

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D35/89

Profits tax – whether profits on sale of properties constituted property trading – Business Registration – onus of proof.

Panel: William Turnbull (chairman), Michael Choy Wah Ying and Richard Lee.

Dates of hearing: 4 and 5 July 1989.

Date of decision: 18 August 1989.

The two taxpayers purchased and sold a number of properties over a number of years. Initially the profits made by them were offered for assessment for profits tax. The taxpayers filed profits tax returns and registered themselves as carrying on a joint venture business of property dealing. When the taxpayers incurred losses they filed tax returns claiming the losses. Subsequently the taxpayers failed to file profits tax returns and estimated assessments were issued. The taxpayers acquired a number of adjoining sites which they sold for a profit or gain of \$48,555,580. The assessor assessed this profit to tax and the taxpayers appealed against the assessment on the ground that when the taxpayers had acquired the properties in question they had done so with a view to rental collection and not with a view to development and sale.

Held:

The taxpayers had not been able to discharge the onus of proof placed upon them. The taxpayers did not appear to give evidence and no witnesses were called. On the evidence before the Board it was clear to the Board that the taxpayers were carrying on a joint venture property trading business and the profits were taxable. Even if this were not the case it was clear on the facts that this was a venture in the nature of trade.

Appeal dismissed.

[Editor's note: The taxpayer has filed an appeal against this decision.]

Wong Chi Wah for the Commissioner of Inland Revenue.
Lau Kam Cheuk of S Y Leung & Co for the taxpayer.

Decision:

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This is an appeal by two taxpayers against a profits tax assessment and an additional tax assessment both for the year of assessment 1981/82. The two assessments are in respect of certain profits which the Commissioner claims were profits from property trading and which the Taxpayers say were capital gains.

The facts are as follows:

1. Starting in 1975 the Taxpayers jointly acquired a number of properties. Initially the properties were held in equal shares but with effect from October 1979 they changed the sharing relationship from 50/50 to 60/40.
2. The first property was property A which the Taxpayers purchased and disposed of in 1975. They filed a profits tax return for the year of assessment 1975/76 in their joint names and offered for assessment the profit which they had made on this transaction. In their profits tax return they described the nature of their business as 'property transaction'.
3. In April 1976 the Taxpayers purchased property B and disposed it in the same month. The profit derived from this transaction was also declared and offered for assessment in the profits tax return filed by the Taxpayers in their joint names for the year of assessment 1976/77.
4. In November 1978 the Taxpayers filed a 'nil' return in their joint names for the year of assessment 1977/78 declaring that 'no joint venture has been conducted during the year.'
5. In November 1979 as a result of the Taxpayers failure to file a profits tax return for the year of assessment 1978/79 the assessor raised an estimated assessment on the Taxpayers an estimated profits of \$100,000. The Taxpayers did not object to this estimated assessment.
6. As a result of enquiries made by the business registration office, the Taxpayers applied for registration of joint venture business in September 1980. The Taxpayers described the nature of their business as 'property dealing'.
7. In February 1981 the Taxpayers filed a profits tax return for the year of assessment 1979/80 in which they declared a net loss of \$618,465 for the year ended 31 March 1980.
8. In January 1982 the Taxpayers filed a profits tax return for the year of assessment 1980/81 in which they declared a loss of \$1,434,415 for the year ended 31 March 1981.

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9. As a result of the Taxpayers' failure to lodge a profits tax return for the year of assessment 1981/82 the assessor issued an estimated assessment in December 1982 in which he estimated the profit of the Taxpayers at \$21,000,000 and offset against this profit the losses which the Taxpayers had claimed in the two preceding years.
10. In December 1982 the assessor raised a further estimated profits tax assessment on the Taxpayers for the year of assessment 1981/82 on estimated additional assessable profits of \$33,000,000.
11. By notice of December 1982 the Taxpayers through their tax representatives lodged objection against the two estimated assessments for the year of assessment 1981/82 and informed the Inland Revenue Department that the joint venture business had ceased in April 1981. The objection was accompanied by a profits tax return for the year of assessment 1981/82 and was supported by a profit and loss account for the period 1 April 1981 to 28 April 1981. The tax return declared a loss of \$319,467 for the period.
12. In the course of enquiry the assessor noted from information available to him that the Taxpayers had disposed of the following properties during the period from July 1975 to April 1981:

<u>Location of property</u>	<u>Remarks</u>
(1) Property A (29 & 29A X Street)	Profits included in the accounts for 1975/76 and assessed.
(2) Property B (5 Y Street)	Profits included in the accounts for 1976/77 and assessed.
(3) Property C (1 Y Street)	- “ -
(4) Property D (3 V Street)	- “ -
(5) Property E (7 W Street 5/F)	See fact 14 below
(6) Property F (35-39 Z Street Basement and G/F)	See fact 14 below
(7) 1-7 X Lane 68-80 Y Street 89-99 Z Street	Profits not included in accounts for 1981/82 and contended as capital gains. These are the properties which are the subject matter of this appeal.

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13. The assessor was not clear as to what transactions the Taxpayers had carried out during the period from 1975 up to April 1981, and made enquiries of the Taxpayers and issued various protective estimated assessments against which the Taxpayers duly lodged objections. Explanations and information were provided which enabled all of the outstanding disputes between the Taxpayers and the Commissioner to be resolved except for the profits arising on the properties which are the subject matter of this appeal ('the subject properties').
14. In the course of resolving the outstanding disputes mentioned under the preceding fact 13 the Taxpayers filed a profits tax return for the year of assessment 1978/79 declaring a profit of \$89,272 which arose from the disposal of property E. It was also established that property F had been sold and the proceeds brought to account in the accounts and profits tax return for the year ended 31 March 1980.
15. The subject properties comprise a total of 17 separate properties forming one large site bounded on three sides by Y Street, X Lane and Z Street. Details of the 17 separate properties and the dates of their acquisition are as follows:

<u>Property</u>	<u>Date of Acquisition</u>
70 Y Street	25 May 1976
93 Z Street	14 Jun 1976
74 Y Street	28 Oct 1976
95 Z Street	9 Oct 1977
91 Z Street	7 Jul 1978
3 X Lane	13 Jan 1979
7 X Lane	15 Jun 1979
99 Z Street	18 Aug 1979
76 Y Street 1/F	1 Oct 1979
76 Y Street G/F	4 Oct 1979
1 X Lane	16 Oct 1979
5 X Lane	16 Oct 1979
97 Z Street	16 Oct 1979
78 Y Street	20 Oct 1979
89 Z Street	20 Nov 1979
72 Y Street (1/2 share)	23 Nov 1979
68 Y Street	28 Nov 1979
80 Y Street	29 Nov 1979
76 Y Street 2/F	17 May 1980
76 Y Street 3/F	3 Jul 1980
72 Y Street (1/2 share)	8 Jul 1980

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Some of the foregoing properties were acquired by the Taxpayers from third parties, some from themselves individually or from companies in which they were interested and/or over which they had control and some from themselves and/or their wives.

16. The sequences of main events relating to the subject properties was as follows:

- May 1976 - Acquisition of the first of the subject properties
- Dec 1978 - Building plans approved for redevelopment of 91-95 Z Street
- Oct 1979 - Loan of \$10,000,000 obtained from Bank
- May 1980 - Building plans for the subject properties submitted for approval
- Jul 1980 - Acquisition of the last of the subject properties
- Oct 1980 - Agreement for sale of subject properties to third party property development group

17. The loan from the Bank was used to enable the Taxpayers to acquire a number of the individual properties comprised in the subject properties. It was repaid when the sale of the subject properties to the third party property development group was completed.

