INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D8/94

Profits tax – restaurant business – purchase of premises used for restaurant business by separate company – whether gain on subsequent sale of property subject to profits tax.

Panel: William Turnbull (chairman), Stephen Lau Man Lung and Nigel A Rigg.

Date of hearing: 24, 25 November and 1 December 1993.
Date of decision: 3 May 1994

The taxpayer was a private limited company which owned shares in another company (Company A) which carried on a restaurant business. Company A carried on its business in leased premises. Company A encountered difficulty with the relevant licensing authority because the premises were unsuitable. Company A was suffering financial losses in its restaurant business. The persons having ownership and control of both the taxpayer and Company A decided to sell a controlling interest in Company A and at the same time to acquire the premises being used by Company A for its restaurant business. All of the shares in Company A owned by the taxpayer were sold and the taxpayer acquired the premises. Subsequently the taxpayer sold the premises to an unrelated party at a substantial profit. The taxpayer submitted that the acquisition of the premises was a long term investment to assist Company A in running its restaurant business.

Held:

The acquisition by the taxpayer of the premises was a property trading transaction. The taxpayer acquired the premises with a view to making a profit on resale. Accordingly when the premises were resold by the taxpayer the profit was subject to profits tax.

Appeal dismissed.

Cases referred to:

Simmons v IRC 53 TC 461
Hillerns and Fowler v Murray 17 TC 77

Yim Kwok Cheong for the Commissioner of Inland Revenue.
Benjamin Chain instructed by Messrs George Y C Mok & Co for the taxpayer.

Decision:

This is an appeal by a taxpayer against a determination of the Commissioner in which he has decided that the gain or profit arising from the disposal of certain property is subject to profits tax. The facts of the case are as follows:

1. The Taxpayer is a private limited company incorporated in Hong Kong in early 1981.

2. The Taxpayer was owned and controlled by Mr T and members of his family. Mr T was the managing director of the Taxpayer and was responsible for making decisions with regard to the policy and business of the Taxpayer. He was assisted by his sons and in particular his eldest son and a younger son.

3. A former employee of Mr T, namely Mr L, established a restaurant in Kowloon. Mr L was indebted to Mr T in the sum of $500,000 and it was agreed that Mr L would give to Mr T a 25% shareholding in the company which owned the restaurant in satisfaction of the debt of $500,000. For convenience we will refer to the company which owned and operated the restaurant as Company A. Subsequently Mr T decided to acquire further shares in Company A and eventually acquired 100% of the ownership of Company A. He decided that he would not own all of the shares himself and that the Taxpayer would own 50% thereof with the remaining 50% being owned by himself and other members of his family. The initial 25% of the shares in Company A were acquired in 1982 and by April 1983 the Taxpayer, Mr T, and the other members of his family had acquired 100% of the ownership and control of Company A.

4. Company A carried on its restaurant business in five units of a commercial building. One unit was used as an office and for administration, two units were licensed by the Urban Council for use as a restaurant and two units were licensed or permitted to be used for entertainment purposes in association with the restaurant.

5. Another company owned and controlled by Mr L was the owner of the five units used and occupied by Company A for its restaurant business.

6. In April 1983 it was agreed that Company A would enter into a long lease or tenancy with the landlord of the five units. A lease dated in April 1983 was executed between the landlord and Company A. Mr T and one of his sons signed the lease on behalf of Company A and Mr L signed the lease on behalf of the landlord. The lease was for a period of 8 years expiring on 31 March 1991 at a monthly rent of $125,000 for the first period of 5 years and thereafter $162,000 for the remainder of the 8-year period.

7. The eldest son of Mr T was interested in restaurant business and was responsible for running the restaurant business of Company A.

8. Application was made on 16 May 1983 to the Urban Council for a restaurant licence to be granted in respect of the two units which were used as premises for

entertainment. This would legalise what in fact was already being done namely to run all four units as a fully licensed restaurant. An architect had been employed and plans were submitted to the Urban Council. The same were rejected for a number of reasons but in particular because there was not an adequate fire exit for the two additional units if used as part of Company A. There was lengthy correspondence between Company A and the Urban Council and various proposals were put forward but it was impossible to meet with the fire exit requirement because it required direct access from the restaurant premises to the ground floor or street level. This obviously could not be achieved by Company A whose premises were situated in the commercial building. By 1987 the position was becoming critical so far as the restaurant business was concerned because it was known to the Urban Council that Company A was illegally carrying on a restaurant business in the two units licensed as premises for entertainment. The Urban Council instituted a number of prosecutions against the licence holder of Company A who at that time was the younger son of Mr T. The Urban Council gave notice to Company A that they must either use the two units in question as premises for entertainment or the restaurant licence for the other two licensed units would be withdrawn. In view of this it was decided that Company A would withdraw its application to have the two units licensed as a restaurant and by letter dated 27 April 1987 Company A formally withdrew the application which it had made to obtain a restaurant licence for the two additional units.

