

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D83/98

Profits tax – assessable profit – gains realized from sale of property by a company – whether the sale of the property amounted to trade – section 2, 14, 68(4) of the Inland Revenue Ordinance Chapter 112.

Panel: Christopher Chan Cheuk (chairman), Victor Hui Chun Fui and Kenneth Ku Shu Kay.

Dates of hearing: 12, 20 February and 12, 26 March 1998.

Date of decision: 4 September 1998.

The taxpayer purchased the Property, namely 2 to 12 floors of Building A, on 25 October 1989. However, over fifty units in the Property were sold within four years of the purchase. The sale took place at different times: (1) the first sale was the sale of Unit X on 1 December 1989, approximately five weeks after the completion of its purchase; (2) it was closely followed by the sale of the whole of 4th floor on 4 January 1990; and (3) about four months later, on 12 May 1990 the taxpayer sold Unit Y.

The three sales together brought in \$6,835,5000 to the taxpayer. Then there was a gap of nearly half a year when no sale took place. For the period of one year commencing in September 1991 the taxpayer resumed its sale which happened nearly every month. During this period up to 16 October 1992 the taxpayer handled 35 sale bringing in a total of \$45,907,964. Then there was a lapse of another half year with no sale, after which the taxpayer sold another 2 units and the whole of 12th floor which together had a sale proceeds of \$9,945,000.

The taxpayer submitted that the Property was purchased for long-term investment for the following reasons:-

- (i) The taxpayer had attempted to instruct its tax representative to apply for change of name of the Property, though it was rejected by the Companies Registry;
- (ii) The taxpayer had appointed a new management company upon acquisition of the Property;
- (iii) After acquisition the taxpayer immediately instructed contractor to effect certain renovation works to the Property;
- (iv) The principal object clause of the memorandum of the association of the taxpayer was amended to the effect that the taxpayer was a property investment company;

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- (v) The taxpayer entered into a sub-deed of mutual covenant at the time of the sale of the first Unit X for the sake of better management of the building;
- (vi) The taxpayer expected that the overall rental increase would not be less than 35% of the total;
- (vii) The taxpayer had various resolutions which clearly stated the Property was acquired and would be maintained as long-term investment;
- (viii) The sale of the Property was due to certain specific special circumstances;
- (ix) The taxpayer continued with its effort to let out the remaining Property.

The Revenue pointed out the Property had been held by the taxpayer for a short period of time; the bank loan was in fact a short term loan; there was no thorough feasibility study or at least a lack of such evidence; there was no long term planning; soon after the acquisition the taxpayer ran into difficulty and was in need of working capital; there were certain inconsistencies between the correspondence and evidence; and the transaction bore different badges of trade as set out in Marson v Morton [1986] 1 WLR 1343 at 1348.

Held:

1. The main issue of this case is whether the sale of Property amounted to trade. The taxpayer can prove either that it is not trading or that the acquisition is for long-term investment. (Lionel Simmons Properties Ltd (In Liquidation) and Others v CIR 35 TC 461; All Best Wishes Limited v CIR 3 HKTC 750 considered and applied.)
2. The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant. (section 68(4) of the IRO)
3. The Board has to consider whether the taxpayer had the 'genuinely held, realistic and realisable intention' at the time of acquisition. (Marson v Morton [1986] 1 WLR 1343 considered and applied).
4. The Board found that the taxpayer has failed to discharge its duty of proof on the grounds that:-
 - (1) All money whether in form of rental or sale proceeds would be used for servicing the bank loan. These are not the terms that will be expected for long-term investment;
 - (2) The renovation works carried out were rather limited to covering the floor of the hall and the steps with stones and improvement on lighting, it was consistent with sale as well as letting;

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- (3) The taxpayer's explanation for the first sale dated 1 December 1989 is not convincing as the Board doubted very much that prudent businessman who claimed that he intended to maintain the Property as capital asset would have agreed to sell a unit breaking up the integrity of the Property;
- (4) The taxpayer's explanation for the second sale is first it could hardly find any tenant after the existing tenant had left. However, the tenancy expired on 30 November 1989 and that the Taxpayer completed the transaction of sale and purchase on 25 October 1989 and that Company F was appointed as the leasing agent on 1 November 1989. The Board doubted how much effort the taxpayer had made to secure tenants before it committed to sell the 4th floor on 4 January 1990 which was about one month after the tenancy expired. The taxpayer's second reason that it was in need for short term working capital is also found to be incredible as this would reduce the overall rental income and thus cannot help to solve the problem of shortage of working capital;
- (5) For the subsequent sales, the Board found it inconsistent that on one hand the taxpayer claimed that it had no confidence in investment in office premises due to the softening of the rental market and decided to sell, but on the other hand after or in the course of the sale of the Property the taxpayer acquired the whole floor of Building I for office use in District J and two properties at District K for office and commercial redevelopment;
- (6) The taxpayer's view that it would look at the Property as long-term investment subject to a 35% increase within five to ten years is more like gamble – a speculation on whether the taxpayer could achieve 35% increase which, we hasten to add, was not a modest increase, and if the taxpayer could not achieve it the taxpayer would drop it.

