

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D30/99

Profits Tax – whether the sale of a property was a sale of capital asset or trading stock – testing the taxpayer’s assertion against the surrounding circumstances – under what circumstances would the rebuilding allowance be granted – section 14(1) and 60 of the Inland Revenue Ordinance.

Panel: Anna Chow Suk Han (chairman), Douglas C Oxley and Roderick Woo Bun.

Date of hearing: 14 May 1999.

Date of decision: 30 June 1999.

This was an appeal by the taxpayer, a private company, against the relevant profits tax assessment relating to the sale of a property (‘the Property’). The main issue was whether it was acquired by the taxpayer as a capital asset or a trading stock.

Held:

- (1) In considering whether an asset was a trading asset or a capital asset, one had to consider the intention which existed at the time of acquisition of the asset: Simmons v IRC [1980] 1 WLR 196 at 1199.
- (2) A self-serving statement by a person was of limited value until it had been tested against the objective facts: All Best Wishes Limited v CIR 3 HKTC 750 at 771 per Mortimer J.
- (3) It was therefore the task of the Board to ascertain the actual intention of the taxpayer at the time when the Property was purchased. The Board had to be satisfied that its intention at the time was to purchase the Property as the quarter of a director of the taxpayer and such intention was on the evidence ‘genuinely held, realistic and realizable’.
- (4) Although the taxpayer asserted that its business was trading in plastic materials and that it had not participated in any property dealings, the lack of repetition by itself was not conclusive. In law, a one-off transaction was capable of being an adventure in the nature of trade.
- (5) As the taxpayer’s balance sheet was a self-serving document, it needed to be tested against the surrounding facts.

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- (6) The taxpayer's assessable profits for the years of assessment 1991/92 and 1992/93 were \$28,609 and \$352,794 respectively. The annual mortgage repayment to Bank F alone amounted to \$483,768. This factor rendered the taxpayer's stated intention to hold the Property on a long-term basis unrealistic. As Company G (a company related to the taxpayer and financed the purchase of the Property by an interest free loan) and the taxpayer were two separate legal entities, the Board did not accept that in considering the taxpayer's financial ability, it should take Company G's financial resources into account.
- (7) Although the taxpayer claimed that the Property was meant to be a director's quarter, given the following fact, the Board was of the view that such claim was not credible.
- (8) There were no provisions of quarters for the other directors of the taxpayer nor for that director ('Director C') concerned save and except for the limited period from March to August 1993 when the taxpayer held the Property.
- (9) Director C subsequently acquired another property as his residence and in his own name.
- (10) Both the taxpayer and Director C in their respective returns did not declare the Property as Director C's quarter. The amended employer's return must indeed be an after-thought to support the claim.
- (11) Nothing was mentioned in the minutes of the taxpayer's directors' meeting that the Property was acquired as a quarter for Director C.
- (12) A renovation expense was a neutral factor. Renovation could enhance the value of a property. The renovation of the Property could have been carried out for this purpose.
- (13) Testing the taxpayer's assertion against the surrounding circumstances, the Board was of the view that the Property was acquired by the taxpayer with the intention of disposing of it as at a profit. The Board was not satisfied on the basis of the evidence adduced that the taxpayer had discharged the onus of proof.
- (14) If the Property was a trading stock, it followed that rebuilding allowance should not be granted. Under section 60 of the IRO, the assessor, may within the year of assessment or within 6 years after the expiration thereof, assess such person at the amount or additional amount at which according to his judgment such person ought to have been assessed.

Appeal dismissed.

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Cases referred to:

D65/95, IRBRD, vol 11, 35
Simmons v IRC [1980] 1 WLR 196
All Best Wishes Limited v CIR 3 HKTC 750
D11/80, IRBRD, vol 1, 374

Fung Ka Leung for the Commissioner of Inland Revenue.
Lau Kam Cheuk of Messrs S Y Leung & Co for the taxpayer.

