Case No. D8/01

Profits tax – whether diminution in value of properties – whether deductible.

Panel: Kenneth Kwok Hing Wai SC (chairman), John Lee Luen Wai and Francis Lui Yiu Tung.

Date of hearing: 13 March 2001.
Date of decision: 11 April 2001.

The taxpayer was a company doing property business.

For the year of assessment 1997/98, the taxpayer declared assessable profits after deducting a provision for diminution in value of properties held for resale amounting to $14,275,238 (' the Provision').

The Commissioner of Rating and Valuation valued the properties at $206,000,000 on 31 December 1997.

The assessor considered the Provision not deductible and raised on the taxpayer additional profits tax assessment.

Held:

1. The value of the properties on 31 December 1997 is a question of fact.

2. The taxpayer did not adduce any evidence on the valuation of the properties on 31 December 1997. There is no basis for the taxpayer to challenge the valuation by the Commissioner of Rating and Valuation.

Appeal dismissed and a cost of $5,000 charged.

Chu Wong Lai Fun for the Commissioner of Inland Revenue.
Thomson Lai Yiu Wah of Messrs Thomson Y W Lai & Co for the taxpayer.

Decision:

1. This is an appeal against the determination of the Commissioner of Inland Revenue dated 29 September 2000 confirming the additional profits tax assessment for the year of assessment 1997/98 under charge number 1-2889900-98-1, dated 9 September 1999, showing additional assessable profits of $14,275,238 with additional tax payable of $2,119,873 (after the 10% tax rebate) ('the Assessment').

The facts

2. The Taxpayer has not disputed any of the facts stated in 'Fact (sic) upon which the determination was arrived at' in the determination and we find them as facts.

3. The Taxpayer has objected to the additional profits tax assessment for the year of assessment 1997/98 raised on it, claiming that the profits assessed are excessive and that a provision for diminution in value of certain properties is deductible.

4. The Taxpayer was incorporated as a private company in Hong Kong on 11 February 1992. At all relevant times, the issued and paid up share capital of the Taxpayer remained at $10,000. In its profits tax returns, the Taxpayer described the nature of business carried on as 'property investment'.

5. The Taxpayer declared assessable profits of $6,979,337 in its profits tax return for the year of assessment 1997/98. The figure was arrived at after deducting a provision for diminution in value of properties held for resale amounting to $14,275,238 ('the Provision').

6. In the notes to the financial statements for the year ended 31 December 1997, it was stated that:

> 'Stock of properties held for resale are stated at the lower of cost and net realizable value. The net realizable value is supported by an independent professional valuation dated May 13, 1998 less estimated further costs to sale.'

7. The Taxpayer's accounts for the year ended 31 December 1997 were approved by the directors on 30 July 1998.

8. The assessor raised on the Taxpayer the following profits tax assessment for the year of assessment 1997/98 subject to enquiries issued:

Profits per return	$6,979,337
Tax payable	$1,151,590

The Taxpayer did not object to the assessment.

9. The assessor raised enquiries with the Taxpayer on the Provision made. In reply, Company A ('the Representative'), on behalf of the Taxpayer, provided the following information:

(a) The Provision was made in respect of 165 residential units at Address B and Address C ('the Properties'). The total floor area of the Properties was 92,492 square feet.

(b) A qualified surveyor was appointed to prepare a valuation report on the Properties. According to the valuation report, the open market value of the Properties as at 13 May 1998 was $160,000,000.

(c) The Provision was calculated as follows:

	$	$
Stock at cost, as at 31 December 1997	164,275,238	
Provision for diminution	4,275,238	4,275,238
Amount per valuation report [see (b) above]	160,000,000	
Further revaluation of stock		
3 units (1,608 square feet) sold subsequently, valued at cost	2,859,000	
162 unsold units (90,884 square feet) valued at about $1,620 per square foot	147,141,000	
Value per account	150,000,000	
Further provision		10,000,000
Total provision		14,275,238

10. The Commissioner of Rating and Valuation valued the open market value of the Properties as at 31 December 1997 on vacant possession basis at $206,000,000.

11. The assessor considered the Provision not deductible and raised on the Taxpayer the following additional profits tax assessment for the year of assessment 1997/98:

additional assessable profits	$14,275,238

additional tax payable (Note) $\underline{\underline{\$2,119,873}}$

Note: after taking into account the 10% tax rebate under the Tax Exemption (1997 Tax Year) Order.

