INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D99/97

Profits tax – sale of property – unilateral declaration of the intention of the company – financial ability of the company – internal allocation of units to shareholders – change of the intention of the company.

Panel: Ronny Tong Ka Wah SC (chairman), Erwin A Hardy and Yu Yui Chiu.

Date of hearing: 3 November 1997.
Date of decision: 22 January 1998.

The taxpayer company on 22 January 1998 purchased the subject property. In April 1990, the same shareholders of the taxpayer company formed or acquired another company called D Limited. On 28 June 1990, D Limited acquired a property next to the subject property ('the Adjourning Property'). On 9 February 1991, the taxpayer company and D Limited agreed to jointly redevelop both the subject property and the Adjoining Property.

The next building was completed in 1993. A number of units in the new building were 'internally allocated' to various shareholders and related persons of the taxpayer company and D Limited on or about 5 April 1993. A day later, the new building was offered for sale to the public. Eventually the taxpayer company did not end up keeping any of the units in the new building.

The taxpayer company's case was that it never had the necessary intention to trade the subject property or the new building until at a meeting in March 1993 that the taxpayer company decided to offer the new building for sale of the public. Having heard the evidence given by one of the shareholders and directors of the taxpayer company, the Board was unable to accept his evidence at to their intention towards the subject property at the time of acquisition.

Held:

(1) The unilateral declaration of the taxpayer company is never conclusive (Marson v Morton [1986] 1 WLR 1348, Lionel Simmons Properties Ltd v CIR [1980] 35 TC 461 and All Best Wishes Ltd v CIR [1992] 3 HKTC 750 applied).

(2) The classification of the Properties as 'fixed assets' in the financial statements of the Company is by no means conclusive. One must look at all

the circumstances to see if that self-declaration of intent of the taxpayer company is bore out by the facts (Shadford v H Fairweather & Co Ltd [1966] 43 TC 291 applied).

(3) The taxpayer company had no long term finance worked out to hold the subject property. The taxpayer company had no finance at all except a substantial mortgage loan repayable on demand. The rental income was hardly enough for even the mortgage payments. The inference is obvious that the taxpayer company did not care about its rental income because it was never its intention to hold the subject property for rental income (D11/80 considered).

(4) The distribution of the units to the shareholders of the taxpayer company must be regarded in accountancy as well as legal terms as sales or dispositions of these units by the taxpayer company to its shareholders. The fact that the taxpayer company ended up with none of the units cannot be supportive of its declared intention that it had always held the subject property as long term investment.

Appeal dismissed.

Cases referred to:

Marson v Morton [1986] 1 WLR 1348
Lionel Simmons Properties Ltd v CIR [1980] 35 TC 461
Sharkey v Wernher [1956] AC 58
All Best Wishes Ltd v CIR [1992] 3 HKTC 750
Shadford v H Fairweather & Co Ltd [1966] 43 TC 291
D11/80, IRBRD, vol 1, 374

Fung Chi Keung for the Commissioner of Inland Revenue.
Taxpayer represented by a Counsel.

Decision:

BACKGROUND FACTS

1. This is an appeal brought by the Taxpayer ('the Company') against a determination of the Commissioner of Inland Revenue ('the CIR') dated 24 February 1997 ('the Determination') by which the following assessment was confirmed:

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Assessable Profits	53,056,264
Less set-off of loss brought forward	874,586
Tax payable thereon	9,131,793

2. The Company was incoporated with authorized and paid up share capital of $10,000 and $2 respectively on 30 October 1987. On 22 January 1988, the Company bought the property at No. A, Street B ('the Property') at a purchase price of $3,350,000. Between December 1989 and February 1990, the Company increased its paid up capital to $9,997 by the issue of new shares to a number of people ('the Shareholders'). One of the original shareholders and directors is Mr C who gave evidence at the hearing on behalf of the Company.

3. In April 1990, the same Shareholders formed or acquired another company called D Limited which also had an authorized and paid up capital of $10,000 and $2 respectively. On 28 June 1990, D Limited entered into a sale and purchase agreement for the acquisition of the property at No. E, Street B ('the Adjoining Property') next to the Property.