Decision:

The appeal

1. This is an appeal by the Taxpayer against the determination dated 23 December 1998 by the Commissioner of Inland Revenue rejecting the objection raised by the Taxpayer against (1) additional profits tax assessment for the year of assessment 1992/93 dated 13 September 1995, showing additional assessable profits of \$56,400 with tax payable thereon of \$9,870 and (2) profits tax assessment for the year of assessment 1993/94 dated 13 September 1995, showing assessment profits of \$900,271 with tax payable thereon of \$157,547.
2. The Taxpayer claims that the property at District A with a car parking space ('the Subject Property') which it had acquired was not a trading stock, thus rebuilding allowance should be granted and the profits derived from the disposal of the Subject Property should not be assessable to profits tax.
3. Both questions depend on whether the Subject Property was acquired by the Taxpayer as a capital asset or a trading stock.

The background facts

4. The Taxpayer was incorporated as a private company in Hong Kong on 27 June 1991 with an authorized capital of \$10,000 divided into 10,000 shares of \$1 each of which had been issued. On 8 December 1992, the Taxpayer increased its authorized capital to \$100,000 and on the same date, 99,998 additional shares of \$1 each were issued, making the issued capital to \$100,000.
5. For the years of assessment 1992/93 and 1993/94, the following persons were the directors of the Taxpayer:

- (i) Mr B

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(retired on 31 December 1993)

- (ii) Mr C
- (iii) Ms D
(appointed on 8 February 1993)
- (iv) Mr E
(appointed on 20 September 1993)

Ms D and Mr E are children of Mr C.

6. The Taxpayer was a trader of plastic materials. In its profits tax return for the year of assessment 1991/92, the Taxpayer declared assessable profits of \$28,609.

7. By an agreement dated 9 February 1993, the Taxpayer agreed to purchase the Subject Property at a consideration of \$4,230,000. The purchase was completed on 10 March 1993 when the Subject Property was assigned to the Taxpayer.

8. Part of the said purchase price was financed by a mortgage loan of \$2,000,000 from Bank F, which was repayable by 60 monthly instalments of \$40,314 each.

9. The balance of the purchase price was financed by an interest free loan from Company G, a company related to the Taxpayer. As at 31 March 1993, the Taxpayer owed Company G \$2,150,138 which was classified in the Taxpayer's financial statement as an amount owed to trade creditor, a current liability item of the Taxpayer.

10. On 8 July 1993, Mr C contracted to purchase a property at District H ('Property 2') at a consideration of \$2,300,000. The purchase was completed on 30 September 1993 when Property 2 was assigned to Mr C.

11. By a provisional agreement dated 14 July 1993, the Taxpayer sold the Subject Property to a company for a consideration of \$5,200,000. The sale was completed on 31 August 1993.

12. In its profits tax return for the year of assessment 1992/93, the Taxpayer declared assessable profits of \$352,794 which were arrived at after deduction, inter alia, of rebuilding allowance of \$56,400 in respect of the Subject Property.

13. On behalf of the Taxpayer, Messrs S Y Leung and Company ('the representatives') submitted its profits tax return for the year of assessment 1993/94 together with the financial statements for the year ended 31 March 1994 and proposed tax computation which showed assessable profits of \$349,176. The gain arising from the sale of the Subject Property, in the amount of \$551,095, was treated as an extraordinary item and

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not offered for assessment. In their covering letter, the representatives explained in the following terms that the gain from the disposal of the Subject Property was a capital gain:

‘the Subject Property was purchased in 1992/93 as a quarter for a director (Mr C). After moving in, it was discovered that it was flooded whenever there was heavy rain and therefore not suitable for director’s quarter. Mr C therefore acquired Property 2 for himself. As the Subject Property was left unoccupied, the Taxpayer decided to dispose it.’

14. The assessor did not accept the Taxpayer’s claim that the Subject Property was purchased as its capital asset and it withdrew the building allowance for the year of assessment 1992/93 and raised on the Taxpayer the following profits tax assessment:

(a) **Year of assessment 1992/93**

Additional assessable profits	<u>\$56,400</u>
(being rebuilding allowance withdrawn)	
Tax payable thereon	<u>\$9,870</u>

(b) **Year of assessment 1993/94**

Profits per return	\$349,176
<u>Add</u> : Gain on disposal of the Subject Property	<u>551,095</u>
Assessable profits	<u>\$900,271</u>
Tax payable thereon	<u>\$157,547</u>

15. By a letter of 20 January 1999, the representatives on behalf of the Taxpayer, lodged an appeal against the aforesaid assessments on the ground that it was a sale of a capital asset. The bases of its contention were as follows:

- (a) The Taxpayer has no intention and has not participated in property dealing since date of inception.
- (b) The Subject Property was acquired as quarter for a director, Mr C.
- (c) 45% of the funding was from a long term mortgage loan repayable by 60 instalments and the remaining 55% was from its related company and a director.
- (d) Rebuilding allowance representing it was acquired as a capital asset was granted for the year of assessment 1992/93.
- (e) Renovation work especially leakage wall repairing was done to the Subject Property.

