

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D83/99

Profits Tax – sale of property – change of the intention of purchase – whether audited accounts truly reflect the state of affairs of the company concerned – urgency in the preparation of the account – lack of contemporaneous document to support.

Panel: Ronny Wong Fook Hum SC (chairman), Roger Leung Wai Man and Paul Ng Kam Yuen.

Dates of hearing: 5 July, 6 and 21 September 1999.

Date of decision: 27 October 1999.

The taxpayer is a private company carrying on property trading and investment. The taxpayer purchased the Subject Property on 29 December 1990. The Subject Property was classified as stock-in-trade in the financial statement of the taxpayer by the year ended 31 March 1991. However in the financial statement of the taxpayer by the year ended 31 March 1993, the Subject Property was reclassified as fixed asset.

The taxpayer sold the Subject Property on 30 January 1995. In response to the enquiries from the Revenue, the taxpayer informed the Revenue that the taxpayer's intention in purchasing the Subject Property is long term investment purpose and the reason for leading to sale was to finance funds for certain overseas projects. The taxpayer further explained that the taxpayer was not aware of the classification of the Subject Property as trading stock in the audited account by the year ended 31 March 1991 and such classification as trading stock was merely a clerical mistake by the company in preparation of the audited account in the year ended 31 March 1992.

Held:

- (1) The Revenue is entitled to expect audited accounts prepared by professionals to truly reflect the state of affairs of the company concerned. No auditor should put forward financial statements as setting forth 'a true and correct view of the state of affairs' of a company unless the auditor concerned and received full explanations from that company. The Board did not accept his case of urgency of the taxpayer in the preparation of the accounts.
- (2) There is no contemporaneous document to suggest that the taxpayer had segregated the Subject Property from its trading portfolio. The Board found no evidence to support the belated assertions of the taxpayer. Besides given the taxpayer's extensive

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trading, the magnitude of the facility and the readiness of the bank to consider finance for the project, the Board was not persuaded that the taxpayer would have difficulty in funding the overseas projects without recourse to the Subject Property. The Board therefore found that the taxpayer failed to discharge its onus of proof.

Appeal dismissed.

Tse Yuk Yip for the Commissioner of Inland Revenue.

Ho Chi Ming instructed by Ho, Wong & Wong, Solicitors & Notaries for the taxpayer.

Decision:

The Taxpayer and its associates

1. The Taxpayer is a private company incorporated in Hong Kong on 7 June 1988. On 11 July 1988, Mr A and Mr B were appointed directors of the Taxpayer. On the same day, Mr B and Mr C were each allotted 5,000 shares of \$1 each in the share capital of the Taxpayer. Mr A allegedly resigned as director of the Taxpayer with effect from 31 January 1991. This has not been reflected in the financial statements of the Taxpayer for the years ended 31 March 1991 or 31 March 1992.
2. On 18 January 1989, Mr D was also appointed a director of the Taxpayer. On the same day, 290,000 shares in the Taxpayer were allotted in Mr D's favour.
3. Mr D is the husband of Ms E ['Mrs D']. They were married in China on 13 January 1984. Ms F is the sister of Mrs D. According to Mr D, the allotment of shares in the Taxpayer and his appointment as a director of the Taxpayer were steps taken to facilitate his application for entry into Hong Kong via a foreign country. In relation to his directorship with the Taxpayer, he is the nominee of Ms F. In relation to his shareholding in the Taxpayer, he holds the 290,000 shares registered in his name in favour of Mr B and Ms F on an equal basis.
4. On 21 January 1984, Ms F registered an estate agent business in the name of Company G.
5. Company H is another private company incorporated in Hong Kong on 24 September 1985. According to its return made up to 24 September 1995, its issued share capital consisted of 2 shares of \$1 each registered in the respective names of Mr B and Ms F. Mr B and Ms F were also directors of Company H.