9. Company A continued to operate its restaurant business in the five units which it had leased until the end of the lease on 31 March 1991. Company A could carry on its restaurant business with or without the restaurant licence for the two additional units the main difference being that it was not able to host large banquets. No satisfactory explanation was given to the Board of Review as to the difference between a company licensed to carry on a restaurant business in two units and unlawfully carrying on business in the other two units which had a pending application for a restaurant licence and a similar restaurant business which did not have a pending application for a licence. It would appear that the same business was conducted both before and after the withdrawal of the licence application.

10. Some time during 1985 the eldest son of Mr T emigrated to Country C and the younger son became responsible for the operation of Company A. The eldest son had been actively interested in the restaurant business and had spent a considerable amount of his time in relation thereto. The younger son was not so interested in restaurant business and spent less of his time with regard thereto.

11. In 1986 the company owned by Mr L which owned the five units had financial difficulties and the bank to which the five units were mortgaged forced the sale of the same. A number of prospective purchasers visited the premises. The bank and/or Mr L then contacted Mr T to see if he or the sitting tenant would be prepared to purchase the premises. A price of $11,000,000 was negotiated and Mr T decided that another company of his, namely the Taxpayer, would acquire the five units subject to the existing lease in favour of Company A which was owned by himself, his family, and the Taxpayer. It was considered by the Taxpayer that the agreed purchase price was an attractive price at that time. By an assignment dated 15 August 1986 the Taxpayer acquired the five units at the price of

$11,000,000. Mr T considered that the purchase was attractive because the instalments which would have to be paid to the bank which was financing the purchase was not much more than the rent which was being paid by Company A. As he, his family, and the Taxpayer owned Company A he considered that the rent would be duly paid.

12. Simultaneously with the negotiations for the acquisition of the five units by the Taxpayer, Mr T was actively negotiating with one or more of his friends to sell a controlling interest in Company A. He was successful in so doing and by an agreement dated 22 August 1986 made between the Taxpayer and Company B it was agreed that 60% of the issued share capital of Company A would be sold to Company B. Company B was a company owned and controlled by a group of individuals who were friends of Mr T or friends of each other. Mr T had no interest in Company B. Under the agreement Mr T and his family gave up control of Company A but remained 40% shareholders therein and directors thereof. All of the shares belonging to the Taxpayer were sold to Company B and thereafter the Taxpayer ceased to have any shareholding in Company A.

13. When Mr T acquired the initial 25% interest in Company A an up to the time of his selling a controlling interest in Company A, it was operating at a significant loss and had actually lost all of its paid up capital of $2,000,000 and was showing a net deficit. When Company B acquired control of Company A it was arranged that a Mr K, who was the motivator behind Company B, would take over the management of the restaurant and that he would introduce a team of persons who would be able to run, operate and manage the business efficiently. With effect from the financial year ending 31 March 1988 Company A began to make substantial profits.

14. By an agreement in May 1988 the Taxpayer sold the five units to an unrelated third party for a consideration of $22,300,000. The proceeds of sale were used by the Taxpayer to pay off the balance of the bank mortgage, to make advances to an associated company (fact 17 below) to purchase two shops in Place A (fact 19 below), and to place money on deposit with the bank in foreign currencies (fact 21 below).

15. The main business of Mr T and his family was operating Factory A in the New Territories. Factory A comprised a number of buildings with a gross floor area of approximately 60,000 square feet. Factory A had been operated for very many years on a site which was low lying and subject to flooding. The problem regarding flooding was resolved by installing flood gates and pumps. In 1988 Mr T decided to enter into a joint venture to transfer Factory A to Country B and in 1989 a new factory of the same field as that of Factory A was constructed in Country B. The old premises in Hong Kong which had been used for the manufacture of Product A was then used as warehouse, administration, and showrooms.

16. Mr T and/or his family and/or companies owned and controlled by them owned many pieces of land in the New Territories and Mr T and his family were very conversant with land transaction in the New Territories.

