

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D100/96

Profits tax – whether profit derived from sale of property assessable to profits tax.

Panel: Robert Wei Wen Nam SC (chairman), Philip Lam Bing Lun and Dianthus Tong Lau Mui Sum.

Dates of hearing: 26 September and 28 October 1996.

Date of decision: 21 February 1997.

In September 1990, two brothers (the taxpayers) purchased a flat the subject of this appeal on a pre-sale. The occupation permit was issued in August 1991. In January 1992 the subject flat was sold at a profit. The issue is that whether that profit is subject to profits tax. The first taxpayer gave evidence and was found to be a credible witness. The Board found that, at the time of the acquisition, the taxpayers' intention was to hold the flat as a long-term investment and to use it for self-residence when it was ready for occupation in about ten months' time. In the meantime, they continued to reside at a flat (Flat C) owned by the first taxpayer and his wife. However, with the arrival of a Filipino maid in November 1990 and the birth of a baby in January 1991, there was an immediate need for more spacious accommodation to solve the overcrowding problem at Flat C – a problem the seriousness of which, due to their inexperience, they had not foreseen. The long-term investment plan for the subject flat was frustrated because they could no longer wait until it was ready for occupation. In the end, in April 1991, they acquired another flat which offered a quicker solution to the overcrowding and was spacious enough to accommodate both families. They moved there two months later. With the accommodation problem solved, they had no further use for the subject flat and it was sold in January 1992.

Held:

The subject flat was sold, not in pursuit of an adventure in the nature of trade, but in realisation of a capital asset. The profit arising from the sale was a capital gain which is not assessable to profits tax.

Appeal allowed.

Cases referred to:

Simmons v CIR 53 TC 461

All Best Wishes Limited v CIR 3 HKTC 750

INLAND REVENUE BOARD OF REVIEW DECISIONS

J R Smith for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

Introduction

1. This is an appeal by two individuals (the first and the second Taxpayers) against the profits tax assessment raised on them for the year of assessment 1991/92. The Taxpayers contend that the profit arising from the disposal of a flat ('the Subject Flat') is capital gain and therefore not assessable to profits tax.

2. There were two hearings of this appeal, taking place on 26 September and 28 October 1996 respectively. The Taxpayers appeared in person at both hearings, while the Commissioner of Inland Revenue (the CIR) who had confirmed the assessment under appeal was represented by Mr Bale at the first hearing and by Mr Smith at the second and last hearing, Mr Bale having in the meantime retired. The first Taxpayer gave evidence on behalf of the Taxpayers. No other witness was called.

Evidence

3. The first Taxpayer produced a bundle of documents (the Taxpayers' bundle) consisting of a chronology of events with supporting documents. His evidence may be summarised as follows.

In chief

3.1 From May 1973 until May 1983 the first Taxpayer, his younger brother (the second Taxpayer) and their nanny Madam X lived in a flat at a public housing estate ('Flat A'). Madam X was the registered tenant.

3.2 In May 1983, the first Taxpayer married and the couple, together with the second Taxpayer, moved into a flat ('Flat B') which had been purchased for self-residence by the first Taxpayer and his wife in April 1983. The flat had two rooms with an area of 410 square feet.

3.3 Madam X passed away in June 1987.

3.4 In December 1987 the first Taxpayer and his wife purchased a flat ('Flat C') for self-residence. In February 1988 the first Taxpayer and his wife moved into Flat C while the second Taxpayer continued to reside at Flat B. In December 1988 the second Taxpayer married and after marriage the couple resided at Flat B.

3.5 In December 1988 a son was born to the first Taxpayer.

INLAND REVENUE BOARD OF REVIEW DECISIONS

3.6 In April 1989 the second Taxpayer was granted a tenancy in respect of Flat A of which Madam X had been tenant (see paragraph 3.1 above).