18. All of the buildings situate on the sites of the individual properties comprised in the subject properties were pre-war or post-war premises subject to rent control. The Taxpayers continued to collect rent from existing tenants. There is no evidence as to whether they relet any of the units in any of the buildings but there was some evidence of the Taxpayers paying compensation to obtain vacant possession. Rents collected and interest paid in respect of the subject properties were brought into account by the Taxpayers in the accounts and profits tax returns prepared by them for their joint venture business. As the rents were very low the losses referred to in facts 8, 9 and 12 arose because of substantial sums of interest paid by the Taxpayers after they had borrowed money from the bank.

19. When the Taxpayers sold the subject properties they made a profit or gain of \$48,555,580 which the assessor decided was a taxable trading profit of the Taxpayers and accordingly assessed it to tax in the year of assessment 1981/82.

20. The Taxpayers objected to this assessment to tax and by a determination dated 11 May 1988 the Commissioner, inter alia, upheld the decision of the assessor that the profit or gain on the disposal of the subject properties was taxable.

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However, in order to make certain adjustments relating to other properties not the subject matter of this appeal the Commissioner confirmed the original 1981/82 profits tax assessment and revised the additional profits tax assessment for that year as follows:

Year of Assessment – 1981/82 (Additional)

Basis period: 1 April 1981 to 28 April 1981	
	\$
Loss per return	(319,467)
<u>Less: Profits on disposal of the properties</u>	<u>48,555,580</u>
	48,236,113
<u>Less: Set-off loss b/f</u>	<u>2,052,880</u>
	46,183,233
<u>Less: Profits already assessed</u>	<u>18,947,120</u>
Additional Assessable Profits	<u>27,236,113</u>
Tax Payable thereon	<u>\$4,085,416</u>

21. The Taxpayers have filed notice of appeal to the Board of Review against this decision of the Commissioner on the grounds that the profits which arose on the sale of the subject properties were not trading profits but were disposals of capital assets.

At the hearing of the appeal no witnesses were called to give evidence but the representative of the Taxpayers and the representative of the Commissioner both tabled a number of documents in support of their respective cases.

The representative for the Taxpayers submitted that when the Taxpayers had registered themselves as carrying on a business in joint venture they had done so by mistake and because of the insistence of the business registration office that they should do so. He said that the Taxpayers had acquired the subject properties with a view to collecting rental income and had no intention of selling the subject properties or of developing the subject properties and selling units in the new building. He said that the tax returns which the Taxpayers had filed and which appeared to include the rental income of the subject properties had been prepared and filed because of the investigation by the Inland Revenue Department and should be disregarded.

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The representative for the Commissioner submitted that the Taxpayers were carrying on the business in joint venture of property trading and that the subject properties had been included by them in the stock in trade of this joint venture. He drew our attention to the various tax returns which the Taxpayers had prepared and filed and pointed out that the interest payable on loans which had been obtained to acquire some of the subject properties and the rental income received from the subject properties had been included in the tax returns which the Taxpayers had filed. He pointed out that the Taxpayers had not appeared before the Board to give any direct evidence as to what was their intention when they had acquired the subject properties and that it was therefore necessary to infer from the objective facts what had been the intention of the Taxpayers. He further pointed out that both of the Taxpayers were property traders and that they had embarked upon the acquisition and sale in joint venture of a number of other properties and had agreed that those properties were trading properties and had volunteered the profits for taxation. He said that no distinction should be drawn between the subject properties and the other properties which the Taxpayers accepted were trading properties.

The representative for the Commissioner went on to say that even if it was not accepted that the subject properties were part of the joint venture business of the Taxpayers, the profits would still be taxable because the Taxpayers had embarked upon a venture in the nature of trade when they had acquired the various sites and buildings which ultimately comprised the subject properties. He said that as soon as the Taxpayers had completed the acquisition of the final site and building which completed the entire block forming the subject properties the Taxpayers had sold the subject properties at a very large profit to a property developer.