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Property dealings of the Taxpayer

6. Between its commencement of business and 31 March 1992, the Taxpayer dealt with the following pieces of property:

Property No.	Purchase		Sale		Remarks
	Date	Price \$	Date	Price \$	
1	22-2-1989	522,500	29-3-1989	630,000	
2	22-3-1989	1,300,000	25-4-1989	1,400,000	
3	8-7-1989	250,000	31-8-1989	340,000	
4	27-10-1989	110,000	30-12-1989	320,000	
5	29-12-1989	335,000	2-5-1990	580,000	
6	30-12-1989	248,000	21-6-1990	350,000	
7	30-12-1989	240,000	12-3-1990	295,000	
8	30-12-1989	225,000	22-2-1990	285,000	
9	30-12-1989	248,000	21-6-1990	350,000	
10	30-12-1989	243,000	25-6-1990	468,000	
11	25-3-1990	483,000	15-8-1991	700,000	
12	25-3-1990	483,000	19-6-1990	560,000	
13	25-3-1990	483,000	13-11-1991	865,000	
14	25-3-1990	483,000	9-7-1990	580,000	
15	25-3-1990	483,000	14-11-1990	758,000	
16	25-3-1990	483,000	24-4-1991	760,000	
17	25-3-1990	483,000	15-3-1991	780,000	
18	25-3-1990	483,000	15-7-1991	800,000	
19	25-3-1990	483,000	25-1-1991	620,000	
20	25-3-1990	483,000	14-8-1990	780,000	
21	25-3-1990	483,000	2-1-1991	730,000	
22	25-3-1990	483,000	12-2-1991	650,000	
23	25-3-1990	483,000	14-1-1991	800,000	
24	25-3-1990	483,000	20-9-1990	800,000	
25	2-4-1990	540,000	10-5-1990	540,000	
26	3-4-1990	1,280,000	29-5-1990	1,400,000	
27	21-6-1990	300,000	19-7-1997 to an associated company Sale blocked by Revenue's charging order	1,000,000	Alleged to have been acquired as long term investment
28	10-7-1990	500,000	11-1-1991	800,000	
29	17-7-1990	488,000	27-10-1990	830,000	
30	21-7-1990	300,000	7-9-1990	450,000	

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31	2-8-1990	480,000	6-8-1990	580,000	
32	24-9-1990	740,000	16-4-1991	810,000	
33	15-10-1990	520,000	28-2-1991	735,000	
34	2-11-1990	312,000	9-1-1991	360,000	
35	28-2-1991	345,000	25-7-1991	485,000	
36	2-4-1991	290,000	20-5-1991	430,000	
37	31-5-1991	500,000	12-11-1991	498,000	Alleged to have been acquired as long term investment
38 [' Subject Property']	29-12-1990 [Date of agreement] 24-6-1991 [Date of assignment]	5,300,000	29-3-1995	13,800,000	Alleged to have been acquired as long term investment
39	18-7-1991	440,000	29-8-1991	530,000	
40	8-8-1991	360,000	16-9-1991	525,000	
41	8-8-1991	375,000	16-3-1992	718,000	
42	8-8-1991	245,000	1-10-1991	418,000	
43	30-10-1991	2,000,000	18-7-1997 to Company H Sale blocked by Revenue' s charging order	4,000,000	Alleged to have been acquired as long term investment

Property 38 in District I [' The Subject Property']

7. By an agreement for sale and purchase dated 29 December 1990, the Taxpayer purchased Property 38 [' the Subject Property'] for \$5,300,000.

8. The purchase was financed in part by facilities extended by Bank J. Those facilities consisted of an overdraft of \$1,700,000 and a bank loan of \$2,000,000 repayable by 84 equal monthly instalments of \$34,509 each. The following amounts were repaid to Bank J:

Period	Amount repaid \$	Remarks
21-6-1991 to 21-3-1992	166,482.78	
21-4-1992 to 21-3-1993	228,030.06	
21-4-1993 to 21-3-1994	271,358.86	
21-4-1994 to 21-3-1995	1,334,128.30	Inclusive of \$988,658.21 for redemption of loan on 21

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		March 1995
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The financial statements of the Taxpayer and the alleged manner whereby Alan Chan & Co prepared the financial statements of the Taxpayer

9. The financial statements of the Taxpayer for the relevant periods indicate the following :

Period	Auditor	Approval by directors	Authorised and issued share capital	Principal activity of the Taxpayer	Remarks
7-6-1988 to 31-3-1989	Lau, Cheung, Fung & Chan	Mr A and Mr B on 1-3-1990	300,000 shares of \$1 each	Property trading and investment	
Year ended 31-3-1990	Ditto	Mr B and Mr D on 7-3-1991	Ditto	Ditto	
Year ended 31-3-1991	Alan Chan & Co	Mr B on 18-5-1994	Ditto	Ditto	The Subject Property was classified as stock-in-trade. ' Stock consists of properties held for disposal' .
Year ended 31-3-1993	Ditto	Mr D on 15-11-1994	Ditto	Property investment	The Subject Property together with Properties 27, 37 & 43 in paragraph 6 above were reclassified as fixed assets.
Year ended 31-3-1994	Ditto	Mr D on 15-11-1994	Ditto	Ditto	
Year ended 31-3-1995	Ditto	Mr D on 25-5-1995	Ditto	Ditto	
Year ended 31-3-1996	T M Ho, H C So & Co	Mr B on 15-5-1998	Ditto		

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10. Alan Chan & Co was engaged as the Taxpayer's auditor in April 1994. Mr Yu Man Wai was then the audit manager of Alan Chan & Co.

