

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D148/99

Profits Tax – real property – whether the gains arising from the disposition of a property was liable for profits tax.

Panel: Ronny Wong Fook Hum SC (chairman), Edward Chow Kam Wah and David Yip Sai On.

Date of hearing: 14 December 1999.

Date of decision: 27 March 2000.

The taxpayer is a private company incorporated in Hong Kong. It purchased two properties on 24 September 1992. An agent was engaged to locate an interested purchaser on 28 September 1992. The two properties were sold on 2 October 1992 by the taxpayer as confirmor. The taxpayer relied on the sworn evidence of one Mr B who could not give any reason as to why various assertions were given by the taxpayer's professional advisers and financial controller in the pre-hearing correspondence between the taxpayer and the Revenue.

Held, dismissing the appeal:

1. The principles are clear. The Board has to be satisfied that the taxpayer's avowed intention of acquiring the properties as long term investment is on the evidence 'genuinely held, realistic and realisable'.
2. Little weight could be attached to the written documents relied upon by the taxpayer because of the inconsistencies between them. The fact that the two properties were purchased on 24 September 1992, an agent was engaged to locate an interested purchaser on 28 September 1992 and the properties were sold on 2 October 1992, coupled with the nature of the properties, were strong indicia that the taxpayer was then engaged in trading activities.

Appeal dismissed.

Case referred to:

All Best Wishes Limited v CIR 3 HKTC 750

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Yeung Siu Fai for the Commissioner of Inland Revenue.

Ho Chi Ming instructed by Messrs Ernst & Young for the taxpayer.

Decision:

Background

1. Company A is a company incorporated in Hong Kong. At the material times, Mr B was one of its directors and Company C held 30% of its issued share capital. The remaining 70% of its issued capital was held by Company D. Company C was a company under the control of Mr B. It carried on a real estate business since about 1986.

2. On 9 August 1990, Company A purchased the ground floor including the yard at the rear of a building in District E [' Property 1 '] for \$4,400,000. On 1 December 1990, Company A acquired the ground and mezzanine floors of a building adjacent to Property 1 [' Property 2 '] for part of \$4,700,000. On 17 April 1991, orders were made by the Building Authority under section 26 of the Building Ordinance declaring both properties to be dangerous or liable to become dangerous.

3. By a joint venture agreement dated 3 August 1992 [' the Joint Venture Agreement '] between Mr B and Mr F trading as Company G, Mr B and Mr F agreed to form a private limited company with Mr B contributing 70% and Mr F contributing 30% of its capital and to procure that company to purchase Properties 1 and 2. The recital of the Joint Venture Agreement referred to their desire to acquire both properties ' for the purpose of long term investment ' . It was further agreed between them that the two properties ' shall not be sold within the first five years. '

4. The Taxpayer is a private company incorporated in Hong Kong on 10 September 1992. Upon incorporation, two of its shares were registered in the respective names of Mr H and Ms I. Mr H and Ms I were appointed directors of the Taxpayer on 21 September 1992. Mr H was the manager and Ms I was the administrative manager of Company A for the period between 1 April 1992 and 31 March 1993.

5. Ms I and Mr H allegedly attended a directors' and a shareholders' meeting of the Taxpayer both held on 24 September 1992. The minutes of these two meetings were in substantially the same terms. The shareholders and the directors of the Taxpayer allegedly resolved to purchase Property 1 and Property 2 at \$19,800,000. It was further resolved ' that the intention for the acquisition of the foregoing properties as (*sic*) long term investment for rental purpose. '

6. By a sale and purchase agreement dated 24 September 1992 [the Purchase Agreement '] the Taxpayer agreed to purchase from Company A Property 1 and Property 2 for \$19,800,000. \$200,000 was paid before the signing of the Purchase Agreement. A further sum of

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\$1,780,000 was scheduled to be paid upon signing. This sum was paid by a withdrawal that day from Mr B's account with a bank. The sale was subject to a tenancy over Property 1 granted on 24 July 1991 for 30 months from 1 May 1991 to 31 October 1993 with rental at \$41,000 per month and another tenancy over Property 2 granted on 20 March 1991 for 2 years from 1 May 1991 to 30 April 1993 with rental at \$45,000 per month. The sale and purchase was to be completed on 2 December 1992 with payment of the balance of \$17,820,000.

