

Case No. D7/11

Profits tax – whether gains on disposal of properties chargeable to profits tax – section 14 of Inland Revenue Ordinance (‘IRO’).

Panel: Kenneth Kwok Hing Wai SC (chairman), Alan Chan Chung Yee and Kelly Wong Yuen Hang.

Date of hearing: 31 August 2009.

Date of decision: 7 June 2011.

The appellant bought and sold a Residential Unit and an Office Unit (‘the 2 properties’).

The appellant objected to the profits tax assessment raised on it in respect of the gain on disposals of the 2 properties contending that the 2 properties were acquired as investment properties and held on a long term basis.

Held:

1. The acquisitions of the 2 properties were funded wholly by loans. The appellant was financially unable to fund the acquisition of or hold the 2 properties as investment property on a long term basis.
2. In the absence of any evidence on their financial net worth, neither the witness (shareholder and director of the appellant) nor his wife is a reliable source of financial support for the appellant.
3. The only reason given for the sale of the Residential Unit was the termination of the tenancy agreement by the tenant and that for the Office Unit was the attractiveness of the offer from the buyer.
4. Considering all the circumstances of this case, the appellant acquired the Residential Unit and the Office Unit as trading stock.

Appeal dismissed.

Cases referred to:

Shui On Credit Company Limited v Commissioner of Inland Revenue, (2009) 12

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HKCFAR 392
D58/09, (2010-11) IRBRD, vol 25, 54
Lee Yee Shing Jacky and Yeung Yuk Ching v Commissioner of Inland Revenue
[2008] 3 HKLRD 51

Joseph Law Shek Hung, Messrs K L Young & Co, Certified Public Accountants, for the Taxpayer.

Lau Wai Sum and Chan Wai Yee for the Commissioner of Inland Revenue.

Decision:

Introduction

1. The appellant bought and sold a residential property ('Residential Unit') and an office unit ('Office Unit'), collectively 'the 2 properties'. The assessor assessed the appellant's gains to profits tax for the 2004/05 year of assessment. The appellant objected. The Deputy Commissioner of Inland Revenue disagreed with the appellant's objection and confirmed the assessment.

2. The issue in this appeal is whether the gains are chargeable to profits tax under section 14 of the Inland Revenue Ordinance, Chapter 112, ('the Ordinance').

3. The issue in an appeal before the Board is whether the assessment appealed against is incorrect or excessive, not whether the reasons given by the Commissioner were wrong¹. The appeal is a hearing *de novo*². The onus of proving that the assessment appealed against is excessive or incorrect is on the taxpayer³. As the appeal is a hearing *de novo* and the onus of proof is on the appellant, it will be more helpful and constructive for tax representatives to seek the agreement of the respondent on facts which are not in dispute and adduce evidence with a view to proving facts in issue. The Revenue's treatment of facts at the objection stage is at best of historical interest and it is seldom, if ever, helpful to indulge in criticism of the Revenue's treatment of facts at the objection stage. As Lord Walker NPJ said in Shui On Credit Company Limited v Commissioner of Inland Revenue, (2009) 12 HKCFAR 392, at paragraph 30:

'The taxpayer's appeal is from a determination (section 64(4)) but it is against an assessment (section 68(3) and (4)).'

The appellant's transactions in relation to the 2 properties

¹ CIR v The Board of Review, ex parte Herald International Ltd [1964] HKLR 224 page 237; and Cheung Wah Keung v CIR [2002] 3 HKLRD 773 at paragraph 43.

² Shui On Credit Company Ltd v CIR (2009) 12 HKCFAR 392 at paragraph 30.

³ Section 68(4) of the Ordinance and Mok Tsze Fung v CIR [1962] HKLR 258 at page 281; and All Best Wishes Limited v CIR (1992) 3 HKTC 750 at page 772.

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4. The following is a summary of the appellant's dealings with the 2 properties:

<u>Date</u>	<u>Residential Unit</u>	<u>Office Unit</u>
21-12-02	Provisional acquisition agreement, consideration at \$2,100,000	
03-01-03	Formal acquisition agreement	
10-01-03	Mortgage loan offered by a bank for \$1,100,000, repayable by 180 instalments of \$7,321.74 per month	
05-03-03	Completion of acquisition	
07-06-03	Tenancy agreement for 2 years but terminable by notice during the second year. Monthly rental of \$9,800 inclusive of rates, management fee and property tax	
13-06-03		Provisional acquisition agreement, consideration at \$1,853,000
15-07-03		Mortgage loan offered by a bank for \$1,000,000, repayable by 84 instalments of \$13,382.99 per month
21-07-03		Completion of acquisition
30-08-03		Tenancy agreement for 2 years at a monthly rental of \$12,000 exclusive of rates, and management fee
28-06-04	Tenant gave notice to terminate tenancy agreement with effect from 27-07-04	
14-09-04		Provisional sale agreement, consideration at \$4,138,200
28-09-04	Provisional sale agreement, consideration at \$2,960,000	
18-11-04	Completion of sale	

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11-03-05		Completion of sale
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Fundamental uncertainty of the appellant as a going concern

5. The appellant is a private company incorporated in Hong Kong. At all relevant times, the appellant's authorised and issued capital remained at \$10,000 and \$200 respectively. There were 2 directors and shareholders.