Appeal dismissed.

Cases referred to:

Lionel Simmons Properties Ltd (In Liquidation) and Others v CIR 35 TC 461
All Best Wishes Limited v CIR 3 HKTC 750
Marson v Morton [1986] 1 WLR 1343

K A Lancaster for the Commissioner of Inland Revenue.
George A Ribeiro of Messrs Vivien Chan & Co for the taxpayer.

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Decision:

I. Appeal

1. This is an appeal by a company ('the Taxpayer') against the determination made by Mr WONG Ho-sang, the Commissioner of Inland Revenue on 14 July 1997 in respect of the profits tax assessments raised on the Taxpayer for the years of assessment 1990/91, 1991/92, 1992/93 and 1993/94 relating to gains made arising from the sale of the property described as 2 to 12 floors of Building A ('the Property').

II. Proceedings

2. The hearing took four long sessions and Mr B, the person who beneficially owned and controlled the Taxpayer company gave evidence. It happened that Mr B's wife is the senior partner of the Taxpayer's tax representative in this case. The Chairman of this Board knows her very well. After disclosure of this fact both parties indicated that they had no objection that the Chairman continued to hear the case. Notwithstanding this the Board wants to make it very clear that it will not take into consideration the fact that Mrs B is the senior partner of the tax representative and is the wife of Mr B.

3. Mr RIBEIRO for the Taxpayer tendered two statements dated 5 February 1998 and 11 February 1998 respectively ('the Statements'). These two Statements were confirmed by the witness Mr B as true and correct, and were treated as part of the evidence in the examination in chief. The Statements were supplemented with the witness' verbal testimony.

4. The Board has been supplied with three sets of documents: (a) the usual appeal bundle prepared and filed with the notice of appeal having 131 pages, (b) the bundle annexed to the Statements produced by the Taxpayer of over 200 pages and (c) the bundle of 188 pages prepared and produced by the Revenue. These three bundles have many documents in common and overlap each other. If the parties had been conscientious of environmental protection they should have taken time to sort them out instead of wasting so much paper on duplication. The Board earnestly urges the parties to be more co-operative. As in this case we can actually cut down half of the paper used: nearly all the documents were produced by consent. We see no reason for each party to prepare and produce its own separate bundle.

III. The Issue

5. The main issue of this case is whether the sale of the Property amounted to trade. Section 14 of the Inland Revenue Ordinance (the IRO) states: '*Subject to the provisions of this Ordinance, profits shall be charged for each year of assessment at the standard rate on every person carrying on a trade ...*' In section 2 of the IRO '*trade*' has an

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inclusive definition which states '*trade includes every trade and manufacture, and every adventure and concern in the nature of trade*'.

6. In fact, the Taxpayer can prove either that it is not trading or that the acquisition is for long-term investment. As Lord Wlberforce in Lionel Simmons Properties Ltd (In Liquidation) and Others v CIR, 35 TC 461 at 491 states: '*What I think is not possible is for an asset to be both trading stock and permanent investment at the same time, nor to possess an indeterminate status – neither trading stock nor permanent asset*', we think it will be the same if the Taxpayer can prove that the Property was an investment asset.

IV. Basic Facts

7. The following are the basic facts not in dispute:

- (a) The Taxpayer was incorporated on 18 July 1989 and initially had an issued and fully paid up share capital of \$2. The issued and fully paid up share capital was increased to \$5,000 on 5 May 1993 by the issue of 4,998 shares of \$1 each.
- (b) The Taxpayer was at all material times beneficially owned and controlled by Mr B.
- (c) By an agreement for sale and purchase dated 6 October 1989 the Taxpayer agreed to purchase the Property at a price of \$42,000,000. Completion of the sale and purchase took place on 25 October 1989.
- (d) Save and except 2 units and the whole of 7th floor and the main roof as well as the flat roof on the 4th floor, all the units in the Property were purchased subject to and with the benefit of existing tenancies for fixed terms. More than half of them were due for renewal within one year of the acquisition.
- (e) However, over fifty units in the Property were sold within four years of the purchase.
- (f) The sale took place at different times:
 - i. The first sale was the sale of Unit X on 1 December 1989, approximately five weeks after the completion of its purchase;
 - ii. It was closely followed by the sale of the whole of 4th floor on 4 January 1990; and
 - iii. About four months later, on 12 May 1990 the Taxpayer sold Unit Y.