7. By letter dated 24 September 1992, Company C informed the Taxpayer of its willingness to provide 'loan facilities for Properties 1 and 2'. The Taxpayer was also told by their solicitors Messrs Elaine Tam & Co that Messrs Cheung, Chan, Chung & Fong had on behalf of their client tendered a cheque for \$1,240,000 by way of earnest money. Messrs Elaine Tam & Co sought the Taxpayer's instructions as to whether they were interested in selling the two properties. The cheque was returned by Messrs Elaine Tam & Co to Messrs Cheung, Chan, Chung & Fong on 25 September 1992 with an intimation that 'our client is not interested in selling the above properties to your client' and that 'nothing herein contained shall constitute a legally binding agreement between our respective clients unless and until a formal agreement for sale and purchase has been signed by both parties concerned.'

8. On 28 September 1992, the Taxpayer appointed Company J as its representative to negotiate with intended developer in relation to Properties 1 and 2. It was a term of Company J's mandate that the Taxpayer be given an option to purchase the ground floors of the redevelopment upon its completion. Company J's appointment was to span between 28 September and 31 December 1992. In the event of any disposal at price exceeding \$33,000,000, Company J would be paid an agency fee of \$2,500,000.

9. According to the minutes of a directors' meeting and the minutes of a shareholders' meeting of the Taxpayer dated 2 October 1992, Ms I and Mr H resolved as directors and shareholders of the Taxpayer to dispose of Properties 1 and 2 in favour of Company K for \$35,000,000. It was further resolved that the Taxpayer would purchase from Company K the equivalent shop units of 2,000 square feet in the completed re-development. Company K was to furnish a guarantee in the sum of \$8,000,000 to secure their commitment to redevelop and resell.

10. By a sub-sale agreement dated 2 October 1992 ['the Sub-Sale Agreement'], the Taxpayer as confirmor sold Properties 1 and 2 in favour of Company K for \$35,000,000. \$8,000,000 was paid before the signing of this Sub-Sale Agreement. Mr B received \$1,240,000 on 2 October 1992 and \$6,760,000 on 6 October 1992. The balance of \$27,000,000 was scheduled to be paid on completion on 24 December 1992 (which was also the date of completion under the Purchase Agreement). Clause 32 of the Sub-Sale Agreement conferred upon the Taxpayer an option exercisable on or before 31 October 1993 to purchase shop units with saleable area of 2,000 square feet in the redevelopment of Company K at price to be agreed between the Taxpayer and Company K. Company K was to pay the Taxpayer a sum described as 'liquidated damages' computed on the basis of \$4,000 for each square foot of saleable area if the purchase

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did not materialise for reasons specified in the Sub-Sale Agreement. Company K may delay payment of the liquidated damages to 31 December 1993 if one Company L shall have exercised its right to postpone the date of completion for two months in respect of the sale and purchase of another property on the first floor of a building in District E (' Property 3 '). This provision was amended by a supplemental agreement dated 2 December 1992 [' the Supplemental Agreement '] whereby payment of the liquidated damages may be postponed for two months to on or before 31 December 1993 if so agreed in writing by the Taxpayer.

11. By an assignment dated 2 December 1992 made between Company A as the vendor; the Taxpayer as the confirmor and Company K as the purchaser, Properties 1 and 2 were assigned in favour of Company K. On the same day Messrs Cheung, Chan, Chung & Fong drew a cheque for \$9,180,000 in favour of Company C. Company C in turn drew a cheque for like amount in favour of Mr B on 3 December 1992. This sum of \$9,180,000 was arrived at as follows:

	\$
Proceeds receivable under the Sub-Sale Agreement	35,000,000
Amount payable under the Purchase Agreement	<u>19,800,000</u>
Difference:	15,200,000
 <u>Add:</u>	
Initial deposits of \$200,000 & \$1,780,000 to Company A	1,980,000
 <u>Deduct:</u>	
Initial deposit of \$8,000,000 received from Company K	<u>8,000,000</u>
Balance payable	<u><u>9,180,000</u></u>

12. Between 5 February 1993 and 31 October 1994, Company C drew cheques totalling \$6,167,926.20 in favour of Company G as its share of the profit arising from the Taxpayer' s dealings with the two properties.