4. Within a few months, building plans were submitted to the Building Ordinance Office for the redevelopment of both the Property and the Adjoining Property. On 6 February 1991, a building mortgage loan of $22,000,000 was obtained from Bank F. On 19 February 1991, the Company and D Limited signed a memorandum of joint redevelopment ('the Memorandum') and agreed to jointly redevelop both the Property and the Adjoining Property.

5. The new building ('the Building') was completed in 1993 but before occupation permit was issued on 12 November 1993, a number of units in the Building were 'internally allocated' to various shareholders and related persons of the Company and D Limited on or about 5 April 1993. A day later, the Building was offered for sale to the public. None of the units was retained by the Company.

6. It is the Company's contention that it never had the necessary intention to trade the Property or the Building; that it always intended to keep the Property and subsequently, the Building for long term investment and it was not until at a meeting in March 1993 that the Company decided to offer the Building for sale to the public.

APPLICABLE LEGAL PRINCIPLES

7. The legal principles involved in this appeal are not in dispute. What we are looking for is independent evidence demonstrating the true intention of the Taxpayer. In this respect, the unilateral declaration of the Taxpayer is never conclusive.

8. The principle to be applied on the question of ascertaining intent is well settled and cannot be doubted. In Marson v Morton [1986] 1 WLR 1348, Sir Nicholas Browne-Wilkinson V-C said (at page 1348 of the report):

> *'It is clear that the question whether or not there has been adventure in the nature of trade depends on all the facts and circumstances of each particular case and depends on the interaction between the various factors that are present in any given case. The most that I have been able to detect from the reading of the authorities is that there are certain features or badges which may point to one conclusion rather than another.'*

9. The learned Judge then went on to list out (at page 1348 to 1349 of the report) some of these features or badges, which are of course by no means exhaustive:

(a) Whether the transaction was a one-off transaction?
(b) Was the transaction related to the trade which the taxpayer otherwise carries on?
(c) What is the nature of the subject matter?
(d) What was the way in which the transaction was carried out?
(e) What was the source of finance of the transaction?
(f) Was work done to the item purchased before it was resold?
(g) Was the item resold in one lot or broken down into saleable lots?
(h) What were the purchasers' intentions at the time of purchase? and
(i) Did the item provide enjoyment for the purchaser?

In approaching these questions, common sense must be applied.

10. In Lionel Simmons Properties Ltd v CIR [1980] 35 TC 461, HL, Lord Wilberforce said (at page 491G):

> *'Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment? Often it is necessary to ask further questions: a permanent investment may be sold in order to acquire another investment thought to be more satisfactory; that does not involve an operation of trade, whether the first investment is sold at a profit or at a loss. Intentions may be changed. What was first an investment may be put into the trading stock – and, I suppose, vice versa. If findings of this kind are to be made precision is required, since a shift of an asset from one category to another will involve changes in the company's accounts, and possibly, a liability of tax (cf. Sharkey v Wernher [1956] AC 58). 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. It must be one or other, even though, and this seems to me legitimate and intelligible, the company, in whatever character it acquires the asset, may reserve an intention to change its character. To do so would, in fact, amount to little more than making explicit what is necessarily implicit in all commercial operations, namely that situations are open to review.'*

11. Mortimer J (as he then was) in All Best Wishes Ltd v CIR [1992] 3 HKTC 750 summed up the position well (at page 771):

> *'The Taxpayer submits that this intention, once established, is determinative of the issue. That there has been no finding of a change of intention, so a finding that the intention at the time of the acquisition of the land that it was for development is conclusive.*
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> *I am unable to accept that submission quite in its entirely. I am, of course, bound by the Decision in the* ***Simmons*** *case, but it does not go quite as far as is submitted. This is a decision of fact and the fact to be decided is defined by the Statute – was this an adventure and concern in the nature of trade? The intention of the taxpayer, at the time of acquisition, and at the time when he is holding the asset is undoubtedly of very 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 is rightly said that actions speak louder than words.'*

12. It follows that the classification of the Properties as 'fixed assets' in the financial statements of the Company is by no means conclusive (see for example, Shadford v H Fairweather & Co Ltd [1966] 43 TC 291, at page 299 per BuckleyJ). One must look at all the circumstances to see if that self-declaration of intent is bore out by the facts.