The three sales together brought in \$6,835,500 to the Taxpayer. Then there was a gap of nearly half a year when no sale took place. For the period of one year commencing in September 1991 the Taxpayer resumed its sales which

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happened nearly every month. During this period up to 16 October 1992 the Taxpayer handled 35 sales bringing in a total of \$45,907,964. Then there was a lapse of another half year with no sale, after which the Taxpayer sold another 2 units and the whole of 12th floor which together had a sale proceeds of \$9,945,000.

V. Taxpayer's case

8. Apart from the testimony by Mr B the Taxpayer also relied on the following facts as evidenced by the different documents:

(a) Attempt to change the name of the Taxpayer

It was claimed by Mr B the name of the building bore certain phonetical resemblance with his first name. He liked it very much and instructed the tax representative to apply for change of name but was rejected by the Companies Registry. Mr Ribeiro submitted that if the Property were not for long-term investment Mr B would not have been taken the trouble of changing the name of the Taxpayer.

(b) Taking over the building management of the Property

It was a term of its original offer that the Taxpayer required the vendor to procure the termination of the contract of the then existing management agent, Company C. For some reasons unknown to us this did not become part of the term. After acquisition the Taxpayer gave notice of termination resulting in payment of a compensation to Company C. The Taxpayer claimed that it was a clear indication of its strong desire to have the Property managed by itself and for long-term purpose; otherwise, it would not have taken the trouble.

(c) Renovation

After acquisition the Taxpayer immediately instructed contractor to effect certain renovation work to the Property.

(d) Change of the object clause

The principal object clause of the memorandum of the association of the Taxpayer was amended to read as follows: '*1. To hold the property known as 2nd to 12th floors inclusive, flat roof on 4th floor and main roof of Building A as a long term investment.*' The business registration with the Revenue was also amended to the effect that the Taxpayer was a property investment company.

(e) Creation of a Sub-Deed of Mutual Covenant

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Mr B considered that for the sake of better management of the building and to avoid dispute with the tenants or other occupiers over management and maintenance fees it was necessary to enter into a sub-deed of mutual covenant, which the Taxpayer did at the time of sale of the first Unit X.

- (f) Realisation of his expectation

The Taxpayer purchased the Property because he thought the seller desperately wanted to sell the Property, and he had a good bargain. He believed that the then existing rent was low, more than half of them were due for renewal within one year, and he could obtain a significant increase. He expected that the overall rental increase would not be less than 35% of the total. After acquisition he had some success in procuring the increase in rent; some tenancies had 100% or more increase. The trend of rent increase was supported by Government statistics.

- (g) He had various resolutions which clearly stated that the Property was acquired and would be maintained as long-term investment.
- (h) The sale of the Property was due to certain specific special circumstances.
- (i) The Taxpayer continued with its effort to let out the Property remaining.

VI. Revenue's Argument

9. A quotation from Mr Justice Mortimer's decision in All Best Wishes Limited v CIR 3 HKTC 750 at page 771 can well reflect the Revenue's position:

'The intention of the taxpayer, at the time of acquisition, and the time when he is holding the asset is undoubtedly of 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 upon 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 rightly said that actions speak louder than words.'

10. Mr LANCASTER started off and asked whether the Taxpayer's intention was 'genuinely held, realistic and realisable'. He pointed out that the Property had been held by the Taxpayer for a short period of time; the bank loan was in fact a short term loan; there

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was no thorough feasibility study or at least a lack of such evidence; there was no long term planning; soon after acquisition the Taxpayer ran into difficulty and was in need of working capital; there were certain inconsistencies between the correspondence and evidence; and the transactions bore different badges of trade as set out in Marson v Morton [1986] 1 WLR 1343 at 1348. It is not our intention to set out the Revenue submission in full as the burden of proof does not fall on the Revenue.

VII. Burden of Proof

11. Section 68(4) clearly states: *‘The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.’* Although the arguments for both sides have been set out in the above manner it does not exonerate the Taxpayer’s burden of proof. The first thing we need to consider is whether the Taxpayer had the *‘genuinely held, realistic and realisable intention’* at the time of acquisition. We will adopt the approach suggested by Sir Nicholas Browne-Wilkinson V-C in Marson v Morton, supra, at page 1349: *I believe that in order to reach a proper factual assessment in each case it is necessary to stand back, having looked at those matters, and look at the whole picture and ask the question – and for this purpose it is no bad thing to go back to the words of the statute – was this an adventure in the nature of trade?’* We would also like to ask it in a slightly different way: *‘Was the acquisition of long-term investment?’* So we begin our analysis of the evidence from the very beginning and to examine what conclusion we should draw from the analysis.