13. By letter dated 8 June 1993, Messrs Elaine Tam & Co sought to exercise the Taxpayer' s option under the Sub-Sale Agreement to purchase 2,000 square feet of shops at \$2,500 per square foot. This was unacceptable to Company K. Attempts to improve the unit price failed to move Company K. By letter dated 11 June 1993, Company K sent to Messrs Elaine Tam & Co a cheque for \$8,000,000. Mr B was paid this sum by Messrs Elaine Tam & Co on 17 June 1993.

14. At all relevant times, the Taxpayer' s authorised capital remained at \$10,000 and issued capital at \$2. By allotments dated 18 August 1993, the Taxpayer allotted an additional

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9,997 shares with 3,332 shares in favour of Ms I; 3,332 shares in favour of Mr M and 3,333 shares in favour of Ms N. Two days later Mr H resigned as director of the Taxpayer. Mr M and Ms N were appointed additional directors.

15. In about September/October 1993, Company J was paid its commission due under its appointment of 28 September 1992.

16. The issues before us are:

- (a) Whether the Taxpayer is liable for profits tax in respect of the gains of \$9,032,074 it obtained from its disposal of the two properties. This amount was arrived at after deducting from \$15,200,000 Company G's share of the profit at \$6,167,926.
- (b) Whether the Taxpayer is liable for profits tax in respect of the sum of \$8,000,000 paid by Company K as liquidated damages under the Sub-Sale Agreement.

Correspondence between the parties before the hearing

17. The Revenue commenced its enquiry in early 1995. Messrs Robert Chui & Cheung, certified public accountants, were then acting for the Taxpayer. By letter dated 27 February 1995, the Revenue was informed by the Taxpayer via that firm that 'The acquisition was financed by a loan from a director, [Ms I]' and 'The purchased property was originally intended for long term rental income purposes.' By letter dated 10 April 1995, the Revenue was further informed that 'Since the properties were disposed shortly after acquisition, the rental income on the properties were agreed to be transferred to the purchaser, thus no rental income was recorded.'

18. Messrs Albert Y K Lau & Co replaced Messrs Robert Chui & Cheung in August 1995. In their letter dated 5 August 1995, Messrs Albert Y K Lau & Co submitted that 'the properties were purchased by [the Taxpayer] with the intention to redeveloped (*sic*) and to hold by [the Taxpayer] as a long-term investment for the generation of rental income.' Messrs Albert Y K Lau further contended that the Taxpayer is not liable as 'The circumstances of the disposal of the properties were exceptional, and were disposed by the developer without the consent by [the Taxpayer]'. By letter dated 10 October 1995, the Revenue was further informed that Company J 'directly approached' the Taxpayer to act as its representative in the negotiation of the redevelopment of the properties.

19. By letter dated 6 October 1997, the Taxpayer through its financial controller informed the Revenue that 'the intention of [the Taxpayer] was to re-develop the properties as long term investment for rental purposes' and that the sole reason for the option was to 'have the properties back as long term investment for rental purpose.'

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20. The Revenue also conducted extensive correspondence with Mr F in relation to its share of the profit amounting to \$6,167,926. Mr F asserted that:

- (a) The Taxpayer is a joint venture 'to develop the site with an outside developer'.
- (b) Company O had several joint ventures with Company G. In relation to the Taxpayer, 'Company O did not take part in the joint ventures directly. As Company G and Company O agreed to share profits between each other and Company O had contributed some capital and consultancy. In return, profits of \$3,000,000 had been paid to Company O.'
- (c) 'Regarding the joint venture, Company O did not contribute any capital but to introduce potential clients and to supply technical consultancy relating to the development.'
- (d) 'Subsequently Company G also introduced a re-developer to the Taxpayer, whom is introduced by Company O ... to Company G, to enhance the feasibility of the project. A conclusion was thus made by matching the site with a suitable re-developer.'