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- (f) It was sold because flooding caused nuisance to occupier who refused to use as residence.'

16. To support the Taxpayer's contention, the representatives provided copies of an application form for water supply to the Subject Property dated 19 March 1993, the demand notes for water gas and electricity consumption and the renovation quotation in respect of the Subject Property.

The Taxpayer's case

17. The Taxpayer called Mr E, a director of the Taxpayer, to give evidence in support of its case. Mr E was appointed as a director of the Taxpayer on 20 September 1993, after the purchase and the sale of the Subject Property. He was called as a witness because the directors at the relevant times were not available. Mr B and Mr C had passed away and Ms D was in overseas.

18. Mr E is also a director of Company G, a related company of the Taxpayer.

19. Mr E gave evidence that Mr C and his wife lived with Ms D in another building in the same development of the Subject Property before they moved to the Subject Property. After Mr C moved into the Subject Property, he discovered that, whenever there was heavy rainfall, there was leakage through the wall and also flooding from the garden. As Mr and Mrs C were then almost 60 years of age, they did not want to live at the Subject Property and wanted to look for an alternative accommodation. They found Property 2 which was within walking distance of Mr E's home. Mr E explained that although he did not take part in the purchase or the sale of the Subject Property, he knew the purpose for which the Subject Property was acquired through Mr C and reading the Taxpayer's files. He also learnt the leakage problem from Mr C. He also helped Mr C packing and moving to Property 2.

20. Mr E as a director of Company G, also gave evidence on behalf of Company G. He gave evidence to the effect that Company G had the financial resources to extend the interest free loan to the Taxpayer for its acquisition of the Subject Property. As the Taxpayer and Company G had the same shareholders, the Taxpayer would be allowed to use the loan as long as it was necessary.

21. It was submitted by the representatives that the Taxpayer had no intention to participate nor had participated in any property dealings from its commencement of business on 19 July 1991 to the year of assessment 1995/96. Its business was trading in plastic materials.

22. The representatives further submitted that the Subject Property was classified as a fixed asset in the Taxpayer's balance sheet as at 31 March 1993 and as stated in the schedule of the balance sheet, it was a director's quarter.

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23. The representatives agreed that the Taxpayer by itself might not have the necessary financial means to acquire the Subject Property and to hold it on a long term basis but we were asked to also take into account the financial resources of Company G.

24. As the usage and disposal of the Subject Property were disclosed in the Taxpayer's accounts ended 31 March 1993, the representatives objected to the assessor's claim that after having reviewed the information not previously available, the rebuilding allowance granted for the year of assessment 1992/93 had to be withdrawn.

25. The representative asserted that if the Subject Property was a trading stock, the Taxpayer would not have incurred the renovation expenses of \$165,000 and would reap a greater profit.

26. The Subject Property which was intended as a residence for Mr C, was sold because of the flooding caused by heavy rain. Mr C found the flooding a nuisance and refused to live in it.

27. The representatives referred us to a Board decision D65/95, IRBRD, vol 11, 35.

The Respondent's (the CIR's) case

28. It is the Respondent's case that the Subject Property was acquired by the Taxpayer as a trading stock and that the Taxpayer did not have the financial means to hold the Subject Property as a capital asset on a long term basis and that alleged water leakage was not a compelling reason for the sale of the Subject Property.