17. In 1987 Mr T became aware of a large piece of land in the New Territories comprising 260,000 square feet which had previously been used for recreational purposes. He acquired the same in the name of another of his companies, Company O at a price of approximately $10,000,000. In order to help to finance this acquisition he arranged for the five units then owned by the Taxpayer and occupied by Company A to be re-mortgaged to another bank. By paying off the then existing mortgage and re-mortgaging the premises the Taxpayer was able to raise an additional $3,000,000 which it on lent to Company O. When the Taxpayer sold the five units it repaid the existing mortgage and out of the surplus funds available lent further sums of money to Company O totalling about $3,000,000. The purpose of these additional advances was to enable Company O to improve the land which it had purchased.

18. The reasons given by Mr T for purchasing the site of 260,000 square feet was that it might be possible to use it to relocate Factory A, might be able to be used for parking purposes, might be able to be used for residential development or might be able to be used for storage purposes. In the event Mr T decided that Company O should enter into a joint venture with another company to build a warehouse or godown on the site for storage purposes.

19. Shortly after the Taxpayer had sold the five units it purchased two shop units in a new building in the New Territories. The Taxpayer used bank finance to finance the purchase of the same. One unit was sold at a substantial profit within 12 months of the purchase of the same. The second unit was retained for rental purposes by the Taxpayer.

20. The Taxpayer acquired two residential units in a large residential development in the New Territories shortly after disposing of the five units. The reasons stated to the Board was that they were purchased to be homes for two of the sons of Mr T who were getting married or who it was expected would be married. However in reality both homes were sold shortly after acquisition, also at a profit.

21. The majority of the net proceeds of sale of the five units was placed on deposit in foreign currencies by the Taxpayer at attractive rates of interest.

22. In default of receiving the profits tax return for the year of assessment 1988/89 from the Taxpayer, the assessor raised on the Taxpayer an estimated assessment with estimated profits of $510,000.

23. The Taxpayer lodged an objection against this estimated assessment and filed its profits tax return together with supporting accounts. The accounts showed that the Taxpayer had made a gain on the disposal of the five units of $12,978,850 which the Taxpayer claimed was a capital gain.

24. The assessor did not accept that the gain on the disposal of the five units was a capital gain and informed the company that he proposed to assess the same to profits tax. In due course the matter was referred to the Commissioner of Inland Revenue.

25. By his determination dated 8 March 1993 the Commissioner of Inland Revenue decided against the Taxpayer and directed that the estimated assessment against which the Taxpayer had objected in the sum of $510,000 should be increased to assessable profits of $11,064,199 with tax payable thereon of $1,880,913.

26. By notice dated 30 March 1993 notice of appeal against the determination of the Commissioner was duly given on behalf of the Taxpayer to the Board of Review.

The Taxpayer was represented by Counsel and three witnesses were called to give evidence namely Mr T himself, the younger son of Mr T, and a so called property valuation expert. As the expert had only been instructed in the middle of the proceedings and had clearly not prepared a proper valuation we disregard what he said and the valuation which was tabled before the Board.

With regard to the evidence of Mr T and his son we have set out in the facts above those parts of the evidence which we accept. Those parts of the evidence which we have not set out above are not accepted by us as being correct and the matters which we consider to be of importance are the subject of comment later in this decision.

Counsel correctly submitted that it is the intention of the Taxpayer at the time when it acquired the five units which is all important. It was common ground between the Taxpayer and the Commissioner that the subjective intention of the Taxpayer at that time must be tested against the objective facts. The representative for the Commissioner referred us to the two cases of Simmon v IRC 53 TC 461 and Hillerns and Fowler v Murray 17 TC 77 in support of this proposition. It is so well known and was accepted by both of the parties so that it is not necessary for us to deal with it further in this decision.

Counsel for the Taxpayer having placed before us the evidence on behalf of his client took us through the same. His case was to the effect that the Taxpayer had purchased the five units because there was a forced sale at the time and prospective purchasers visiting the restaurant premises were having an adverse effect on the morale of the employees who were not sure as to whether or not there would be a change of management in the restaurant and had difficulty in differentiating between the landlord selling the premises and the owners of the business selling the business. He said that Mr T was very interested in the restaurant business as a long-term investment and he wanted to secure the tenure of the premises not only during the current period of eight years but thereafter.

Counsel for the Taxpayer submitted that a principal reason for purchasing the premises was the adverse effect that prospective purchasers were having on the morale of the staff. With due respect we do not accept this submission. On the facts before us it was more material that Mr T was then negotiating for the sale of a controlling interest in Company A. We further note that Company A had been losing money throughout the period that Mr T had owned shares in Company A up to the time when he sold a controlling interest. It was then that the restaurant company started making profits.

Counsel for the Taxpayer went on to say that there were three matters which contributed to the decision by the Taxpayer to sell the five units; that an unsolicited good offer was received, that Mr T required money elsewhere, and that the application to obtain a full restaurant licence for two of the units had failed. We accept that a good unsolicited offer was received for the five units. However we do not accept that the units were sold because Mr T required money elsewhere nor that the units were sold because of the failure to obtain a full restaurant licence in respect thereof.