VIII. Family background

12. Mr B was in de facto control of the Taxpayer’s company. He gave us a detail account of his family background. His father was a merchant dealing in importation and sale of chemicals, mainly dyeing materials. His father’s business later branched out into manufacturing and established factories in different parts of the world. Mr B told us the main business of his family was trading in and manufacturing of chemicals. His father thought that all these businesses had its risky side and it was necessary to prepare for *the rainy days’*. The best way was to make some long-term investment in properties. Mr B claimed that later he became more involved in the family business and also inherited this philosophy.

IX. Mr B, the witness

13. Mr B is a very well educated person and has very strong business acumen. In 1975 he graduated from university with a master degree in engineering. He went to Country D and joined a chemical factory. There he spent four years. In 1979 he returned to Hong Kong and worked in his family business. Mr B actively participated in different aspects of his family business which included the redevelopment of a property. During the period he also made property investment in Country E, the properties of which he still holds as long-term investment. He is a typical Hong Kong entrepreneur of the younger generation who has received modern western education but against his strong Chinese traditional

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cultural background. From the manner he gave evidence we find that he is a cautious person and is prepared to take calculated risk.

14. For the period from 1985 to 1989 he became more involved in Hong Kong real estate but according to his evidence there was *'nothing of high value'* and all of them were around the region of \$5,000,000 as it was still his trial period and he was not familiar with Hong Kong market. Acquisition of the Property was his first major investment in Hong Kong. The Property was introduced to him by estate agent shortly after the June 4 incident in 1989 when Hong Kong had the *'million people'* demonstration. Mr B found that people decided *'to sell their properties, even at a depressed price and go into rental.'* His theory was that the rental market would soon pick up. He carefully examined and considered the tenancy list supplied to him. He discovered that most of the floors were subdivided into small units and more than half of them were due to expire within one year. He firmly believed that the overall rental income could be increased by at least one-third. He found that the price was right and he could obtain very favourable lending terms from a bank. With such belief and under such circumstances he acquired the Property.

15. Incidentally, the Property was known as Building A which had certain similarity with the first name of Mr B. He liked it very much. He claimed that as the Property was for long-term investment he instructed his solicitors to apply for change of the name of the Taxpayer. Mr B also showed us that after acquisition he was successful in obtaining rent increase at least with six units at the rate of 100% or more. There were three other units and the whole of 7th floor which were let to associate company at comparable rates. He also submitted as proof that the rental market was good by showing us an extract from Hong Kong Property Review 1997.

X. Acquisition of the Property

16. It would be helpful to arrange and examine the events from the date leading to acquisition to the first sale in chronological order:

- | | |
|-------------------|--|
| 11 September 1989 | The Taxpayer through its solicitors made the offer to purchase |
| 5 October 1989 | The Taxpayer through its solicitors applied for change of name |
| 6 October 1989 | The Taxpayer entered into the agreement for purchase |
| 14 October 1989 | The Taxpayer confirmed that he accepted the terms of the bank loan. |
| 19 October 1989 | Directors' meeting confirming the purchase and the intention for change of name |
| 25 October 1989 | Assignment and legal charge executed and extraordinary general meeting to amend the memorandum |
| 1 November 1989 | Taxpayer entering into leasing agency agreement with Company F. |

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9 November 1989	Amendment of business registration to holding and investment of property
20 November 1989	Solicitors' letter to terminate the management agency contract with Company C
1 December 1989	Entering into agreement for sale of Unit X
15 December 1989	Completion of the sale and entering into sub-deed of mutual covenant
24 December 1989	Completion of renovation of the lobby work which commenced on 7 December 1989

XI. Change of Name

17. We find it as fact that it is rather unusual for a company to apply for change of name except for specific reason. The Taxpayer's argument was that the Property acquired was for long-term investment and Mr B liked the name. We accept that the application for change of name was an unusual step and this piece of evidence gave some support to the Taxpayer's case.

XII. Resolutions

18. Mr Ribeiro for the Taxpayer stated that the different resolutions and the amendment of the business registration were good evidence of proof of the Taxpayer's intention. Mr Lancaster for the Revenue classified them as self-serving. We shall not dismiss them as '*self-serving*' but shall evaluate them against the circumstances of the case. As Mr Mortimer described it, these are '*stated intention of the taxpayer*' and '*cannot be decisive*'. We have set out the events of this case and all happened within a short period of time including the first sale. We have to consider them carefully whether the circumstances are consistent with the stated intention.

