

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D80/97

**Profits tax** – disposal of property – investment or trade.

Panel: Ronny Wong Fook Hum SC (chairman), David Wu Chung Shing and William Zao Sing Tsun.

Date of hearing: 30 August 1997.

Date of decision: 6 November 1997.

The taxpayer is a company incorporated in Hong Kong and Mr A was one of its directors at all material times. On 8 July 1992, the taxpayer signed a letter of intent with Limited B in Country C for the establishment of a joint venture enterprise in Country C for the production of electrical appliances. In November 1992, Mr D of Limited B informed Mr A that Limited B was interested in investing in properties. Mr A was asked to locate for Limited B luxurious premises.

On 24 May 1993, the taxpayer purchased a property for \$14,514,350 by a term loan of \$7,660,000 from a bank. The minutes of the board meeting of the taxpayer held on 8 July 1993 recorded that the board resolved that ‘the property is held for the long term rental income generating purposes.’

On 17 December 1993, the taxpayer sold the property for \$19,000,000.

Held:

The Board found that the taxpayer was to transfer the property to Limited B once it established a footing in Hong Kong and had no intention to hold the property for ‘long-term rental generating purposes’ as asserted in the board minutes. The profits arose not from disposition of a capital asset but from a trade carried out by the taxpayer.

**Appeal dismissed.**

Case referred to:

Marson v Morton [1986] 1 WLR 1343

Chiu Kwok Kit for the Commissioner of Inland Revenue.  
Taxpayer represented by Danny Choi, Barrister.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### **Decision:**

### **The Background**

1. The Taxpayer is a company incorporated in Hong Kong on 13 November 1987. At all material times, Mr and Mrs A were its directors.

2. On 8 July 1992, the Taxpayer signed a letter of intent with Limited B in Country C for the establishment of a joint venture enterprise in Country C for the production of electrical appliances. The total investment envisaged was US\$3,800,000. The Taxpayer was to contribute 30% towards such investment.

3. By a letter dated November 1992, one Mr D of Limited B informed Mr A that apart from electrical appliances, Limited B was also interested in investing in properties. Mr A was asked to locate for Limited B premises of 300-400 square metres with car park and swimming pool located in a quiet district (the Property). Mr A was assured that there would be adequate funding from Limited B for the purchase.

4. On 28 February 1993, the Taxpayer and Limited B signed an 'equipment contract' for the importation of electronic parts into Country C. 40% of the total costs amounting to US\$2,478,240 was to be paid as to US\$1,500,000 by the Taxpayer on behalf of Limited B and the balance by Limited B itself. 60% of the total costs was to be paid by irrevocable letter of credit.

5. By a provisional agreement for sale and purchase dated 24 May 1993, the Taxpayer purchased the Property for \$14,514,350. Pursuant to a formal agreement dated 18 June 1993, the Taxpayer completed this purchase on 15 July 1993.

6. There has been produced before us minutes of a meeting of the board of directors of the Taxpayer held on 8 July 1993 and attended by Mr and Mrs A. The board resolved to purchase the Property and to accept a loan of \$7,660,000 from Bank E to support that purchase. The board further resolved that:

'(e) the Property is held for the long-term rental income generating purposes'.

According to the facility letter from Bank E, the \$7,660,000 loan was part of the credit facilities extended by that bank in favour of the Taxpayer. It was repayable by monthly instalments of \$65,268.23.

7. There has further been produced before us a document which purports to be a facsimile transmission ['the Disputed Fax'] from Mr D of Limited B to Mrs A dated '6-3-1993'. It is hotly disputed between the parties whether this connotes 6 March 1993 or 3 June 1993. Limited B pointed out in the Disputed Fax that the equipment contract had to be redrawn due to lack of particulars such as model number and place of production.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

Limited B further requested that a lease be prepared for their consideration at a rate of \$90,000.