3.7 After the incident of 4 June 1989, the first Taxpayer applied for emigration to Country Y.

3.8 In September 1989, the first Taxpayer and his wife sold Flat B for \$480,000. In the same month arrangements were made for the second Taxpayer to move with his family into Flat C.

3.9 In October 1989, the first Taxpayer and his family went to Country Y to pursue his application for immigration. The application was unsuccessful. In February 1990, the first Taxpayer together with his family returned to Hong Kong and took up residence at Flat C. In the meantime – in January 1990 – a son had been born to the second Taxpayer.

3.10 In May 1990, the first Taxpayer's wife was pregnant. Delivery was expected in January 1991.

3.11 In July 1990, the first Taxpayer entered into a contract to employ a domestic helper from the Philippines.

3.12 In September 1990, the Taxpayers purchased the Subject Flat because it gave the two families a chance to live apart. Flat C had two rooms and one toilet with an area of 700 square feet, while the Subject Flat had three rooms and two toilets with an area of 767 square feet. Their idea was that, if they could afford it, the first Taxpayer would move into the Subject Flat while the second Taxpayer would stay on in Flat C; on the other hand, if they could not afford it, the two families would move together into the Subject Flat since it had three rooms and two toilets and Flat C would be let out.

3.13 The Taxpayers used funds in their joint Canadian dollar account to purchase the Subject Flat. The account consisted mostly of the first Taxpayer's money from the proceeds of sale of Flat B (see paragraph 3.8 above), while the second Taxpayer had contributed a small portion of the funds in the account.

3.14 The Taxpayers had purchased the Subject Flat on a pre-sale; construction was not completed nor was the occupation permit issued until 27 August 1991.

3.15 In November 1990 the Filipino domestic helper arrived. In January 1991, a daughter was born to the first Taxpayer, with the result that there were now eight persons (five adults and three children) living at Flat C.

3.16 In April 1991, the first Taxpayer and his wife purchased a flat ('Flat D') because there were too many people living at Flat C; the birth of the first Taxpayer's daughter was making the living condition very crowded. The Subject Flat would not be ready for occupation until August 1991. When the first Taxpayer discovered Flat D, which

INLAND REVENUE BOARD OF REVIEW DECISIONS

had an area of 1,500 square feet with three rooms and two toilets, it occurred to him that they could sell Flat C and then the two families could live together at Flat D. They had faith in the Filipino maid and they would like the two families to live together in Flat D.

3.17 Had they not purchased Flat D, their financial condition would have allowed the first Taxpayer and his family to move into the Subject Flat, leaving the second Taxpayer and his family in Flat C. But that would have meant a wait of seven months with eight inmates at Flat C.

3.18 The purchase price of Flat D was \$2,180,000. The purchase was financed by (1) a loan of \$1,540,000 secured by a mortgage on the flat, (2) a loan of \$550,000 secured by a mortgage on Flat C and (c) some \$150,000 cash.

3.19 In June 1991 the Taxpayers with their families and the Filipino maid moved into Flat D.

3.20 In August 1991 Flat C was sold for \$1,620,000.

3.21 On about 27 August 1991 the construction of the Subject Flat was completed and the occupation permit was issued. In January 1992 the Subject Flat was sold for \$2,815,000.

3.22 In January 1992, the second Taxpayer was notified that Flat A would be demolished and that he was offered a choice between moving to another public housing flat and purchasing a Home Ownership Scheme flat. The second Taxpayer chose the latter. In February 1992, the second Taxpayer and his wife were allocated a flat ('Flat E') under the Home Ownership Scheme.

3.23 In anticipation of his brother's move to Flat E, the first Taxpayer started planning to move out of Flat D. In January 1993, the first Taxpayer and his brother-in-law purchased a flat ('Flat F') for use by the first Taxpayer as a residence. It had an area of 850 square feet. The purchase price was \$2,050,000. The brother-in-law, a 50% co-owner, took part in the purchase to make it easier to obtain a mortgage loan.