11. The first set of account of the Taxpayer dealt with by Alan Chan & Co was for the year ended 31 March 1992. No time costs records of that firm for the audit of this set of accounts was produced before us. The accounts were approved by Mr B on 18 May 1994.

12. According to the time costs records of Alan Chan & Co for audit of the Taxpayer's accounts for the years ended 31 March 1993 and 31 March 1994, Mr Yu Man Wai had a 2-hour meeting with his firm's client on 11 October 1994. On 29 and 31 October 1994, he spent respectively 3 and 2 hours reviewing the audits by his firm. Mr D of the Taxpayer approved those accounts on 15 November 1994.

13. According to the time cost records of Alan Chan & Co for audit of the Taxpayer's accounts for the year ended 31 March 1995, Mr Yu Man Wai had a 2-hour meeting with Mr B on 28 April 1995. Mr Yu Man Wai spent 3 hours on 16 May 1995 reviewing the audit by his firm. Mr D of the Taxpayer approved those accounts on 25 May 1995.

The joint venture in Region K, China

14. On 12 October 1994, Mr B and Ms F on behalf of Company L signed an agreement [' the Highway Agreement '] with Company M in relation to the construction of a section of a highway between two regions in Province N, China [' the Highway Project ']. Under the Highway Agreement as amended on 12 March 1998, Company L agreed to contribute within the year US\$3,000,000 for the construction of that section of the highway. Company M agreed to repay within 3 years commencing from full contribution of US\$3,000,000 by Company L.

15. The following remittances were said to have been made by or on behalf of Company L pursuant to the Highway Agreement:

Date	Amount US\$	Source
6-10-1994	200,000	
21-10-1994	150,000	
2-11-1994	200,000	
2-12-1994	200,000	
20-12-1994	350,000	
19-1-1995	130,000	From the personal account of Ms F with Bank O
10-3-1995	800,000	The Taxpayer received \$7,620,000 on 9 March 1995 by way of further deposit on sale of the Subject Property.

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		On 10-3-1995, \$7,200,000 was transferred from the Taxpayer' s account with Bank J into Ms F' s personal account with Bank O. The said personal account of Ms F was debited \$6,188,040 on 10-3-1995 in respect of this remittance.
16-3-1995	930,000	\$7,500,000 transferred from Company H' s account with Bank P to the personal account of Ms F with Bank O [see paragraph 17 below].
20-3-1995	40,000	
	3,000,000	

16. By letter dated 24 January 1995, Bank O indicated to Company L that they approved Company L' s application for a US\$2,500,000 loan in respect of the Highway Project. Bank O further indicated that the application was still being processed.

17. By letter dated 28 February 1995, Bank P confirmed their agreement to grant loan facilities of \$10,000,000 to Company H repayable by 84 monthly instalments of \$179,212.4 [' the Facility']. The Facility was intended to be secured by legal charges over 2 pieces of property in Hong Kong and the unlimited guarantees from Mr B and Ms F. The relevant legal charges were executed by 15 March 1995.

Disposal of the Subject Property

18. Commencing from 1 January 1995, advertisements were placed in the newspapers on the availability of the Subject Property. The telephone number of Company G was given as the contact.

19. By a provisional agreement for sale and purchase dated 30 January 1995, the Subject Property was sold by the Taxpayer in favour of Mr Q and Mr R for \$13,800,000. A deposit of \$1,380,000 was paid on the signing of that agreement. The balance of \$12,420,000 was scheduled to be paid at completion on 28 March 1995. On 9 March 1995 and 29 March 1995, \$7,620,000 and \$4,300,000 said to be the balance due on completion were deposited into the Taxpayer' s account with Bank J.

Correspondence between the Taxpayer and the Revenue

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20. In response to enquiries from the Revenue dated 9 April 1996, the Taxpayer through its then representative Messrs Lui Siu Tang & Co. informed the Revenue on 25 November 1996 that the Taxpayer's 'intention in purchasing [the Subject Property] is long term investment purpose and letting' and 'The reason for leading to sale was to finance funds for certain overseas projects.'