The representative for the Commissioner likewise took us through the relevant facts and highlighted a number of matters.

He pointed out that at the time when the five units were being purchased the Taxpayer was negotiating and selling all of its shares in the restaurant business. He pointed out that the Taxpayer had written down the value of the shares which it owned in Company A to nil because of the losses being made by Company A. He pointed out that the five units had been sold after a comparatively short period of ownership of about two years. He submitted that it was not correct to allege that prospective purchasers visiting the restaurant premises were having an adverse effect on the restaurant business.

The representative for the Commissioner went on to reject the submission that the refusal by the authorities to grant a restaurant licence to the two units concerned had caused the Taxpayer to sell the units. He then referred to the application of the sales proceeds and submitted that Mr T had no pressing need for the money.

It is well known and accepted by the parties that the function of this Board is to ascertain the intention of the Taxpayer at the time when it acquired the five units. The subjective intention of the Taxpayer must be tested against the objective facts to find out what was the true intention of the Taxpayer at the relevant time. The authority for this law is contained in the two cases cited to us by the representative for the Commissioner which we have mentioned above.

Mr T appeared before us and gave evidence and was cross examined. The younger son also appeared before us and gave evidence. The younger son had become involved with the Taxpayer and Company A in 1985 and was accordingly able to speak to events both when the Taxpayer acquired the five units and when the same were sold. He was also involved with the business of Factory A operated by Mr T. Counsel for the Taxpayer said that the younger son was more able to deal with detailed matters such as accounts than his father and we accept that this was the case.

We found the evidence of both Mr T and the younger son to be only partially correct. We are not able to accept the evidence which they gave with regard to their intentions in relation to various matters and in particular with regard to the five units. They both said that it was the intention of the Taxpayer to acquire the five units as long-term capital investments for rental purposes. Unfortunately for the Taxpayer we are unable to accept that this was the true intention of the Taxpayer at the relevant time. Both Mr T and the younger son wanted us to connect the purchase of the five units very closely with

Company A and its business. However at most we can only say that perhaps this had some possible effect upon the decision to purchase the five units but it was a very secondary reason if it existed at all. The real reason as we see it after we heard the evidence and reviewed the documents before us was a simple matter of buying a property at a good price and selling it for a very substantial profit shortly afterwards.

No doubt if Mr T had not known Mr L and if he and his family had not owned Company A they would not have purchased the five units. Because they owned Company A they were in a very favourable position to negotiate a good price from the bank and/or Mr L. They effectively owned the long-term lease on the premises. Apparently a number of people had visited the premises as potential purchasers but it had not been possible to sell the premises. It was the bank or Mr L who approached Mr T to see if as sitting tenants they would be interested in acquiring the five units.

In the evidence given before us it was said that it is common practice for the owner of a restaurant to own the premises in which the business is carried on. The reason given was because this would stop the landlord from imposing a large rental increase upon the tenant. This logic may or may not be true but it likewise applies to all other businesses and not just restaurants. All successful shopkeepers face the same problem as does anyone else carrying on business in rented premises. However in the present case it was not the Company A which was buying the five units.

The owner of any premises wants to receive the highest rent that he can for the premises which he owns. If a person buys premises to avoid paying full market rental for the same then that person is indirectly subsidizing the business which he carries on in those premises. This point is very material in the present case because at the same time that the Taxpayer was acquiring the five units, Mr T was actively negotiating to sell a 60% controlling interest in the Company A. We do not accept, as Mr T and the younger son would like us to believe, that it was the intention of Mr T when the eight-year lease expired to grant a new tenancy to the Company A at a rent substantially below market rental levels to benefit a company of which they only owned 40%.

In the evidence given before us both Mr T and the younger son gave great importance to the fact that prospective purchasers of the five units when visiting the premises were having an adverse effect upon the morale of the staff. We fully accept that confusion can arise in the minds of employees if they see prospective purchasers visiting the premises but that was not the real situation in the case before us. In the case before us it was not a matter of rumour for the employees to deduce from prospective real estate purchasers visiting the premises. The reality was that Mr T was actively negotiating with his friends to sell a controlling interest in Company A. Prior to 1986 Company A had been suffering substantial losses and Mr L who had already disposed of Company A to Mr T, his family and the Taxpayer, was the owner of the five units through his company. It is hard to believe in such circumstances that prospective purchasers of the real estate would have such an adverse effect upon the business that Mr T would see fit to purchase the five units. Perhaps it would be more believable if the five units had been purchased by a company jointly owned by Mr T and Company B which was simultaneously purchasing 60% of Company A.

