxpayer was a private company incorporated in Hong Kong on 28 June 1974. Since incorporation, the Taxpayer has been a wholly owned subsidiary of its parent company ('Parent Company'), a company incorporated in Country A. At all relevant times, the Taxpayer was registered as a money lender with the Money Lenders Registry. In its profits tax returns for the years of assessment 1991/92 and 1992/93, the Taxpayer described the nature of its business as 'financing business'.

3. On 21 August 1991 the Taxpayer made an application ('the Application') to the Parent Company for approval to purchase a property at a building in District B ('the Property'). In the Application, the Taxpayer set out the general information of the Property, the consideration given by the Taxpayer for the acquisition of the Property, a cash flow and profit projection for holding the Property and the reasons for the acquisition of the Property. In the Application, the Taxpayer emphasized that on the assumption of a funding cost at 7% per annual the net income for the first year would be negative but from the second year onward, positive income would be expected. The Taxpayer also pointed out that there was a possibility of a rise in price in the future and that the Property was undervalued by 8.6%.

4. By a letter of intent dated 22 August 1991, the Taxpayer offered to purchase the Property, subject to all existing tenancies and the existing management agreement at a price of $70,712,600.

5. On 23 August 1991, the Parent Company approved the purchase of the Property.

6. On 30 August 1991, the Taxpayer entered into a formal sale and purchase agreement. The assignment for the purchase was completed on 24 September 1991.

7. Particulars of the then existing tenancy (‘Tenancy Agreement’) were:

‘Date of Tenancy Agreement:	15-8-1988 (as varied by a Deed of Variation dated 5-8-1991).	
Name of the Tenant:	[Name of Tenant]	
Term:	6 years from 16 July 1988 to 15 July 1994 with an option to renew for a further term of 3 years.	
Monthly Rental:	16-7-1991 to 15-5-1992	$342,210.00
	16-5-1992 to 15-7-1994	$488,967.60’

8. On 24 September 1991, the Taxpayer entered into a management agreement (‘Management Agreement’) to appoint the previous property manager (‘Management Company’) as the property manager of the Property for an initial period of three years from 24 September 1991 and thereafter the appointment should continue on the same terms and conditions, such appointment being determinable by either party serving on the other party a written notice of not less than three months.

9. In all of the financial statements of the Taxpayer during the ownership of the Property, the Property was classified as investment properties under fixed assets.

10. The Taxpayer filed its profits tax return for the year of assessment 1991/92 on about 29 July 1992 showing an assessable profit of $2,559,993 after deducting a rebuilding allowance of $471,417 for the Property. The Commissioner of Inland Revenue (‘the Commissioner’) raised on the Taxpayer a profits tax assessment for the year of assessment 1991/92 as per return submitted. In the tax computation, the Taxpayer stated that the Property acquired in that year of assessment was investment property.

11. By an agreement dated 21 August 1992, the Taxpayer agreed to sell the Property at a price of $88,888,888, completion to take place on 31 December 1992.

12. On 23 July 1993, the Taxpayer filed its profits tax return for the year of assessment 1992/93 showing an assessable profit of $3,374,925. The gain arising from the disposal of the Property amounting to $15,006,136 was treated by the Taxpayer as capital gain and was not included in assessable profits.

13. On 13 September 1993, the Commissioner raised on the Taxpayer a profits tax assessment for the year of assessment 1992/93 in accordance with the Taxpayer’s return subject to the acceptance of the accounts submitted which were being examined.

14. The Commissioner then raised enquiries in relation to the purchase and sale of the Property. The tax representative initially provided further information as follows:

(a) The Property was held as a long term investment for deriving rental income.

(b) The acquisition of the Property was financed by a rollover loan.

(c) The Property was sold upon the instruction of the Parent Company.

(d) The sale proceeds of the Property were applied for settlement of loans obtained for the purchase and payment of dividends to shareholders.

(e) The Property was leased out for rental income during the period of ownership.

15. The Commissioner then came to the view that the Property had been acquired by the Taxpayer as its trading stock and on 10 June 1994, raised on the Taxpayer the following additional assessments:

<u>1992/93 additional profits tax assessment</u>

Additional assessable profits	$15,006,136
	=========
Additional tax payable thereon	$2,626,073
	========

<u>1991/92 second additional profits tax assessment</u>

Additional assessable profits to disallow the rebuilding allowance previously granted	$81,895
	======
Additional tax payable thereon	$13,512
	======

The Taxpayer's Case

16. In the ground of appeal and the hearing before us, the Taxpayer by its tax representative made the following submissions:

(a) The principal activity of the Taxpayer was provision of loans to corporate borrowers. Major business of the Taxpayer had not changed since commencement of its operation.