12. The Representative, on behalf of the Taxpayer, objected against the additional assessment claiming that the Provision is deductible.

13. The Representative contended that:

(a) ' according to paragraph 14 of SSAP 9, it is ... stated that *"A material post balance sheet event requires changes in the amounts to be included in financial statements where it is an adjusting event."* In paragraph 27(d) of SSAP 9, it shows one of the examples of post balance sheet events which normally should be classified as an adjusting event, such as *"for stocks and work in progress, the receipt of proceeds of sales after the balance sheet date or other evidence concerning the net realizable value of stocks"*. Therefore, the reduction of selling prices of closing stock or lower value as at the date of approval of financial statements are adjusting events which need to be adjusted in the financial statements, not just disclosed in the notes to the financial statements.'

(b) ' the valuation of stock in this case should be governed by the old SSAP 3 and according to paragraph 42 of the SSAP 3, it is provided that *"events occurring between the balance sheet date and the date of completion of the accounts need to be considered in arriving at the netrealizable value at the balance sheet date. (For example, a subsequent reduction in the selling prices)."* Thus it is quite obvious that the subsequent selling prices or the lower value as at date of approval of the financial statements of the closing stock can be considered in determining the market value of the closing stock ...'

(c) ' although it is a general principle of taxation that a profit cannot be taxed and a loss cannot be deducted until it is realized, however, it is an important exception to this principle relating to provision for stock loss or obsolescence as aforementioned. Such a provision is fully deductible for tax purpose in "Whimster E Co. v CIR". Also, in the Duple Motor Bodies Ltd. v Ostime (1961) 39 TC 537, Lord Reid stated the principle that *"if the market value of the stock was less than the cost, the taxpayer could anticipate the loss of diminution of stock."*'

14. The assessor requested the Taxpayer to supply details of the three units sold after 31 December 1997 but before the date of approval of the account; and a valuation report to support the estimated value of the remaining 162 units at $147,141,000 [paragraph 9(c) above]. Up to the date of the determination, the Taxpayer has not responded to the assessor's request.

The appeal hearing

15. At the hearing of the appeal, the Taxpayer was represented by Mr Thomson LAI Yiu-wah of Messrs Thomson Y W Lai & Co, certified public accountants, and the Respondent was represented by Mrs CHU WONG Lai-fun, chief assessor. Neither party called any witness.

16. Mr Thomson LAI Yiu-wah contended, among others, that:

(a) the value of the Properties fell below cost as at 31 December 1997.

(b) '... The conditions of property devaluation were certainly existing at December 31, 1997 but the outcome was not known on the balance sheet date.

... The company had seeked (sic) independent valuations twice as to give a true and fair valuation of the company's major and dominant asset on the balance sheet date. This shows the Board of Directors of our client was a responsible management team to try their best to provide reliable information on financial statements. The post balance sheet activities (not events) were undertaken by the company to additionally throw light on the conditions which did exist on the balance sheet date at 31 December 1997 and the adjustment of the stock value to NRV was definitely a genuine decision.'

Our decision

17. The value of the Properties on the **balance sheet date (31 December 1997)** is a question of fact.

(a) The cost of the Properties **as at 31 December 1997** was $164,275,238.

(b) The Commissioner of Rating and Valuation valued the Properties at $206,000,000 **as at 31 December 1997**.

(c) Nothing is further from the truth than Mr Thomson LAI Yiu-wah's assertion that the Taxpayer twice sought the value 'on the balance sheet date'.

(d) The first valuation relied on by the Taxpayer is the report dated 13 May 1998 of Company D valuing the Properties at $160,000,000 **as at 13 May 1998**. This valuation is of no assistance to us in resolving the factual question of the value of the Properties on the balance sheet date of 31 December 1997.

(e) The second and only other valuation relied on by the Taxpayer is the report **dated 26 October 2000** of Company E valuing **the remaining 162 units** of the Properties at $150,000,000 **as at 25 July 1998**. This valuation is of no assistance to us in resolving the factual question of the value of the Properties on the balance sheet date of 31 December 1997. Incidentally, this valuation did not come into existence until more than two years and two months after the approval by the directors of the accounts on 30 July 1998. If the directors had ' seeked (sic) independent valuation ... as to give a true and fair valuation of the company' s major and dominant asset on the balance sheet date' the valuation should have been on 165 units, not the 162 units which remained after the sale of three units more than three months **after the balance sheet date**.