XIII. The Loan

19. Mr B told us that he could obtain very favourable terms from a bank ('the Bank'). He claimed he had very good relationship with it and the Bank could offer him the following terms:

- (a) Loan amount of \$33,600,000.
- (b) Interest rate at 1.375% about 3 or 6 months' HIBOR which meant an annual interest of about \$4,707,000 as against the annual income of about 4,188,690.
- (c) Repayment of 1% of the loan amount per annum

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20. Mr Lancaster submitted that the terms were not as favourable as Mr B would have thought it would be, particularly for the purpose of long-term investment and we also find the following:

- (a) Apart from the first legal charge and other usual security document he had to give a personal guarantee;
- (b) All the rental would be paid into monthly retention account for servicing the loan; and
- (c) The loan was for a term of two years and at the second anniversary day at the option of the Bank to be renewed for only 50% of the total amount.

21. Mr B was confident that the loan would be renewed in full and his confidence was proved to be well founded by the fact that the loan was extended for three more years in the sum of over \$25,000,000. We accept that he had good confidence but this did not remove the risk that the Taxpayer had to take at that time. During the negotiation stage the Bank was not the only bank that the Taxpayer had approached: it had approached at least two other banks and they both refused to make any loan arrangement for the Property. A prudent businessman should realise the potential danger, and should plan ahead and consider how to service the loan. Mr B explained to us that if the Taxpayer needed money he would inject more fund into the company, of which we have no reason to doubt his ability. But, his claim of his willingness to inject more fund did not fit in very well with one of his reasons for sale: the Taxpayer was in lack of operating capital and wanted to reduce its indebtedness.

22. In examining the loan documents we have certain observation to make in respect of Clause 4 of *'the other conditions'* as set out in the letter of offer dated 14 October 1989 from the Bank, the contents of which were also repeated in Clause 5 of the renewal letter dated 14 October 1991 from another bank. The clause referred to sales proceeds and was built in the legal charge as Clause 3(e)(vi): *'All sale proceeds of the premises shall be deposited in an interest earning account with the lender and applied on an interest payment date towards reducing firstly the payment of interest and other monies hereby secured and secondly the loan or any part thereof in inverse order of maturity'*. This point was raised in examination in chief but not challenged or cross-examined by the Revenue. From this clause it is wrong for us to draw any conclusion that the Taxpayer had discussed with the Bank about sale of the units before offer and commitment. But, our query is that the Taxpayer was practically unable to draw any money: as the rent was to be deposited with the monthly retention account for servicing the loan and the sale proceeds would be used for no other purpose but to pay interest and repayment, are such terms really favourable for long-term investment? We shall further elaborate this point when we come to the sale of the first few units and the question we want to raise is: would the sales help to relieve the problem of lack of operating capital? As we understand, all money whether in form of rental or sale proceeds would be used for servicing the bank loan. These are not the terms we expect for long-term investment.

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XIV. Termination of the Management Agency

23. The management agency agreement with Company C was terminated by a notice dated 20 November 1989, about a month after acquisition. The Taxpayer had to give a compensation of \$22,000 for short notice. We were not given the reason for such urgency and on 1 December 1989 the Taxpayer entered into the first sale. Was it a mere coincidence or was it deliberate for better management of the building? Company F was appointed as the leasing agent for the Taxpayer on 1 November 1989 and Company G as the management agent by the sub-DMC.

XV. Renovation

24. Shortly after the acquisition the Taxpayer caused the main hall of the Property to be renovated at a price of \$59,700. We notice from the agreement set out in Exhibit 'A-19' that the works carried out were rather limited to covering the floor of the hall and the steps with stones and improvement on lighting. This renovation was consistent with sale as well as letting.

XVI. Sale of the Property

25. Mr Ribeiro submitted that we should not take any particular factor for sale in isolation but to consider the combined effect of the different factors together. We think this is the right approach; however, we were informed that the first three sales had reasons of their own and because of this we are bound to consider them on individual basis.

XVII. The First Sale

26. This sale took place on the 1st day of December 1989, about on month and six days after the assignment to the Taxpayer on 25 October 1989. It was a sale to the existing tenant. We were not informed whether the initial approach was made by the tenant or the Taxpayer. At that time, it was Mr B's own theory that there were very few people interested in buying after the June 4 incident and we are rather surprised by the speed that the transaction was put through: on 1 December 1989 agreement for sale and purchase was entered into and fifteen days later completion took place. We do not know whether any negotiation took place but we are sure that the transaction took only fifteen days to complete. We must say it was most unusual.