The hearing before us

21. The Taxpayer tendered a statement from Ms I. Ms I explained that she was merely a nominee director and shareholder of the Taxpayer. Mr B and Mr F were her principals. Mr B and Mr F made all the decisions in relation to the Taxpayer. The Revenue made no challenge against the contents of Ms I's statement.

22. Mr B gave sworn evidence before us. The following are salient features of his testimony:

- (a) He is extremely wealthy and had substantial amount of cash at his disposal at the relevant time.
- (b) Company A was in the business of development of properties for resale. Company A was unsuccessful in acquiring the upper floor units above Properties 1 and 2. As it was not the policy of Company A to hold properties for long-term investment, Company D wished to dispose of Properties 1 and 2 in about May/June 1992. He was unaware that Company K had successfully acquired various upper units above Properties 1 and 2 in the second half of 1992.

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- (c) He was optimistic with the long-term growth potential of the two properties. He discussed the matter with Mr F, his secondary school classmate and good friend. They decided to acquire the two properties jointly. Their plan was to hold the same 'as a long-term investment for rental income purpose or to operate a restaurant there.' What he had in mind by way of a restaurant was a Chinese styled coffee shop.
- (d) He carried out some calculations at the time. The rental income from the two properties amounted to \$86,000 per month. The yield based on the proposed purchase price of \$19,800,000 was about 5% odd. He considered that to be a good yield sufficient to cover the interest element in any mortgage. He was of the further view that the rent could be increased after expiration of the subsisting tenancies as a new commercial complex had just been completed nearby. As far as he was concerned, there was only one tenant for each shop. He was surprised that Company K had to pay compensation to ten tenants at Property 1 and eight tenants at Property 2.
- (e) The minutes of 24 September 1992 were produced as the same were required by solicitors handling the Purchase Agreement.
- (f) At the time of execution of the Purchase Agreement, he was not aware that there would be an interested purchaser.
- (g) Shortly after executing the Purchase Agreement, he received a cold call from a property agent [' the Agent '] asking if he would like to sell. He indicated to the Agent that he was not interested. The Agent requested a commission of \$2,500,000 in case a deal was entered into. The call was followed by Messrs Cheung, Chan, Chung & Fong' s tender of earnest money.
- (h) Despite his lack of interest, the Agent persisted on 26 September and indicated that his client was prepared to offer \$31,000,000 to \$32,000,000 plus an option to buy back a shop of 1,000 square feet. After some negotiations, it was agreed that the purchase price be \$35,000,000 with an option to purchase 2,000 square feet of saleable area. It was his intention that any shop so purchased would be used to operate a coffee shop. He had in mind operating such a coffee shop since his school days. He has no further recollection as to the name of this Agent.
- (i) Before execution of the Sub-Sale Agreement, the Agent called him again pointing out that it would not be feasible to commit the purchaser in a sale of the shops as there were many uncertain factors. The Agent suggested that the

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option be worded in such a way as to allow the purchaser to pay compensation if the purchaser failed to sell the same.

- (j) He did not meet any one from Company K from inception of negotiation up to the time of execution of the Sub-Sale Agreement.
- (k) He was not involved in the pre-hearing correspondence between the Taxpayer and the Revenue. He cannot give any reason as to why various assertions were made by the Taxpayer's professional advisers and financial controller.
- (l) He disagreed with the statements made by Mr F/Company G in his correspondence with the Revenue.

The applicable principles

23. There is no dispute on the principles applicable to this case. It is common ground between the parties that our task is to ascertain the Taxpayer's intention at the time when the two properties were purchased. We have to be satisfied that the Taxpayer's avowed intention of acquiring the properties as long term investment is on the evidence 'genuinely held, realistic and realisable'.

24. As pointed out by Mortimer J (as he then was) in All Best Wishes Limited v CIR, 3 HKTC 750:

'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.'

We find this statement of principle of particular relevance to the facts of this case.