8. On the application of Limited B two letters of credit for US\$781,000 and US\$2,198,600 were opened on 28 May 1993 in favour of the Taxpayer for shipment of various machines from Country F to Country C. The terms of these LCs were amended on 29 July 1993 and 2 August 1993.

9. By letter dated 1 August 1993, the Taxpayer confirmed instructions to a real estate agent for the letting out of the Property.

10. Between 3 to 6 November 1993, advertisements were placed by the Taxpayer in a newspaper for the letting or sale of the Property.

11. By a provisional agreement dated 17 December 1993, the Taxpayer sold the Property for \$19,000,000.

12. The Taxpayer was involved in other real estate transactions in 1992/93:

- a. On 1 September 1992, the Taxpayer purchased workshops 9 and 10 of Industrial Building G. Workshop 9 was sold on 14 May 1993 and Workshop 10 on 28 May 1993.
- b. The Taxpayer also purchased a lorry parking space in Industrial Building G on 26 March 1993. This too was sold on 28 May 1993.

The profits arising from these transactions were accepted by the Taxpayer for profits tax assessment after arguments with the Revenue.

13. The issue before us is whether the Taxpayer is liable for profits tax in respect of the profits arising from its disposal of the Property.

### **The Hearing before us**

14. Mrs A gave evidence for the Taxpayer.

15. According to Mrs A:

- a. The Taxpayer commenced an import/export business in 1988.
- b. During negotiations with Limited B in 1992, Limited B repeatedly requested the Taxpayer to provide them with a residence in Hong Kong of 300-400 square metres with car park and swimming pool and located in a quiet district as a condition for the joint venture.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

- c. Although this was not made a term of the letter of intent dated 8 July 1992, the issue was raised by Limited B and the Taxpayer agreed to consider their request.
- d. This request was repeated by Mr D after signing the equipment agreement of 28 February 1993. Mr D was keen to have a flat in Hong Kong to facilitate Limited B's establishment of a 'window' in Hong Kong.
- e. By 3 June 1993, Mrs A had suggested to Limited B that the Property be let to Limited B at \$90,000 computed on the basis of \$20 per square feet for an area of over 3,700 square feet plus the car park.
- f. From mid-June 1993 to the end of July 1993, she tried but could not locate Mr D. She visited Country C in July 1993. Mr D was no longer with Limited B. She was informed by Limited B that the establishment of a 'window' in Hong Kong had to be delayed due to tightening of governmental policies.
- g. She tried to let the Property out but the market response was poor.
- h. She decided to sell the Property because the Taxpayer had never wanted to acquire the Property in the first place. Furthermore, the Taxpayer was then experiencing financial difficulties. The Taxpayer's landlord was proposing a 100% increase in rental for the Taxpayer's office.
- i. When asked about paragraph 2 of the grounds of appeal which reads:

'Further, as [Limited B] intended to invest in the Hong Kong property market and its directors would travel frequently to Hong Kong, the party from Country C requested the Company to purchase a luxury accommodation for its directors. As stated in the letter by [Mr D] in November 1992... the accommodation should be [of 300-400 square metres with car park and swimming pool and located in a quiet district]. The party intended that the Subject Property would be held in long term by the Company in trust for it. The down-payment would first be made by the Company and would be reimbursed later by the party. The party would also pay \$90,000 each month to the Company by way of rental in order to cover the mortgage instalment expenses payable by the Company.'

Mrs A said the Taxpayer was not in a financial position to purchase the Property but Limited B assured her not to worry as Limited B would T/T the necessary fund to support the purchase. She accepted those assurances bearing in mind the two letters of credit of 28 May 1993.

- j. She maintained that the Disputed Fax was received on 3 June 1993. Mr D signed on that document.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

- k. She was expressly asked whether the Property was purchased for Limited B. She answered in the affirmative and further said that the Property would be transferred to Limited B when Limited B sets up its window company in Hong Kong.
- l. The Taxpayer requested for amendments to the two L/Cs in order to comply with the terms of the bank. Shipments under the two L/Cs were duly completed.