3.24 In April 1993, Flat D was sold for \$3,950,000, and the first Taxpayer together with his family moved into Flat F, while the second Taxpayer moved with his family into Flat E.

3.25 In June 1996, it became easier to get mortgage loans, so the first Taxpayer obtained a mortgage loan of \$1,300,000 with which he purchased the other 50% share in Flat F from his brother-in-law.

3.26 In respect of the seven other properties mentioned in the CIR's determination as being for commercial purposes, the first Taxpayer conceded his liability to pay tax (and has in fact paid tax) where profit was made. The transactions concerning the seven properties had no connection with the Subject Flat.

INLAND REVENUE BOARD OF REVIEW DECISIONS

3.27 The first Taxpayer was an electrical foreman by occupation.

In cross-examination

3.28 In April 1990, the first Taxpayer's wife was pregnant and the baby was expected in next January. They continuously thought about how to deal with the situation. Until they bought the Subject Flat, they spent every Saturday looking for properties. Finally they agreed that the Subject Flat was the most suitable. The first Taxpayer would like to have a property which not only fulfilled the basic needs but was a 'better' property. He found the Subject Flat better in terms of materials and also location. They purchased it and were willing to wait out the 10-month construction period before moving in.

3.29 With the arrival of the Filipino maid in November 1990 and the baby in January 1991, the Taxpayer became perplexed by the problem of overcrowding: the first Taxpayer, his wife, their two children and the Filipino maid slept in the larger room with an area of 120 square feet while the second Taxpayer together with his wife and son used the other room which had an area of 70 square feet. Due to their inexperience, they had failed to foresee that the overcrowding could be so serious. The first Taxpayer therefore changed his mind and purchased Flat D after the purchase of the Subject Flat.

3.30 Flat C has a gross area of about 700 square feet or usable area of about 500 square feet with two private rooms and one toilet. The Subject Flat had a gross area of 767 square feet and usable area of 670 square feet, with a master bedroom, two smaller rooms and two toilets, plus a kitchen. The developer of the Subject Flat was a reputable developer. They partitioned the flat very well.

3.31 When they purchased the Subject Flat in September 1990, neither the Filipino maid nor the baby had arrived. Due to his lack of experience, the first Taxpayer thought and hoped that they could put up with it. Upon the birth of the baby, he was really perplexed by the overcrowding. They arranged for the maid to sleep in the living room but then they found the arrangement totally unacceptable, so in the end they started looking for another flat after the Chinese New Year and found Flat D.

The relevant law

4. The question is whether the Subject Flat was acquired with the intention of disposing of it at a profit, or for self-residence (that is, as a long-term investment). A long-term 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. What is not possible is for an asset to be both trading stock and long-term investment at the same time, nor to possess an indeterminate status – neither trading stock nor permanent asset. It must be one or other (see Simmons v CIR 53 TC 461 at 491-492).

INLAND REVENUE BOARD OF REVIEW DECISIONS

5. Frustration of a plan for investment, which compels realisation, even if foreseen as a possibility, surely cannot give rise to an intention to trade (ibid, 494).

6. The stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of the evidence. 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 (see All Best Wishes Limited v CIR 3 HKTC 750 at 771).

The Taxpayers' intention

7. The Taxpayers' case is that their intention at the time of the acquisition of the Subject Flat was to hold it for use as their residence (that is, as a long-term investment). It is the first Taxpayer's evidence that they saw in the Subject Flat a chance for the two families to live apart, the idea being that, if they could afford it, the first Taxpayer would move into the Subject Flat while the second Taxpayer would stay on at Flat C; on the other hand, if they could not afford it, the two families would move together into the Subject Flat since it had three rooms and two toilets and Flat C would be let out (see paragraph 3.12 above). The stated intention of the Taxpayers has to be tested against the facts and circumstances of the case.