Our decision

25. The Taxpayer's case rests on the testimony of Mr B. We do not find Mr B to be a credible witness. We outline hereunder some of the factors which we took into consideration in our assessment:

- (a) Mr B alleged that it was his intention to operate a coffee shop in the two properties. This possibility was mentioned for the first time in his witness statement dated 10 December 1999. It is inconsistent with the Joint Venture Agreement and the terms of the minutes dated 24 September 1992. Given his

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immense wealth, it is surprising that no concrete step was taken by him to further his school boy fancy if such fancy was genuinely held.

- (b) Mr B's alternative case of long term rental income is also difficult to accept. The Building Authority had issued orders declaring both properties to be dangerous. Contrary to his assertion that there was only one tenant for each unit, it is clear that both properties were crammed with tenants. The prospect of ridding those tenants for positive rental growth is most remote.
- (c) Mr B had not told us the whole truth in relation to the option under the Sub-Sale Agreement. Clause 31(2) of the Sub-Sale Agreement gave Company K the right to postpone payment of liquidated damages in the event of Company L postponing completion of Property 3. It is therefore clear that the Sub-Sale Agreement is part of a wider transaction between the Taxpayer and Company K. This casts serious doubts on Mr B's assertion that he did not meet any one from Company K until the signing of the Sub-Sale Agreement.
- (d) Mr B said he could not recall the name of the Agent and the tender of earnest money by Messrs Cheung, Chan, Chung & Fong was entirely out of the blue. This is to be contrasted with the rather detailed account which he gave on the different stages of the alleged negotiations. There is no doubt that Messrs Cheung, Chan, Chung & Fong were acting for Company K. That firm sent Company C a cheque for \$9,180,000 on 2 December 1992 making the balance of the purchase price under the Sub-Sale Agreement. We reject Mr B's evidence that he had no knowledge of the progressive acquisitions by Company K. Mr B had been in real estate business since 1986. The objective of Company K was clear to all.
- (e) We have viewed the correspondence between Mr F/Company G and the Revenue with extreme caution. We are however surprised that if Mr B be right no attempt was made by the Taxpayer to call Mr F to reinforce its case. Messrs Ernst & Young, the present accountant of the Taxpayer, was instructed as long ago as 12 October 1998. The evidence of the co-adventurer is of obvious importance. Mr B gave no explanation as to why this vital witness was not called. The evidence on the disposition of the so-called liquidated damages of \$8,000,000 is also unclear. We find it difficult to see how Mr B can keep the entire sum in the light of the Joint Venture Agreement.

26. In these circumstances, we are of the view that little weight can be attached to the written documents relied upon by the Taxpayer. The Joint Venture Agreement is inconsistent with the case projected by Mr F/Company G in their correspondence with the Revenue. The minutes of 24 September 1992 were signed by two nominees. The terms of the minutes are inconsistent with

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the current contentions of Mr B and Mr F. We accept the Revenue's submissions that those documents are self-serving documents.

27. The two properties were purchased by the Taxpayer on 24 September 1992. An agent was engaged to locate an interested purchaser on 28 September 1992. The two properties were sold on 2 October 1992. Coupled with the nature of the properties, these are strong indicia that the Taxpayer was then engaged in trading activities. The option in the Sub-Sale Agreement reinforces this view. Save for a bottom line of \$8,000,000 by way of liquidated damages, no price was agreed for the purchase of the shop unit in the re-development. The whole arrangement was merely an attempt to defer the reaping of part of the profit coupled with a remote chance for more.

28. For these reasons, we dismiss the Taxpayer's appeal and confirm the assessment.

Preparation for hearing

29. The Taxpayer was represented by one of the leading firms of accountants in Hong Kong. We regret to say that we derived little assistance from their participation. Two substantial bundles were served on this Board and on the Revenue shortly before the hearing. Given the fact that they were instructed as long ago as October 1998, we see no justification for this delay. We deprecate the totally unprofessional manner whereby this case was presented by them to this Board. These criticisms do not extend to Counsel for the Taxpayer who had conducted the case before us with his usual efficiency.