13. Equally, it is of some importance to test the declared intention of the Company by reference to its financial ability: was it within its power to hold a property for long term purposes? In D11/80, IRBRD, vol 1, 374 it was said (at page 378):

> *'when an owner of land exploits it by the development and construction of a multi-storey building and in the course of construction or shortly thereafter he sells units in the building, the inference that would be drawn is that the building was not erected for retention as an investment but for the purpose of resale. If the owner's case is that he intended to retain the property as a long term investment but supervening events outside his control forced him to dispose of the property, then before such a claim can succeed he must satisfy the Board that it was his intention to keep it as an investment or capital asset. ... "Intention" connotes an ability to carry it into effect. It is idle to speak of 'intention' if the person so intending did not have the means to bring it about or had made no arrangements or taken any steps to enable such intention to be implemented.'*

EVIDENCE OF MR C

14. Mr C gave evidence for the Company. We were not impressed by his evidence. He appeared to have a rather selective memory. Nor has he been forthcoming in the production of relevant documents. For example, the Company's Counsel, Mr Barlow opened the case on the basis that the Property was purchased on the strength of a private loan and not a mortgage. When confronted with suggestion found in other documents before us that there was a mortgage, Mr Barlow took instruction and confirmed that there was a mortgage. The mortgage was not produced until we pressed for it. It showed that the mortgage loan was in fact not a term loan but repayable on demand. This was hardly consistent with the declared intention of Mr C that the Property was intended to be held for long term investment. We will not go so far as to say Mr C was deliberately trying to conceal the document from us and the Revenue but the manner in which this document came to light could not lend weight to his credibility. Nor are we in any way seeking to criticise Mr Barlow for it appeared that he obviously was not aware of the existence of the mortgage until shortly before it was produced before us.

FINANCIAL ABILITY OF THE COMPANY

15. Mr C confirmed to us in cross-examination that the Property was a pre-war building purchased with sitting tenants. Despite Mr Barlow's opening to the effect that the Property was 'yielding rents at market levels' at the time of purchase Mr C confessed that the rentals were below market. Not only that, the Company was advised by its solicitors, Messrs Yam & Co, at the time and knew that the tenants were protected tenants. No research on the rental market was done. No cash-flow analysis was prepared. No consideration was given as to what repair and/or maintenance costs would have to be

incurred in holding such a property long term. Needles to say, no board minutes were produced.

16. So the position at the time of purchase was this: the Company had no long term finance worked out to hold the Property. Indeed, the Company had no finance at all except a substantial mortgage loan repayable on demand. Against that, the monthly income was dismal: the Company's accounts for the 14 month period from January 1988 to 31 March 1989 showed a rental income of only $146,412. The average monthly income was therefore in the region of $10,000 only – less than 4% without taking into account necessary expense. A table of prime rates at the time was produced for Mr C to consider and he readily agreed that the rate of interest on the mortgage at the time was 7%. So the rental income was hardly enough for even the mortgage payments on the $2,500,000 mortgage loan. This is ignoring for the moment that the Company has also borrowed a sum of $1,000,000 from its shareholders. Not surprisingly, the accounts showed a net loss of $243,328 for the period and were heavily qualified by the auditors.

17. The position for the next financial year was no better. In fact, it was worse. The net loss had increased to $336,500. This was because the tenant on the ground floor had moved out. Instead of getting in another tenant, the ground floor was not let out. Mr C's explanation was that the Company had intended to oust the second floor tenant so that the whole building could be let out at a higher rent. For the reasons which follow, we have great difficulty in accepting this explanation. The rental income fell even further thereafter. In the accounts ending March 1991, the net loss increased to $490,290 and the rental income fell to $29,270 for that year. No amount of possible increase in rent thereafter could justify the Company suffering such substantial losses for these two years. The inference is obvious: the Company did not care about its rental income because it was never its intention to hold the Property for rental income.