(f) Mr Thomson LAI Yiu-wah said he had no answer to the Chairman' s question why the Taxpayer did not instruct the valuers to value the Properties **as at 31 December 1997**.

(g) Thus, there is simply no evidence that the value of the Properties **as at 31 December 1997** was below the cost of $164,275,238. We remind ourselves that under section 68(4) of the Inland Revenue Ordinance (Chapter 112) (' IRO'), the onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.

(h) Moreover, as Mrs CHU WONG Lai-fun pointed out in her helpful, meticulous and able submission, the Taxpayer sold three units in **April 1998**, three months after 31 December 1997 at an average gross profit of 51%. As at 31 December 1997, the Taxpayer held 165 units with a floor area of 92,492 square feet at a book cost of $164,275,238 [see paragraph 9(a) and (c) above] or $1,776 per square foot. By agreements dated 14 April 1998 and 22 April 1998, the Taxpayer sold three units at $1,437,451, $1,430,297 and $1,450,759 respectively. As the units had a total floor area of 1,608 square feet [see paragraph 9(c)] above, the average proceeds per square feet was $2,686 ($4,318,507/1,608). The gross profit is thus (2,686 - 1,776)/1,776 = 51%. We note that the result is the same by adopting the cost of $2,859,000 asserted by the Taxpayer [see paragraph 9(c) above] (4,318,507 – 2,859,000)/2,859,000 = 51%.

(i) Further, as Mr Thomson LAI Yiu-wah has not adduced any evidence to challenge the valuation by the Commissioner of Rating and Valuation, we find that the value of the Properties **as at 31 December 1997** was $206,000,000.

18. Not only has the Taxpayer not proved that the value of the Properties **as at 31 December 1997** was below the cost of $164,275,238, the Respondent has proved that the value of the Properties **as at 31 December 1997** was higher than the cost of $164,275,238. There is thus no factual basis for Mr Thomson LAI Yiu-wah's contentions and no factual basis for the Provision of $14,275,238. The appeal is bound to fail and fails.

19. The references by Mr Thomson LAI Yiu-wah to the old SSAP 3 and SSAP 9 are red herrings calculated to confuse.

(a) The standard accounting practice under the old SSAP 3 was that '*the amount at which stocks and work in progress, other than long-term contract work in progress, is stated in periodic financial statements should be the total of the lower of cost and net realisable value of the separate items of stock and work in progress or of groups of similar items*' (paragraph 11). The principle was that the amount should be the lower of cost and net realisable value. Nowhere did SSAP 3 authorise or require adoption of the net realisable value of the stock at a **post** balance sheet date, particularly where the net realisable value of the stock on the balance sheet date was higher than the cost.

(b) Under SSAP 9, 'adjusting events' are defined as 'post balance sheet events which provide additional evidence of **conditions existing at the balance sheet date**' (paragraph 11, emphasis added), and 'non-adjusting events' are defined as 'post balance sheet events which concern **conditions** which did **not exist at the balance sheet date**' (paragraph 12, emphasis added). The standard accounting practice is that 'financial statements should be prepared on the basis of **events occurring up to the balance sheet date and conditions existing at the date**' (paragraph 13, emphasis added). A material post balance sheet event must be an adjusting event before it may require changes in the amounts to be included in the financial statements (paragraph 14). Nowhere does SSAP 9 authorise or require adoption of the net realisable value of the stock at a **post** balance sheet date, particularly where the net realisable value of the stock on the balance sheet date was higher than the cost.

20. Mr Thomson LAI Yiu-wah has cited no authority in law and no statement of accounting practice or principle authorising or requiring adjustment on account of a drop in value of the stock which did not occur until **after** the balance sheet date.

21. We have carefully considered all the points raised on behalf of the Taxpayer by Mr Thomson LAI Yiu-wah. The Taxpayer has not begun to discharge the onus of proof under section 68(4) of the IRO.

Disposition

22. We dismiss the appeal and confirm the Assessment.

Costs order

23. We are of the opinion that this appeal is frivolous and vexatious and an abuse of the process. The Taxpayer has wasted the time and resources of the Board of Review and those of the Inland Revenue Department and put forward obviously unsustainable arguments in an attempt to get out of its duty to pay $2,119,873 tax (after the 10% tax rebate). Pursuant to section 68(9) of the IRO, we order the Taxpayer to pay the sum of $5,000 as costs of the Board, which $5,000 shall be added to the tax charged and recovered therewith.