21. On 9 October 1996, Messrs Lui Siu Tang & Co further explained to the Revenue that 'The classification [of the Subject Property] as trading stock was merely a clerical mistake by the company in preparation of the audited account in the year ended 31 March 1992'. Messrs Lui Siu Tang & Co further indicated that 'Later [the Taxpayer] found that the Hong Kong property was abnormally high and thus dispose of for cash for alternative investment opportunities.'

22. Messrs T M Ho, H C So & Co ['Messrs T M Ho'] took over the Taxpayer's tax affairs. In their letter dated 29 October 1997 to the Revenue, Messrs T M Ho informed the Revenue that 'In view of the return from properties the investment was in the acceptable standard, that is, from the year ended 1991 to 1993 the return rate is above 5% of properties' investment, so the company changed its intention to hold the properties for long term investment purpose and to engage in letting.' By further letter dated 15 November 1997, Messrs T M Ho further informed the Revenue that 'The date of change of intention to hold the property in question as a leasehold property for investment purpose was in the year 1992.'

Evidence adduced by the Taxpayer

23. Mr B explained that he and Ms F are equal beneficial owners of the Taxpayer. The Subject Property was introduced to them by an estate agency. They considered the rental income yield and the long term capital appreciation potential of the Subject Property. They decided to purchase the Subject Property as a long term investment for rental income purpose. Apart from the facilities extended by Bank J, he advanced \$1,600,000 to finance the purchase. The monthly rental income at the time of purchase was \$41,599. That was sufficient to cover the monthly instalment of \$34,509 payable to Bank J. In April 1994, estimated additional profits tax assessments for the years of assessment 1990/91 and 1991/92 were issued by the Revenue to the Taxpayer. The Taxpayer must therefore submit audited accounts for the years of assessment 1990/91 and 1991/92 within a very short time in order to validate the objection against such estimated additional assessments. When Mr Yu Man Wai handed him the audited accounts for the years ended 31 March 1991 and 31 March 1992, he did not examine the accounts in detail. He was not aware of the classification of the Subject Property in the accounts. In or about October 1994, when Mr Yu Man Wai prepared the accounts of the Taxpayer for the years ended 31 March 1993 and 31 March 1994, he explained to Mr Yu Man Wai that the Subject Property was purchased as long term investment for rental income purposes. He and Ms F decided to invest in the Highway Project as Ms F's mother is a native of Region K. Although a senior manager of Bank O advised them that finance for the project could be arranged, such finance was not forthcoming. They therefore decided to sell the Subject Property in order to raise finance. The proceeds of sale of the Subject Property were remitted for use in Region K. He denied giving any instruction to Messrs Lui Siu

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Tang & Co to state that the disposal of the Subject Property was attributable to the fact that ‘ the Hong Kong property market was abnormally high’ .

24. Ms F explained that the Taxpayer was managed jointly by Mr B and her. They were forced to sell the Subject Property in order to fund the Highway Project. She pressed Bank O for finalisation of the proposed facility but without avail. She approached Mr R and persuaded him to take the Subject Property at \$13,800,000 with an understanding that the Taxpayer could repurchase the Subject Property at \$15,000,000. She consulted Mr T M Ho when the Revenue sought to tax the Taxpayer for the profit arising from the sale. She explained that the Subject Property was purchased for rental yield. Mr T M Ho noted the reclassification of the Subject Property in the Taxpayer’s accounts for the year ended 31 March 1993 and reckoned this was suggestive of a change of intention on the part of the Taxpayer. Mr T M Ho pointed out that if the Revenue accepted that there was a change of intention, the matter could be settled with the Revenue taxing part of the profits. Ms F discussed the matter with Mr B. ‘ We agreed that a suggestion of change of intention could be an expedient way of settling IRD’s objection.’

25. Mr Yu Man Wai is not professionally qualified as an accountant but had worked in the accountancy field for about 12 years. Mr Yu Man Wai said he was approached by Mr B to take over the audit and tax matters of the Taxpayer in late April 1994. The secretary of Mr B handed him vouchers of the Taxpayer to prepare the final accounts in support of the Taxpayer’s objection to the Revenue’s estimated assessments. The Taxpayer did not have any proper bookkeeping. All the properties of the Taxpayer including the Subject Property were simply designated ‘ property’ in the relevant transfer voucher. As the Taxpayer had previously carried out property trading and the Taxpayer’s previous auditors had classified its properties as stock in trade, he adopted similar classification in the balance sheet for the year ended 31 March 1992. The matter had to be finalised in a hurry. He did not take any proper instructions and Mr B signed the accounts for the years ended 31 March 1991 and 31 March 1992 without proper explanation or inquiries. His firm probably had a standard letter of representation from directors of the Taxpayer. He reclassified the Subject Property as a result of discussion held in October 1994. He prepared the letter of 9 October 1997. He asserted that ‘ Later the company found that the Hong Kong property market was abnormally high and thus dispose of for cash for alternative investment opportunities’ without instruction from the Taxpayer. He was not in Hong Kong when the letter was issued by Mr Lui Siu Tang of Messrs Lui Siu Tang & Co.