Having heard the very lengthy submissions made by the representative for the Taxpayers and having very carefully studied the papers and documents which he tabled before us and the papers and documents which the Commissioner's representative tabled before us together with the Commissioner's determination and the documents annexed thereto we find that the Taxpayers have not discharged the onus of proof which is imposed upon them by section 68(4) of the Inland Revenue Ordinance.

When the facts are carefully analysed the initial apparent complexity falls away and the facts become clear. We have a case of two men who decided to embark upon a series of property transactions. They appear to have handled each transaction or series of transactions individually on a one off ad hoc basis. In the case of the first property in 1975 they bought and sold one site and building in a very short period of time and reported the profit to the Inland Revenue Department for taxation purposes. It would appear that they had a choice as to whether they wished to continue to handle each separate transaction on its own as a separate business or venture, or whether they wished to have an overall partnership to cover all of their property transactions. We do not know what they decided and we do not know what was the real nature of the arrangement between them. For reasons known to themselves they decided not to appear before the Board of Review and give any direct evidence. The facts before us are that for the first transaction in 1975 they filed a tax return and paid profits tax. They did likewise for their second transaction in 1976. In the year of

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assessment 1977/78 they filed a nil return saying 'No joint venture has been conducted during the year'. This we take to mean that they did not sell any property in that year.

The events for the next year of assessment 1978/79 were a little different. The Taxpayers did not file a profits tax return and the assessor issued an estimated assessment on profits of \$100,000. This the Taxpayer did not dispute.

The matter now came to the attention of the business registration office of the Inland Revenue Department who not unnaturally requested the Taxpayers to register their joint venture activities which now spanned four continuous years as a business. After correspondence with the business registration office the Taxpayers decided to register the relationship between them as a business. For the next two years of assessment (1978/79 and 1979/80) they filed tax returns in respect of this joint business. These are events and facts which cannot simply be ignored as the representative for the Taxpayers invited us to do. There is no evidence before us that the Taxpayers were misled by the business registration office. The only evidence before us is that they were asked by the business registration office to register themselves as carrying on a partnership business and after some correspondence they decided to do so. There is nothing before us to say that this was a mistake or that they were misled by the business registration office. Likewise with regard to tax returns and accounts which they filed for the business which they had registered, the facts are that these returns with accompanying accounts were filed by them or on their behalf. The representative for the Taxpayers at the hearing invited us to ignore these tax returns and accounts. That we cannot do. The representative at the hearing could have called the professional persons who prepared these tax returns and accounts and the Taxpayers themselves to give evidence to state that the tax returns and accounts were untrue and false if such really was the case. This was not done. There is no evidence before us to suggest that any of these tax returns or accounts were incorrect.

Included in the returns and accounts were the income and expenses for those properties included in the subject properties which the Taxpayers then owned. Indeed the losses which were incurred in the years 1978/79 and 1979/80 appear to have arisen because of the substantial interest which the Taxpayers were now paying on the loans which they had received to enable them to continue to purchase the subject properties.

From the foregoing facts it is quite clear to us that the Taxpayers were carrying on a joint venture property trading business, that the subject properties were part of this business and that the profits when the subject properties were sold should be brought to account and be taxable.

In his submission the representative for the Taxpayers argued at length that the Taxpayers did not intend to sell the subject properties to a developer. His submission was that the Taxpayers bought the first of the many sites and buildings comprised in the subject properties with the intention of retaining the existing building then standing on the site for rental purposes. With due respect this submission is untenable. Neither of the Taxpayers appeared before us to give any evidence to support this submission. All we have are the

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objective facts. The Board asked the representative for the Taxpayers whether this first existing building which he alleged was acquired for rental income was a pre-war or post-war building, the nature of the rent control applicable to it, what was the rental, what was the return on investment which the Taxpayers would receive from it. He was not able to answer any of these questions. All he said was that all of the subject properties were rent controlled but that the details of the control were not known. We do not accept that any experienced property traders and developers in Hong Kong would acquire property for long term rental purposes without paying attention to such fundamental matters.