We now come to the evidence of Mr T and his younger son relating to the reason for the sale. They say that there was a sudden unexpected and very attractive offer made for the five units. We accept that this was the case though to what extent the offer was above the market value we do not know. However it is sufficient for the purposes of this decision to accept that Mr T and his younger son both thought that the offer was attractive. However it is the rest of what Mr T and his younger son say about the reason for the sale with which we disagree and do not accept their evidence.

They say that the younger son and another son were expecting to be married and that the family wanted to acquire two homes for them in the New Territories. Two residential properties were purchased for them and this was part of the reason for selling the five units. We see no connection whatsoever between the purchase of the two residential units and the sale of the five units other than the fact that the Taxpayer happened to have available to it money following the sale of the five units. In truth the two residential units were not purchased to enable the sons to reside there but were pure trading transactions which the Taxpayer conducted with a view to making a profit and it was successful in so doing.

We were told that part of the proceeds was used for purchasing two shop units in the New Territories and that these two units were purchased as long term investments for rental purposes. Again we find that there was no connection between the sale of the five units and the purchase of the two shops other than the fact that as a result of the sale of the five units the Taxpayer happened to have available to it surplus funds. We note that the two shops were purchased primarily with a bank loan and that one shop was sold at a profit shortly after it was purchased. In our opinion the acquisition of these two shops was no more than a speculative investment by the Taxpayer. We do not consider it relevant that the Taxpayer has retained one of the shops for rental purposes. No doubt that shop is now a long-term investment held by the Taxpayer for rental purposes and it may have been the case when the shop space was first purchased. However that has no effect on what was the intention of the Taxpayer when it acquired the five units in question.

We were told that there was a requirement by Mr T and his family for additional funds to finance the development of the site of 250,000 square feet which they had purchased in the New Territories. With due respect we again totally reject such an inference from the facts which we have before us. First of all we do not accept that Mr T and his family were short of funds so that it was necessary to sell the five units. At that time Mr T was negotiating a joint venture in Country B to move his factory from where it was. We enquired about the utilisation of the $3,000,000 allegedly on lent to Company O. In reality it was not one loan but various much smaller sums of money advanced to Company O over a period of time. It would appear that there was some form of current account between the Taxpayer and Company O. Mr T and his family made use of whatever funds they had available to them and when the Taxpayer had funds available they made use of the same. It was not the reason for selling the five units.

We find the purchase of the 260,000 square foot site to be irrelevant to the case before us. However as Counsel for the Taxpayer felt that it was of importance and led evidence with regard thereto and as the representative for the Commissioner cross examined Mr T with regard thereto we put on record that we do not accept that the reason for purchasing this large site was to enable Mr T to move Factory A from one location in the New Territories to another. To make such a suggestion is purely fanciful. In reality Mr T was then about to negotiate a joint venture with the intention of moving Factory A from Hong Kong to Country B. It would not be logical for him to make a major capital investment in a large piece of land with a view to relocating a factory which he was about to relocate in Country B. He and his younger son said that the existing factory site was subject to flooding. However when asked what had happened subsequently he said that the factory had been moved to Country B and that some years earlier the flooding problem had been overcome by building a flood gate and installing pumps.

We have dealt at some length in this decision with the evidence before us and the case put to us on behalf of the Taxpayer. However in reality this is quite a simple case when the evidence and facts are stripped down to their basic essentials. There was no real connection between the decision of the Taxpayer to purchase the five units and the fact that the Taxpayer and Mr T's family owned the Company A. The Taxpayer at the time when it was selling its shares in the restaurant business became aware of a good opportunity to purchase five units in a commercial building at a good price. It proceeded to do so. The five units were subject to a lease which gave a favourable rental income for a number of years and the rental income was sufficient almost to cover the instalments necessary to maintain the mortgage which the Taxpayer obtained to purchase the five units. It was obviously a good business deal for the Taxpayer. When the value of the five units increased it was not necessary for the Taxpayer to try to market the same because an approach was made to the Taxpayer by a third party offering a favourable price for the five units. Without hesitation the Taxpayer accepted the offer and realised the profit which it had no doubt hoped it would be able to make on the five units. What the Taxpayer did was simply a straight forward trading transaction in property. From the evidence before us it is quite clear that the Taxpayer has engaged in a number of other property trading transactions. The five units which are the subject matter of this appeal were no more and no less than part of the property trading business of the Taxpayer which it has been carrying on.

For the reasons given we dismiss this appeal and confirm the determination of the Commissioner.