26. Mr T M Ho said he noticed the reclassification of the Subject Property under ‘ fixed asset’ in the balance sheet as at 31 March 1993 and the accounts appeared to suggest a change of intention. Although Ms F stated that the original intention in relation to the Subject Property was for rental purpose, they decided to assert a change of intention with the view of settling the matter with the Revenue.

Our decision

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27. We find the evidence of Mr Yu Man Wai disturbing and unsatisfactory. The Revenue is entitled to expect audited accounts prepared by professionals to truly reflect the state of affairs of the company concerned. No auditor should put forward financial statements as setting forth ‘ a true and correct view of the state of affairs’ of a company unless the auditor concerned had received full explanations from that company. In essence, Mr Yu Man Wai’s evidence and the Taxpayer’s case is that it was expedient to put forward the accounts of 31 March 1991 and 31 March 1992 and the letter of 9 October 1992. It is no longer expedient to maintain these contentions when the profits of the Subject Property are at stake. Mr Yu Man Wai did not produce any time cost records pertaining to the preparation of the accounts for the years ended 31 March 1991 and 31 March 1992. We do not accept his case of urgency. We attach no weight to the evidence of Mr Yu Man Wai who, on his own admissions, has no past affiliation to the truth.

28. We are prepared to accept the evidence of Mr T M Ho in relation to his advice but are of the view that his evidence does little to advance the Taxpayer’s case. The Taxpayer’s alleged intention to settle with the Revenue by adopting the stance of change of intention had never been communicated to the Revenue. If Mr B and Ms F genuinely maintained that the Subject Property was purchased by way of long term investment, there is no reason for them not to say so. Mr B signed the relevant financial statements of the Taxpayer. The Taxpayer was sent copies of the correspondence between its account and the Revenue. Mr B and Ms F are businessman/woman of some sophistication. Their previous failure in asserting the truth does not enhance their credibility.

29. What we have to ascertain is the Taxpayer’s intention as at 29 December 1990. We are of the view that we should place little reliance on the Taxpayer’s assertions but should home in on the objective facts around the period. By that date, the Taxpayer had a long history of property trading – 33 properties in all apart from the unit in Street S. 2 sites in particular (2 numbers in Street T & 2 numbers in Street U) were targeted as part of its trading activities. Such trading activities continued after acquisition of the Subject Property. Whilst we accept that the Subject Property is unique in the sense that it comprised of all the units at Property 38 in District I, there is no contemporaneous document to suggest that the Taxpayer had in any way segregated the Subject Property from its trading portfolio. We can find no evidence to support the belated assertions of Mr B and Ms F that they purchased the Subject Property for long term investment.

30. We also view with reservation the alleged pressure to sell arising from the Highway Project. The project stemmed from the sentimental association between the mother of Ms F and Region K. The Subject Property was first placed in the market on 1 January 1995 whilst negotiations with Bank O were still on foot. The letter from Bank O dated 24 January 1995 recorded an agreement to extend a US \$2,500,000 facility. This sequence of events is indicative of the fact that the Subject Property was placed on the market in view of its profit potential. Only 50% of the proceeds from sale of the Subject Property was used towards the Highway Project. This represents about 26% of Company L’s total investment. We have no evidence as to the assets at the disposal of Company L, Mr B, Ms F and Company H. Given their extensive property

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trading; the magnitude of the Facility and the readiness of Bank O to consider finance for the project, we are not persuaded that Mr B and Ms F would have difficulty in funding the Highway Project without recourse to the Subject Property.

31. For these reasons, we hold that the Taxpayer failed to discharge its onus of proof. We dismiss the Taxpayer's appeal.

Documentation in this case

32. This case is complicated. We are not assisted by the manner whereby voluminous documents were placed before us.

33. Parties should in future consider application for pre-hearing directions so as to ensure efficient presentation of the issues before this Board.