(b) The intention of the Taxpayer to acquire the Property was for long-term purpose and to hold it for rental income. In the formal Application submitted

by the Taxpayer to the Parent Company before the acquisition, it was indicated that the intention of the Taxpayer was to hold the Property as long term investment for rental income.

(c) The Parent Company was established in 1971. The major business of the Parent Company had been the provision of loans and finance leases since its establishment. As the Parent Company had many subsidiaries and associated companies, its management maintained tight organization structure and operation procedures. Without authorization from more senior management, junior officials were only allowed to make decisions within the general authorities granted to them. Furthermore, instructions from senior management would never be rejected by junior officials even though they appeared to be unwise. It was a fact that loyalty was highly respected by people in Country A. Management of the Taxpayer acted within the general authorities granted to them and in accordance with the instructions from the Parent Company.

(d) The cash flows and profit projection in the Application showed that the acquisition of Property was profitable and financially feasible when it was held on long term basis.

(e) The major concern of the project was the rental income to be received from the Property. The whole Application expressed the idea that the Taxpayer was willing to acquire the Property for rental income on long term basis. If the Taxpayer's intention was for trading profit, it should not have bought the Property because a property with long tenancy/lease had a lower marketability and would not be preferred by a property dealer.

(f) The Taxpayer had taken various steps before and just after the acquisition in securing the smooth operation of the plan. These include:

(i) Appointment of an agent to check the tenant's credit worthiness and to secure the rental income.

(ii) The Tenancy Agreement to be terminated in about three years was a long term agreement.

(iii) On 28 August 1991, the Taxpayer held a directors' meeting to approve the purchase of the Property.

(iv) After completion of the assignment, the Taxpayer immediately entered into a new Management Agreement with the previous Management Company for a fixed and non-cancellable period of three years from 24 September 1991. Entering a fixed and non-cancellable long term management contract would not be in the interest of a short term property dealer.

(v) If the Taxpayer had intended to hold the Property for trading purpose, it could increase the gain by (i) acquiring a property with vacant possession, (ii) shortening the term of the existing tenancy (iii) contracting with the then Management Company on a much shorter term, say on an annual basis, or even managing the Property itself.

(vi) On the day of the signing the Sale and Purchase Agreement, the Taxpayer contracted with its banker to borrow a three year term loan to finance the acquisition. This was because it had been the major financing policy of the Taxpayer to finance long term assets by means of short term rollover loans. The same financial policy was adopted for financing other long term debtors and investments.

(vii) During the period of ownership of the Property, net rental received by the Taxpayer was higher than the interest expenses resulting in 'net cash inflow/profit' in the aggregate sum of $2,057,140. This indicated that the Property could be held on long term basis by the Taxpayer.

(viii) Disposal of the Property was due to unexpected worsening in the financial position of the Parent Company. During the year 1992 the Parent Company was making its second attempt to have its shares listed on a stock exchange in Country A, and in order to show better financial results, the Parent Company instructed the Taxpayer to dispose of the Property. The gain on disposal was then distributed to the Parent Company by way of dividend. The listing application of the Parent Company was unsuccessful because the economic environment and the stock market in Country A were not favourable.

(ix) From the date of incorporation, the Taxpayer had only disposed of one landed property. The Taxpayer disposed of the Property reluctantly as it was the most profitable investment at that time. Net rental income before tax from the Property was over $2,000,000 for the year 1992. When compared with the total net profit of the Taxpayer for that year amounting to $3,900,000, holding the Property was very profitable and contributed over 50% of the profits in the year. The Property was a self-financing investment. Only one property agent was appointed in negotiating the disposal of the Property.

The Taxpayer had raised $559,000,000 and $341,000,000 by way of new loans in the years 1991 and 1992 respectively. Out of them, only $73,000,000 in the year 1991 was borrowed to finance the acquisition of the Property. This was because the Taxpayer was not a property dealer and had restricted its business in the field of loan provision.

(x) In all the statements of accounts made during the period of ownership of the Property, the Property was classified as fixed assets. Such classification was made by the Taxpayer's management at the time of acquisition after consideration of its intention to hold the Property on a long term basis.

17. At the hearing of this appeal, the Taxpayer emphasized that trading in property was not within the objects of the Memorandum of Association of the Taxpayer.

The Revenue's Case

18. The Taxpayer sold the Property within a year of its purchase. The short period of ownership was strongly indicative that the purchase was for short term.

19. The purchase was financed by a short term loan and no long term finance was made to ensure that the Property could be held on a long term basis.