8. It may be said that the stated intention seems to be inconsistent with: (1) the fact that, knowing that they had an accommodation problem with the arrival of the Filipino maid and the birth of a baby in the near future, the Taxpayers did not purchase a property which could afford immediate relief of overcrowding, (2) the fact that the Subject Flat was not put to any use and (3) the fact that it was lived in but left vacant until it was sold. The first Taxpayer's explanation is that, after having looked around for a property every Saturday from about April 1990 until September 1990, they finally agreed that the Subject Flat was the most suitable, because it was (1) a better property in terms of materials and location (see paragraph 3.28 above) and (2) it was partitioned to provide three bedrooms and two toilets (see paragraph 3.28 above) and (2) it was partitioned to provide three bedrooms and two toilets (see paragraph 3.30 above). So they purchased the Subject Flat and were prepared to wait out a period of some ten months before the completion of the construction and the issue of the occupation permit, thinking that they could put up with the overcrowding in Flat C in the meantime. Due to their inexperience, they failed to foresee the seriousness of the overcrowding problem. In the end they changed their minds about the Subject Flat and bought Flat D in April 1991 and moved in there in June 1991 (see paragraphs 3.29 and 3.31 above). In August 1991 the construction of the Subject Flat was completed and the occupation permit issued. In January 1992 the Subject Flat was sold for \$2,815,000 (see paragraphs 3.21 above).

9. In our view, the first Taxpayer's explanation furnished a satisfactory answer to the apparent inconsistencies mentioned in paragraph 8 above. Throughout the hearing, the first Taxpayer responded to questions in a frank and straightforward manner. Having heard

INLAND REVENUE BOARD OF REVIEW DECISIONS

and observed him, we have no doubt that the first Taxpayer was a credible witness and we accept the truth of his evidence in chief and in cross-examination as summarised above.

10. We find that, at the time when they purchased the Subject Flat in September 1990, the Taxpayers' intention was to hold it as a long-term investment and to use it for self-residence when it was ready for occupation in about ten months' time. However, with the arrival of the Filipino maid in November 1990 and the birth of a baby in January 1991, they found themselves unable to carry out their intention because there was an immediate need for more spacious accommodation to solve the overcrowding problem – a problem the seriousness of which, due to their inexperience, they had not foreseen. The long-term investment plan for the Subject Flat was frustrated because they could no longer wait until it was ready for occupation. In the end, in April 1991, they acquired Flat D which offered a quicker solution to the overcrowding while keeping the two families together (see paragraph 3.16 above), and they moved there two months later. With the accommodation problem solved, they had no further use for Flat C or the Subject Flat; Flat C was sold in August 1991 and the Subject Flat in January 1992. In our view, the Subject Flat was sold, not in pursuit of an adventure in the nature of trade, but in realisation of a capital asset. The profit arising from the sale was a capital gain which is not assessable to profits tax.

11. In his final submission, Mr Smith mentioned that there was no explanation as to why the Subject Flat was not sold earlier. That is quite correct, but we do not think that that should be held against the first Taxpayer because no such question was asked in cross-examination. Mr Smith had also prepared a submission on the Taxpayers' financial ability, but very properly did not pursue that line. Most of the documents he would have liked to refer to had not been produced before the Board. Furthermore, no issue on that score had been raised in the CIR's determination or at the hearing of this appeal, nor was the matter gone into cross-examination. Mr Smith also submitted that 'the presence of other trading transactions does not necessarily mean that the Subject Flat is automatically a trading transactions but looking at the picture as a whole it can also appear that this was one of those trading transactions.' In deciding whether to accept the first Taxpayer's explanation regarding the purchase and sale of the Subject Flat, we considered among other things the trading transactions in respect of which the Taxpayers have conceded liability and have paid the tax (see paragraph 3.26 above). Our conclusion is that the transactions involving the Subject Flat are not trading transactions notwithstanding the presence of the other trading transactions.

Decision

12. It follows that this appeal is allowed and that the profits tax assessment in question is hereby annulled.