29. It was submitted on behalf of the Respondent that contrary to the stated intention of the Taxpayer that the Subject Property was acquired as a quarter for Mr C, the Taxpayer did not declare the same in its employer's return for the year of assessment 1993/94 in respect of Mr C, filed on 16 May 1994, nor did Mr C declare the same in his tax return for the year of assessment 1993/94 dated 17 August 1994. It was only after half a year that by an amended employer's return of 24 November 1994, the Taxpayer declared that the Subject Property was Mr C's quarter. On the other hand, Mr C had not submitted any amendment to his tax return. We were requested to note that the Taxpayer's amended return was submitted after the filing of profits tax return for the year of assessment 1993/94 on 31 October 1994, so as to support the Taxpayer's claim. The Taxpayer's stated intention was further challenged in that, Mr C was not remunerated in cash or otherwise from September 1993 to March 1994, after the sale of the Subject Property, nor was another quarter purchased by the Taxpayer for Mr C. The Taxpayer claimed that Mr C did not like the Subject Property because of the water leakage and replaced it by Property 2. However, Property 2 was purchased by Mr C and not by the Taxpayer. Furthermore, Property 2 was not comparable with the Subject Property. Its purchase price was only \$2,900,000 while the Subject Property was sold for \$5,200,000. It was submitted that inference can therefore be drawn that the Taxpayer had never intended to provide the Subject Property to Mr C as his quarter on a long term basis.

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30. It was submitted that Mr C had not lived in the Subject Property because of the nought water consumption for the period from 19 March 1993 to 12 July 1993.

31. It was submitted that the alleged water leakage problem was not a compelling reason for selling the Subject Property. The Taxpayer was aware of the problem before the renovation and repairs were carried out. There was no evidence that the problem had not been solved after the renovation, as no further repair expenses had been incurred. It was argued by the Respondent that if the problem still existed, it was strange that the Taxpayer did not try to solve it. The Respondent also produced a letter from the subsequent purchaser of the Subject Property confirming that there was no water leakage problem.

32. The Respondent challenged the Taxpayer's financial ability to hold the Subject Property as a capital asset on a long term basis. The Taxpayer's paid up capital was only \$100,000. The purchase price of \$4,230,000 was financed by a mortgage loan of \$2,000,000 from Bank F and an interest free loan from Company G. As at 31 March 1993, the Taxpayer owed Company G \$2,150,138 which was classified as an amount owed to trader creditor, a current liability item of the Taxpayer. As at 31 March 1994 (after the sale of the Subject Property) the Taxpayer did not owe any money to the trader creditor. The net sale proceeds of the Subject Property was used to repay Company G. It was also submitted that there was no evidence that Company G was able or prepared to make the loan to the Taxpayer on a long term basis. In Company G's accounts, the terms of the loan were described as interest free and repayable on demand. As to the mortgage loan from Bank F, the monthly repayment was \$40,314. Its annual repayment of \$483,768 would be greater than the returned profit of the Taxpayer for the year of assessment 1992/93 in the sum of \$352,794. It showed that the Taxpayer would not be able to service the loan on a long term basis.

33. It was submitted that having regard to the short period of ownership and the whole of the surrounding circumstances, the Taxpayer had failed to discharge the onus of proving that the Subject Property was acquired as a capital asset and it followed that rebuilding allowance could not be granted.

The relevant statutory provision

34. The relevant sections of the Inland Revenue Ordinance ('the IRO') are as follows:

(a) Section 14(1)

'Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year

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from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.'

(b) Section 2

“trade” includes every trade and manufacture, and every adventure and concern in the nature of trade.'

(c) Section 68(4)

'The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.'

The established legal principles

35. In considering whether an asset is a trading asset or a capital asset, one has to consider the intention which existed at the time of acquisition of the asset. In the case of Simmons v IRC [1980] 1 WLR 196, Lord Wilberforce said at page 1199:

'One must ask, first, what the Commissioners were required or entitled to find. 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?'

36. A self-serving statement by a person is of limited value until it has been tested against the objective facts. In All Best Wishes Limited v CIR 3 HKTC 750, Mortimer, J said at page 771:

'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.'

37. In Board of Review Decision D11/80, IRBRD, vol 1, 374, the Board said at page 379:

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“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 arrangement or taken no steps to enable such intention to be implemented.’

Our findings

38. As pointed out by Mortimer J, as he then was, in All Best Wishes Limited v CIR (1992), ‘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 therefore our task to ascertain the actual intention of the Taxpayer at the time when the Subject Property was purchased. We have to be satisfied that its intention at the time was to purchase the Subject Property as the quarter of Mr C and such intention is on the evidence ‘genuinely held, realistic and realisable’.