27. The reason for sale was clearly and emphatically stated in Mr B's testimony: it was for better management of the Property and he believed that for such purpose it was necessary for the Taxpayer to enter into a sub-deed of mutual covenant. In the letter of objection dated 4 July 1995 this reason was not given. In the letter dated 4 September 1995 the tax representative in point 5 stated: '*We are instructed the company appointed Company G in or about November 1989 regarding disposition of Unit X, Unit Y and 4/F of the Property for more working capital.*' If the statement were true it would be most detrimental to the Taxpayer's case; it could be construed that the Taxpayer had not carefully planned

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ahead before purchase, that it ran into cash flow problem and that it appointed its associate company to act as sales agent and took the initiative to approach the different potential purchasers including the existing tenants. Mr B readily denied such statement as correct.

28. The reason he gave was for betterment of the management. He told us that other companies within the group experienced the difficulty of collecting management fee and the tenants challenged the right of the landlord. This is not something uncommon: the interests between landlord and tenants are always in conflict. Is this the way one will adopt to avoid dispute? This is the question we have to consider. We have to consider the question not as a lawyer or a conveyancer but as an ordinary businessman. Will one sacrifice the unity and integrity of the Property as a whole by selling one of the many units just for the sake of better management? We accept that the Property itself did not constitute the whole building; the ground and first floor were separately owned. From the evidence we understand that the Property itself had a separate hall and a separate entry. Its owner could appoint separate management agent. It was a separate integral part as if it were a separate building. We doubt very much that a prudent businessman who claimed that he intended to maintain the Property as capital asset would have taken such step and agreed to sell a unit breaking up the integrity of the Property. He should have made enquiries what were the other methods available instead of believing in what his lawyer told him. Having heard Mr B's evidence and having seen his demeanour, we have great suspicion that to enhance the management of the building was the true intention for selling Unit X.

XVIII. The Second Sale

29. The second sale relates to 3 units which form the whole floor of the Property. The copy assignment produced was not dated. Neither have we been supplied with a copy of the agreement for sale and purchase. From Appendix 26 which constitutes Exhibit A-26 produced by the Taxpayer in the 3rd day of hearing and admitted into evidence by consent, we understand that the sale took place on 4 January 1990. The reason for the sale as claimed by Mr B was that many people thought that 4th floor had bad '*fung shui*' because the word '*four*' in Cantonese sounded like death. The main thrust of his argument was not that he believed it was bad '*fung shui*' but that he could hardly find any tenant after the existing tenant had left. We note on page 53 of the Taxpayer's bundle that the tenancy expired on 30 November 1989 and that the Taxpayer completed the transaction of sale and purchase on 25 October 1989 and that Company F was appointed as the leasing agent on 1 November 1989. We doubt how much effort he had made to secure tenants before he committed to sell the 4th floor on 4 January 1990, which was about one month after the tenancy expired.

30. Another reason Mr B advanced for sale could be found in paragraphs 22, 23 and 24 of his Statement: the need for short term working capital. The proceeds of sale could only be used for repayment as we have pointed out in paragraph 22 hereof. This would reduce the Taxpayer's indebtedness to the bank and correspondingly reduced the interest amount. But, we must bear in mind this would also reduce the overall rental income. We do not see how it would help to solve the problem. If sales were what Mr B planned to do in addition to injection of cash, nowhere in the earlier resolutions or in any other document

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mentioned about the possible sale. All the documents gave us only one impression that the whole of the Property would be kept for long-term investment.

XIX. The Third Sale

31. The third sale relates to Unit Y which was sold to the then existing tenant on 12 May 1990, shortly before the expiry of the existing tenancy on 30 May 1990. Mr B told us that the Taxpayer faced with no choice: either the tenant would either vacate and move out or buy the unit. The decision was made and the price was agreed at \$1,020,000. Neither Mr B nor any of the documents produced gives us any reason why such decision was made. The profit margin for sale of this unit, if the average cost was taken as set out in Exhibit A-26, was the lowest, only 19%. The rental market, according to Mr B's evidence, showed sign of softening in later part of 1990 and early 1991 but not at the time of the sale of this particular unit; we do not understand why the Taxpayer was so afraid of the threat that the tenant would vacate, and readily sold the unit. At the time of renewal Mr B would not have realised the softening of the rental market. The other reason given for sale was common to the second sale that is, the lack of operating capital. We have given our observation on this point in earlier paragraphs and if this were the real reason we would like to know why there was a gap of four months between the second and the third sale.