20. The recommendation of the Taxpayer to its Parent Company for the purchase of the property was that

(a) the Property was undervalued by 8½% of the market value,

(b) prices were expected to rise and

(c) rental yields were expected to fall.

21. In view of this, it was difficult to imagine that the Parent Company could have approved the purchase on a long term basis.

22. As to the disposal of the Property, the Taxpayer maintained that the property was sold on the instructions of its Parent Company which was applying for a listing on a stock exchange in Country A for the second time and which needed cash by way dividend to give a boost to its results. The Taxpayer was a small subsidiary of its Parent Company and its contribution to its Parent Company was insignificant. It could hardly be a genuine reason for the Parent Company to give instructions to dispose of the Property.

The Law

23. Section 14 of the Inland Revenue Ordinance (the IRO) Chapter 112 is the charging section:

'Subject to the provisions of this IRO, profits tax shall be charged for each person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.'

24. Section 2 of the IRO defines a 'person' to include any corporation and defines 'trade' by saying that:

> *'trade includes every trade, manufacture, and every adventure and concern in the nature of trade.'*

25. In determining whether a property was purchased for trading/dealing purposes or is a capital asset the intention at the time of purchase has been held to be of very great weight. In All Best Wishes Limited v CIR [1992] 3 HKTC 750, Mortimer J said at page 771:

> *'This is a decision of fact and the fact to be decided is defined by the Statute – was this an adventure and concern in the nature of trade? The intention of the taxpayer, at the time of acquisition, and at the time when he is holding the asset is undoubtedly of very great weight. And if the intention is on the evidence, genuinely held, realistic and realisable, and if all the circumstances show that at the time of the acquisition of the asset, the taxpayer was investing in it, then I agree. But as it is a question of fact, no single test can produce the answer. In particular, the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined on the whole of the evidence. Indeed, decisions upon a person's intention are commonplace in the law. It is probably the most litigated issue of all. It is trite to say that intention can only be judged by considering the whole of the surrounding circumstances, including things said and things done. Things said at the time, before and after, and things done at the time, before and after. Often it is rightly said that actions speck louder than words.'*

26. In the leading case of Lionel Simmons Properties Limited (In Liquidation) and others v Commissioners of Inland Revenue [1980] 2 AER 798. Lord Wilberforce stated at page 800:

> *'Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment?'*

27. Section 68(4) of the IRO states:

> *'The onus of proving that the assessment appealed against is excessive or incorrect shall be on the Company.'*

28. Accordingly, the Taxpayer must prove that it was more likely than not that the property was bought for long term investment purposes.

Conclusion

29. The Taxpayer submitted that in 1991 it obtained from its Parent Company approval to the purchase of the Property to be held for long term investment.

30. However, in its cash flow forecasts, the projections covered the period from the fourth quarter of 1992 to the second quarter of 1994, a period of about three and a half years and no further. The tax representative submitted that to prepare projections beyond three years would be difficult for the Taxpayer. Therefore it would be logical to infer that the projections prepared and annexed in the Application for approval were prepared on a short term or at most a medium term basis. The Parent Company in approving the Application did not have a set of long term cash flow projections to examine nor did it mention that the Property was to be acquired on a long term basis. Further, the Application mentioned that the property was 8.6% undervalued and was worth approximately $7,000,000 more. It also suggested that there was the possibility of price rises in future. The evidence regarding Grade A office market rental was that it would go down in the next two years, making the Property a less attractive investment in the long term. It is difficult to accept that the Parent Company had approved the purchase of the Property on the basis of a long term investment.

31. The purchase of the Property was to be financed by short term loans. The Taxpayer explained that was the usual way it did business. But there was no evidence to show how the three-year loan was to be repaid or indeed any plan to finance the holding of the Property on a long term basis.

32. The tax representative submitted that the Taxpayer could only have purchased the Property for long term investment firstly because dealing in property was not part of the Taxpayer's usual business and secondly dealing in property was not among the objects of the Taxpayer's Memorandum of Association.