The representative for the Taxpayers went on to submit that when the Taxpayers had acquired the three sites, 91-95 Z Street, they changed their intention to retain the existing buildings and instructed an architect to prepare plans to redevelop a new building in these sites. Once again we have no evidence whatsoever of any change of intention or indeed of what was the intention. The representative for the Taxpayers asked us to infer that the intention of the Taxpayers in redeveloping these three sites was that they intended to retain the new building for rental purposes. Here again we are not able to infer such an intention without any evidence whatsoever before us. There is no evidence of the Taxpayers ever having redeveloped buildings for this purpose. The evidence before us is that the Taxpayers had acquired properties with buildings thereon and proceeded thereafter to sell such properties at a profit. If anything is to be inferred from the conduct of the Taxpayers then it must be that they intended the subject properties be the same as any other of the properties which they purchased and later resold.

The representative then invited us to believe that the Taxpayers continued to acquire sites with existing buildings thereon so that they could collect the rental from the existing buildings. Such a submission without any supporting evidence is fanciful. At this stage in the history of the subject properties, the Taxpayers were borrowing up to \$10,000,000 to enable them to acquire the remainder of the subject properties. The tax returns and accounts which they filed with the Commissioner show that the interest which they were now required to pay was substantial and caused the Taxpayers to incur substantial losses for two years. The representative for the Taxpayers asked us to accept that the Taxpayers acquired these properties so that they could retain the existing buildings thereon, collect rents therefrom and incur substantial losses. Once again there is no evidence regarding this suggestion by the representative.

The Taxpayers then instructed an architect to prepare plans for the redevelopment of the entire site comprising all of the subject properties. The representative for the Taxpayers submitted that their then intention was to redevelop with a view to collecting rental and not for resale. He said that they then changed their mind because of the ill health and old age of one of the Taxpayers. He said that the venture could have been in danger during the three years that it took to complete the redevelopment if one partner had died. Yet again we have no evidence to support this submission.

The representative for the Taxpayers argued that the Taxpayers had never had any intention of selling the subject properties to another property developer. He said that

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they had received a very attractive offer from a well-known developer in Hong Kong. Because of the aforementioned old age and ill health of one of the partners it was decided to accept this offer. Here again there is no evidence before us to support the submission.

Because of the lengthy submissions made before us, it has been necessary for us to analyse the case of the Taxpayers in some detail. However in reality this appeal is quite simple. What we have to do is to ascertain the intention of the Taxpayers when they acquired the subject properties and then decided if there was any change of intention. We have no doubt that it was their intention at all times to acquire the subject properties in the hope that they could make a larger site for redevelopment. The question then to be decided is whether the Taxpayers intended to redevelop the subject properties themselves with a view to retaining the new building for the rental purposes. On the facts before us there is nothing to support any such intention. All we know is that the Taxpayers were property developers and traders who acquired the subject properties over a period of time and then resold them as soon as the last site was acquired. If their real intention had been to acquire the subject properties to redevelop and retain for rental purposes then we would expect the facts and evidence before us to be substantially different. At the very least there would be evidence of the long term relationship between the Taxpayers, of how they would finance the redevelopment, how they would repay the bank loan, what was the estimated return on investment and very much more. The clear inference to be drawn from the facts is that the subject properties were part of the joint venture property trading business of the Taxpayers.

Even if one were to ignore the fact that the Taxpayers were carrying on business in joint venture, the decision in this case would be no different. On the facts it is quite clear that this was a venture in the nature of trade and as such the profit which arose is assessable to profits tax.

For the sake of completeness we mention that we have not overlooked the fact that the Taxpayers on two occasions proposed to redevelop part or all of the subject properties. This is apparent from the fact that plans were prepared and submitted to the Government. The most favourable interpretation of this for the Taxpayers is neutral. Indeed without positive evidence regarding long term finance and other similar matters the suggestion would be that the Taxpayers must have intended to redevelop and sell.

For the reasons given the Board found in favour of the Commissioner and dismissed the appeal.