XX. Reasons for Sale after 1990

32. For the first three sales, each had its special reason which we have dealt with. For sale after 1990 Mr Ribeiro invited us to consider a mixture of different reasons and to consider them together. We can identify four as set out below:

- (a) In the Taxpayer's reply dated 20 January 1993 (page 146 of the Taxpayer's Bundle), the accounting manager of the Taxpayer at point (f) stated that *'We have been approached by the purchasers and the directors are contended that the offer price for the Property was attractive and realised the gain.'* This statement was made in response to the enquiry made by the Revenue in respect of the first three sales. Mr B in his evidence denied it but said that it applied to the sales after the three. He also asked us to take into consideration the next factor.
- (b) In his testimony Mr B emphasized and stressed that the rental market began to show sign of weakness in 1991 and the rental yield was not as what he expected.
- (c) In the reply dated 21 March 1994 by Company H on behalf of the Taxpayer to the Commissioner's enquiry the reason given was: *'The disposal is because the company needs the money for the working capital to finance the daily operation.'*
- (d) Mr B was very frustrated by the rapid turnover of his working staff.

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We have been invited by Mr Ribeiro to look at all the reasons together and form our view which we agree so to do but this does not bar us from examining each reason and evaluating it on individual basis before we take the amalgamated effect.

XXI. Attractive Selling Price

33. Mr B in his evidence informed us that the rapid increase in property price was '*not just a one-time increase*' but '*a continual one*'. Mr B showed us an extract from the Hong Kong Property Review indicating the price index for Grade B offices in support of his observation: the rise from 96 in 1990, to 104 in 1991, to 144 in 1992, to 171 in 1993 and 241 in 1994. In Exhibit A-26 the Taxpayer's sales in 1990 had an average profit margin of 23%, in 1991 that of 35% and in 1992 that of 57%. One point that parties have not taken into consideration is that 80% of the purchase price was from bank loan. The real capital outlay by the Taxpayer, as we surmise from the different accounts, was much, much lower. The real attractiveness of the price was that the Taxpayer could make a profit at a rate of more than 100% of his investment in the project. Such profits were difficult to resist by any investor. We do not understand why this point was not brought to light. The weakness of this argument is that such size of profits within such short period of time creates an impression that the Property was acquired for speculation.

XXII. The Rental Market

34. The other reason for the sale was that as Mr B put it '*I was not able to enjoy as much rent increase as I wished for or anticipated.*' He told us that at the time of acquisition he contemplated that he could have an overall increase of total income by 35%. He could achieve this at the beginning. He showed us that shortly after the purchase he could increase the rent of some of the units by 100% as set out in Exhibit 'A-15C' of the Taxpayer's Bundle. After the first round of increase the rental market showed signs of weakness. When it came to 1991, the rental market had gone steady and weakened. Mr B gave examples by telling us in his testimony different individual cases where rent was reduced. The Board found it unnecessary as the list had clearly set out the position. In the list we found five cases of rental reduction; nine cases without rental increases upon renewal; and nineteen cases of increases, of which only seven were made after 1 January 1991 with moderate increases. There were vacant units and units occupied by the Taxpayer's associate companies which have not been included in the above. The above analysis at least shows that there were ups and downs during the period. If the Property were to be taken as a long-term investment this trend should be accepted: one looks for steady return and not for quick profit. As a long-term investor he should have long-term planning to fact the change in market trend. We are a bit surprised that Mr B had not taken this into consideration. As he had no confidence in investment in office premises and decided to sell, we are also surprised to learn that after or in the course of the sale of the Property he acquired the whole floor of Building I for office use in District J and two properties at District K for office and commercial redevelopment. He also claimed that he purchased these office accommodations for long-term investment.

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XXIII. Staff Turnover

35. Another reason for sale was as stated in paragraph 27 of his main statement: *'The frequent departures of responsible staff ... had caused disruptions to the rental operations in respect of the Property. For good management, there had to be well trained staff and continuity of relationship between staff and the tenants. Also, sometimes due to lack of senior supervision and inexperience of new staff, the Company failed to eliminate mistakes in its record.'* He went on to give eight examples by producing eight letters of termination relating to certain senior posts as set out in Exhibit 'A-20'. We doubt whether these were good examples. We were not told the size of his organization and how many employees it had. Neither were we informed what was the turnover rate. The examples do not show the size of the problem: the eight examples cover seven different posts and spread over a period of nearly five years. This is nothing unusual within the context of Hong Kong commercial world. By that time Mr B had been in Hong Kong for over ten years and should have anticipated this. As an example of the undesired consequence for the frequent staff turnover, he described it as a mistake of his staff that the gains from long term investment were included as trading profits for tax. We were not given the circumstances how this *'mistake'* had been made and how long this particular staff had worked for the Taxpayer. The undisputed fact is that the accounts had gone through proper audit by an independent auditor. We would also like to point out that in his evidence Mr B told us that he resolved to sell the Property in early 1991 when the rental market showed signs of weakness but none of the examples of the termination fell within that period and the first example of termination occurred on 4 September 1991.