18. No board minutes within this period were ever produced to us. Indeed, no minutes were produced save those of 31 March 1993 when the Company allegedly 'changed' its intention to sell the Building instead of holding it for investment.

INTENTION TO REDEVELOP

19. Meanwhile, the Adjoining Property was purchased by the same Shareholders through D Limited in June 1990. Mr C's evidence as to the Company's intention on redevelopment of the Property was confusing to say the least. In paragraph 2 of his statement he seemed to suggest that the Company decided against redeveloping the Property at the time of purchase and that it was not until 1989 when the Company learned that there was to be a major redevelopment nearby by the Land Development Corporation that they began considering redeveloping the Property together with the Adjoining Property which property, of course, had not yet been acquired by D Limited.

20. That the intention to redevelop was formed *before* the purchase of the Adjoining Property was clear. Mr C had said he was told at the time of acquisition that the Property by itself was too slim to be redeveloped. Later, the same Shareholders approached

the owner of the Adjoining Property and acquired the same through D Limited in 1990. Building plans were submitted to the Building Ordinance Office right after agreement for sale and purchase was signed in October 1990 even before completion had taken place. In fact, the building mortgage loan was also obtained before completion.

21. However, in cross-examination, Mr C confirmed that '[they] had intended to buy Number E even before [they] had bought Number A'. He added that they intended to redevelop both sites if they could. He produced the Memorandum which was signed in February 1991 no doubt with a view to convince us that the Company and D Limited did not agree to jointly redevelop the two properties until 1991. That plainly cannot be true in view of the facts recited above.

22. We pressed for any company minutes at the time concerning the decision to redevelop both properties but were told none existed. After much discussion, certain minutes of a meeting held on the 18 June 1990 were eventually produced. That was a meeting of the Shareholders in their individual capacities where they agreed to purchase the Adjoining Property. What is interesting is that paragraph 3 of the minutes had a sentence blocked out by white ink. It was never explained to us why that sentence was blocked out or what that sentence was about.

23. The Memorandum does not assist the Company either. It contained a number of elaborate provisions dealing with distribution and sale of units of the Building. There was nothing in the Memorandum about the declared intention of the Company that it intended to keep at least its share of the units for long term investment. No steps were ever taken to arrange long term finance in order to keep the Company's units for long term holding.

CIRCUMSTANCES SURROUNDING THE SALE OF THE BUILDING

24 It is instructive to bear in mind that eventually the Company did not end up keeping any of the units in the Building. On 11 January 1993, surveyors were instructed to prepare a valuation report which they eventually produced on 3 March 1993 ('the Valuation Report'). The surveyors were never instructed to consider the rental market. Their sole brief was to consider the market price of the Building. As soon as the Valuation Report was produced there was a directors' and shareholders' meeting held on 31 March 1993 whereby the Company allegedly resolved to 'change' its intention from holding the Building for investment purposes to redevelopment for sale.

25. Immediately thereafter, the Company and D Limited distributed a number of the units to the Shareholders and persons connected to the two companies on 5 April 1993. Mr Barlow submitted in his opening that the various units were still being kept by the Shareholders was strong evidence that the Property was always intended to be kept for long term investment. With respect, the contrary is the case. The distribution of the units to its Shareholders must be regarded in accountancy as well as legal terms as sales or dispositions of these units by the Company to its shareholders. Putting the Company's case as its

highest, the fact that it ended up with none of the units cannot be supportive of its declared intention that it had always held the Property as long term investment.

OUR DETERMINATION

26. On these facts, we are far from satisfied that the Company had properly discharged its burden under section 68(4) of the Inland Revenue Ordinance, chapter 112 in demonstrating that the Property was acquired for the purpose of long term investment. The appeal must be dismissed and the Determination affirmed.