39. The Taxpayer asserted that its business was trading in plastic materials and that it had not participated in any property dealings. The lack of repetition by itself is not conclusive. In law, an one-off transaction is capable of being an adventure in the nature of trade.

40. We note the accounting treatment of the Subject Property. It was classified as a fixed asset in the Taxpayer’s balance sheet. As it is a self-serving document, it needs to be tested against the surrounding facts.

41. On the evidence before us, the Taxpayer’s assessable profits for the years of assessment 1991/92 and 1992/93 were \$28,609 and \$352,794 respectively. The annual mortgage repayment to Bank F alone amounted to \$483,768. This factor renders the Taxpayer’s stated intention to hold the Subject Property on a long term basis unrealistic. As Company G and the Taxpayer are two separate legal entities, we do not accept that in considering the Taxpayer’s financial ability, we should take Company G’s financial resources into account.

42. As to the Taxpayer’s claim that the Subject Property was meant to be Mr C’s quarter, is this claim credible when there were no provisions of quarters for the other directors of the Taxpayer nor for Mr C save and except for the limited period from March to August 1993 when the Taxpayer held the Subject Property? We think not, especially when Mr C subsequently acquired Property 2 as his residence and in his own name. Both the Taxpayer and Mr C in their respective returns did not declare the Subject Property as Mr C’s quarter. The amended employer’s return must indeed be an after-thought to support the claim.

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43. The Taxpayer produced minutes of the directors' meetings of the Taxpayer in relation to the purchase and the sale of the Subject Property. However, there was no mention in those minutes that the Subject Property was acquired as a quarter for Mr C.

44. The representative challenged the admissibility of the water bill. It is strange that they should do so, since it was a document produced by the Taxpayer itself. Even if we do not take into account the water bill which shows zero water consumption, there is evidence of low gas and electricity consumption during the alleged period of occupation of the Subject Property by Mr C.

45. It was submitted that if the Subject Property was a trading stock, the Taxpayer would not have incurred the renovation expenses. This factor is neutral. Renovation can enhance the value of a property. The renovation at the Subject Property could have been carried out for this purpose.

46. Mr E gave evidence that Mr C and his wife moved to the Subject Property in about May 1993. By its letter of 23 December 1994, the representatives informed the assessor that a property agency was appointed as the estate agent to sell the Subject Property in about May 1993. The speed with which the Taxpayer appointed the estate agent to dispose of the Subject Property, raises doubt on the Taxpayer's stated intention that the Subject Property was meant to be a quarter for Mr C.

47. Mr E also gave evidence that he assisted Mr C and Mrs C move to Property 2. He said that they moved out from the Subject Property around 1993 after Property 2 was considered suitable for living. However, on the evidence before us, completion of the Subject Property took place on 31 August 1993 while the completion of Property 2 did not take place until 30 September 1993. How could Mr E have possibly assisted Mr C and Mrs C moving from the Subject Property to Property 2 when there was a space of one month between the completion of the two properties. This statement indeed casts doubts on the credibility of Mr E.

48. The reason for the sale of the Subject Property by the Taxpayer was because of the water leakage problem. Mr E claimed that there were two problems, a leakage from the wall and flooding from the garden. When cross-examined, Mr E was unable to say with certainty that the leakage from the wall was solved, but believed it to be so because repair was not carried out for a third time. He was also uncertain as to what had been done regarding the flooding problem. His evidence in this connection was vague and evasive.

49. Testing the Taxpayer's assertion against the surrounding circumstances, we are of the view that the Subject Property was acquired by the Taxpayer with the intention of disposing of it at a profit. We are not satisfied on the basis of the evidence adduced that the Taxpayer has discharged the onus of proof.

50. Since we have rejected the Taxpayer's claim that it acquired the Subject Property as a capital asset, the question as to why the Taxpayer changed its mind and decided to sell

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the Subject Property does not arise. We are therefore not concerned as to whether the Taxpayer sold the Subject Property because Mr C found the flooding problem a nuisance and refused to live in it.

51. If the Subject Property was a trading stock, it follows that rebuilding allowance should not be granted. Under section 60 of the IRO, the assessor, may, within the year of assessment or within 6 years after the expiration thereof, assess such person at the amount or additional amount at which according to his judgment such person ought to have been assessed.

52. For the above reasons, we dismiss the appeal and confirm the assessment in the determination.