XXIV. Continue Letting

36. The Taxpayer argued that the Taxpayer continued to let out the Property whenever there were vacant units or when the tenancies came up for renewal. This, the Taxpayer maintained, could be used as an indication of the Taxpayer's intention to hold the Property as long-term investment. We find that this is a neutral factor. The Taxpayer relied its argument on an assumption that vacant office units had a more ready market and could ask for higher price. We have no evidence to support this assumption.

XXV. The Theory

37. Mr B claimed that he relied on one underlying theory: the rent and value of property should rise and fall together. In re-examination and in response to the question by Mr Ribeiro, he expressly propounded this theory: *'... in any market usually rents and value goes hand in hand ...'* At the time of acquisition of the Property he found that the property price was low but he firmly believed that the rent would rise. He was proven to be right. After acquisition he could secure more than 100% increase in some cases. The Government statistics also support his observation. For the period after 1990, he described the situation as follows: *'... in that particular year the astonishing part is the rents fall but value rises.'* First, we wish to clarify for Mr B that he did not mean what he said by *'the rents fall'*. In other parts of his testimony he clearly and vehemently deny that in 1991 the rental market was falling but *'softening'*. The point we would like to raise is if he were a real believer of

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his own theory, he would have expected this would happen. When the rent rises the price will follow that the rent and price go hand in hand in that way. Over a long period of time his theory is true. For any real investor one would expect this to happen: we doubt whether Mr B had carefully thought through the whole investment strategy before he committed to purchase the Property if the Property were to be held for long-term investment.

XXVI. Long-term Investment

38. Mr B's view on long-term investment in respect of the Property can be found in his response to Mr Lancaster's questions as follows:

- (a) *'I would look at it as long-term investment subject to a 35% increase.'*
- (b) *'My long-term theory is five to ten years.'*

We have to analyse why he put two qualifications to long-term investment: (a) there must be a 35% increase in rent and (b) the period is about five to ten years. Usually when one plans for long term one never thinks of selling whether it is for five, ten or twenty years, and does not qualify it. However, we have to consider the manner he was asked and we must acknowledge that it was an arbitrary figure he gave for the sake of answering Mr Lancaster's question. But, the other qualification is very difficult for us to understand. He aimed at an overall 35% increase in rent; he was very confident he could achieve it when he acquired the Property. In fact he had very good beginning. But he did not explain to us the qualification further: does it mean he wanted to have a yearly increase of 35%? In Exhibit 'A-25' we have been given some calculation from October 1989 to December 1990 which shows that it could not achieve his projected income. Does it mean that he just gave up the long-term investment plan when he could not achieve the overall 35% increase, and he did not want to wait and see for one or more years? If one had this set of mind, we could hardly consider this as long term investment. It is more like gamble – a speculation on whether he could achieve 35% increase which, we hasten to add, was not a modest increase, and if he could not achieve it he would drop it.

XXVII. The Conclusion

39. The Taxpayer has produced to us several pieces of evidence like the change of name and the resolutions to show that the original intention was for long-term investment. We do not want to brush them aside as Mr Lancaster suggested to us on the ground that they were self-serving. This suggestion is too hasty for us to accept. The Taxpayer never denied that the lack of operating capital was one of the reasons for sale of the Property. He argued that the sales were to reduce its indebtedness. We have pointed out the weakness of this argument. Having considered and analysed all the evidence and having had the opportunity of hearing the testimony of Mr B and seeing his demeanour we are not convinced, even when we take all reasons together, that the Taxpayer had good reason for sale of the Property if it were to be held as capital asset. We also find that the type of bank loan arranged was not the one for long-term investment although we accept that this was the best he could obtain at that time. Having evaluated all the evidence before us we do not believe

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that the Taxpayer had '*genuinely held, realistic and realisable*' intention to hold the Property as long-term investment.

XXVIII. Decision

40. For reasons given above we find that the Taxpayer has failed to discharge its duty of proof and accordingly we dismiss the appeal and uphold the determination by Mr Wong Ho-sang, the Commissioner made on 14 July 1997.