33. It might well be that it was not the usual business of the Taxpayer to deal in property but this fact by itself does not lead to the conclusion that profits made are not assessable to tax. One must look at all the evidence to decide on the Taxpayer's intention and the Taxpayer's declared and subjective intention is not enough. We find support of our view in the decision of the High Court of Australia in FCT v Myer Emporium Limited 18 ATC 693 at page 697:

> *'Although it is well settled that a profit or gain made in the ordinary course of carrying on a business constitutes income, if does not follow that a profit or gain made in a transaction entered into otherwise than in the course of business is not income. Because a business is carried on with a view to profit, a gain made in the ordinary course of carrying on business is invested with the profit making purpose, thereby stamping the profit with the character of income. But a gain made otherwise than in the ordinary course of carrying on business which nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or gain may well constitute income. Whether it does depends very much on the circumstances of the case. Generally speaking, however, it may be said that if the circumstances*

are such as to give rise to the inference that the taxpayer's intention or purpose in entering into the transaction was to make a profit or gain, the profit or gain will be income, notwithstanding that the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business. Nor does the fact that a profit or gain is made as the result of an isolated venture or "one off" transaction preclude if from being properly characterized as income… The authorities establish that a profit or gain so made will constitute income if the property generating the profit or gain was acquired in a business operation or commercial transaction for the purposes of profit-making by the means giving rise to the profit.'

34. We further find that the Taxpayer's Memorandum of Association did not preclude the Taxpayer from trading in property. Clause (u) of the Memorandum cannot be clearer which is set out below in verbatim:

'*(u) To invest the moneys of the Company upon such investments (other than shares in the Company) or property in such manner as may from time to time be determined and to the same extent as natural persons might or could do, to purchase or otherwise acquire and to hold, own, maintain, work, develop, sell, lease, exchange, hire, convey, mortgage or otherwise dispose of and deal in, lands and leaseholds, and any interest, estate and rights in real property, and any personal or mixed property and any franchises, rights, licences or privileges necessary, convenient or appropriate for any of the purposes herein expressed;'*

35. The Taxpayer said that it entered into the Management Agreement with the Management Company for a period of three years which would demonstrate that the Taxpayer had intended to hold the Property long term. We find that a three-year Management Agreement is equally compatible with holding the Property on a short term basis. In any event, the management fees were a small sum relative to the price of the Property. We do not consider the three-year Management Agreement as an important piece of evidence.

36. It was submitted by the Taxpayer that the Parent Company decided to dispose of the Property because it needed the money by way of dividend to facilitate the Parent Company's listing application. The contribution of dividend to the Parent Company as a result of disposal of the Property was separately listed in the financial statements of the Parent Company. It was a very small percentage of the profits made by the Parent Company during the year and it was certainly not significant enough to induce the Parent Company to dispose of the Property. We find that the Taxpayer has failed to give a reasonable explanation for the quick resale of the Property.

37. There was little direct evidence before the Board as to the Parent Company's intention. The only witness was a Mr C from the Taxpayer. He said that judging from the records of both the Parent Company and the Taxpayer he believed that the Parent Company intended to purchase the Property for long term investment. His reasons were that there was

an income return of about 7.4% with an assumed 7% funding costs, which would make a very attractive long term investment.

He also believed that the Property was sold as a result of the Parent Company's instructions. By a letter dated the 23 February 1992, the Parent Company instructed the Taxpayer to sell 'your asset in hand'. There was no specific mention of the Property. According to the grounds of appeal, it was only on 19 June 1992 when Mr D, then managing director of the Taxpayer, was instructed by the Chairman of the Parent Company to sell the Property. Neither Mr D nor the Chairman of the Parent Company gave evidence before the Board. Mr C had no personal or direct knowledge of what transpired between Mr D and the Chairman of the Parent Company.

Mr C was not a director of the Parent Company and there was no evidence to show that he was involved in the decision making in respect of the purchase and the subsequent sale of the Property. His evidence can have little evidential value.

38. The Taxpayer also produced a letter dated 15 August 1997 from a Mr E, a former managing director of the Taxpayer. Mr E did not give evidence at the hearing.

In his letter, Mr E stated that the Property was acquired with the intention to be held on long term basis for rental income. He was only assigned to Hong Kong to act as managing director of the Taxpayer in July 1992. He could not have known of the Taxpayer's intention when it purchased the Property in 1991.

In his letter, Mr E further stated that the disposal of the Property was based on the unexpected instructions from the Parent Company. According to him, the Parent Company required the disposal of the Property to improve the financial results for the year 1992 when the Parent Company was in its second attempt to have its shares listed on a stock exchange in Country A. Mr E had no personal or direct knowledge of the intention of the Parent Company and he was certainly not in a position to speak for its behalf. We cannot attach much weight to Mr E's letter.

39. In view of all the circumstances, we find that the purchase and sale of the Property by the Taxpayer amounted to an adventure in the nature of the trade. It follows that any gain on the disposal of the Property should be chargeable to profits tax and that no building allowance should be granted in respect of the Property.

40. Accordingly we dismiss the appeal and confirm the second profits tax assessment for the year of assessment 1991/92 and the additional profits tax assessment for the year of assessment 1992/93.