### **The Grounds of Appeal**

16. We have already referred to paragraph 2 of the grounds of appeal in paragraph 15h above.

17. Paragraph 4a of the Taxpayer's grounds of appeal further says this:

‘It is wrong to say that the Company acquired the Subject Property for rental investment purpose. The Subject Property was purchased solely for the purpose of entertaining the request of the party from Country C. It is entirely a commercial decision. It was due to the unexpected macro-economic (sic) control policy in Country C that the co-operation agreement to set up a company had fallen through and that the directors of the party had abandoned their original plan to come to Hong Kong. As a result thereof, the Subject Property became redundant to the Company...’

### **Our Decision**

18. The principles are well known. We have to ascertain the Taxpayer's intention at the time of the acquisition of the Property. The stated intention of the Taxpayer cannot be decisive and the actual intention can only be determined upon the whole of the evidence. We must consider all the objective circumstances to see if the Taxpayer had a genuine, realistic and realisable intention in investing in the Property. ‘Intention’ also connotes an ability to carry the same into effect. It is idle to speak of ‘intention’ if the person so intending did not have the means to bring it about or had made no arrangements or taken any steps to enable such intention to be implemented.

19. The first point of time for consideration is the date of the provisional agreement, namely, 24 May 1993 and not the date of the directors' meeting on 8 July 1993. The gist of Mrs A's evidence as reflected in the grounds of appeal is that the Taxpayer was merely acting as agent or trustee of Limited B. The Taxpayer was in no financial position to make a purchase of this magnitude. Limited B was to fund the purchase by T/T transfer. As at 24 May 1993, it is wholly artificial to maintain that the Taxpayer had any intention to hold the Property as a long term investment. The Property was to be transferred to Limited B once it establishes a footing in Hong Kong.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

20. On the assumption that the Disputed Fax was dated 3 June 1993, Mr D was there requesting a draft tenancy agreement with rental at \$90,000 for Limited B's consideration. The matter was wholly tentative pending Limited B's confirmation at future meeting between the parties. On Mrs A's evidence, as from mid-June 1993 Mr D could no longer be found.

21. It is in this context that we consider the minutes of 8 July 1993:

- a. There was no binding agreement with Limited B for renting of the Property.
- b. There is no evidence to suggest that Limited B had totally abandoned the initial proposal of purchasing the Property themselves.
- c. On Mrs A's evidence, without Limited B, the Taxpayer was not in a financial position to support this acquisition.

In the light of these factors, we view the assertion in the minutes that 'the property is held for the long-term rental income generating purposes' with circumspection.

22. We test the matter further by reference to the 'badges of trade' outlined in Marson v Morton [1986] 1 WLR 1343 on the assumption (contrary to paragraph 19 above) that the Taxpayer purchased the Property for its own benefit:

- a. The purchase in question was not a one-off transaction.
- b. As opposed to its other property dealings, the subject matter in this case was a residence in a luxurious district.
- c. The transaction was initially related to the Taxpayer's import/export business. It was a condition put forward by its joint venture partner.
- d. The directors' meeting was held on 8 July 1993 well after the provisional agreement of 2 May 1993 and the formal agreement of 18 June 1993 for the acquisition of the Property. It was held at a time when Limited B was losing interest.
- e. A substantial part of the purchase consideration was financed by a term loan from a bank. Unless there be concluded a tenancy with Limited B, the Taxpayer was not in a financial position to support the purchase.
- f. There is no evidence indicating that the premises were decorated or occupied by the Taxpayer prior to its disposal.

## INLAND REVENUE BOARD OF REVIEW DECISIONS

- g. The Property was sold about seven months after its purchase on 24 May 1993. It was advertised for sale on 3 November 1993 – less than four months after the directors' meeting of 8 July 1993.

On balance, we are of the view that the profits in question arose not from disposition of a capital asset but from a trade carried on by the Taxpayer.

- 23. For these reasons, we dismiss the appeal and confirm the assessment.