6. As at 31 March 2000 and 31 March 2001, the appellant's audited financial statements showed accumulated losses carried forward and shareholders' deficits. As at 31 March 2002, the appellant's audited financial statements showed accumulated losses carried forward of \$30,761 and shareholders' deficit of \$30,561. The appellant suffered a net loss of \$6,043 for the year ended 31 March 2002 and a net loss of \$9,524 for the year ended 31 March 2003.

7. The appellant's financial statements were audited by Messrs K L Yeung & Co, certified public accountants. Messrs K L Yeung & Co also represented the appellant in the objection process and in the appeal before the Board. The financial statements for the year ended 31 March 2003 and the year ended 31 March 2004 contained statements made by Messrs K L Yeung & Co on 'Fundamental uncertainty' and showed the following:

	<u>Year ended 31 March 2003</u>	<u>Year ended 31 March 2004</u>
Auditor's statement on 'fundamental uncertainty'	In forming our opinion, we have considered the adequacy of the disclosures made in the financial statements in relation to the fundamental uncertainty affecting the applicability of the going concern basis. These financial statements are prepared under the going concern basis and do not include any adjustments that might have been found to be necessary had the shareholders withdrawn their financial support to the company. Details of the fundamental uncertainty have been disclosed in note 2 to the financial statements. We consider that appropriate disclosures have been	In forming our opinion, we have considered the adequacy of the disclosures made in the financial statements in relation to the fundamental uncertainty affecting the applicability of the going concern basis. These financial statements are prepared under the going concern basis and do not include any adjustments that might have been found to be necessary had the shareholders withdrawn their financial support to the company. Details of the fundamental uncertainty have been disclosed in note 2 to the financial statements. We consider that appropriate disclosures have been

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	made and our opinion is not qualified in this respect.	made and our opinion is not qualified in this respect.
Auditor's 'opinion'	In our opinion, the financial statements give a true and fair view of the state of the company's affairs as at 31 March 2003 and of its loss for the year then ended and have been properly prepared in accordance with the Companies Ordinance.	In our opinion, the financial statements give a true and fair view of the state of the company's affairs as at 31 March 2004 and of its profit for the year then ended and have been properly prepared in accordance with the Companies Ordinance.
Turnover	\$3,757	\$3,757
Other revenues (Rental Income)	-	\$170,000
Net profit (loss) for the year	(\$9,524)	\$31,481
Accumulated losses carried forward	(\$40,285)	(\$8,804)
Amount due to a shareholder	\$1,067,687	\$2,002,489
Net current liability	(\$1,151,021)	(\$3,253,589)
Net liabilities	(\$40,085)	(\$8,604)
Note 2 on 'basis of preparation of financial statements'	The financial statements are prepared under the historical cost convention. In view of the net current liabilities of HK\$1,151,021 and the shareholders' deficit of HK\$40,085 at the balance sheet date, the Company's continuance in business as a going concern is dependent upon the continuing financial support of its shareholders. Should the Company be unable to operate as a going concern, additional liabilities might need to be provided for. Furthermore, the carrying amounts of	The financial statements are prepared under the historical cost convention. In view of the net current liabilities of HK\$3,253,589 and the shareholders' deficit of HK\$8,604 at the balance sheet date, the Company's continuance in business as a going concern is dependent upon the continuing financial support of its shareholders. Should the Company be unable to operate as a going concern, additional liabilities might need to be provided for. Furthermore, the carrying amounts of

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	assets might need to be written down to their net realizable amounts. Non-current assets and liabilities might have to be reclassified as current. As the shareholders have undertaken to provide financial support to the Company, the financial statements are prepared under the going concern basis.	assets might need to be written down to their net realizable amounts. Non-current assets and liabilities might have to be reclassified as current. As the shareholders have undertaken to provide financial support to the Company, the financial statements are prepared under the going concern basis.
Note on 'amount due to a shareholder'	Note 8: The amount due was unsecured, interest-free and had no fixed repayment terms.	Note 12: The amount due was unsecured, interest-free and had no fixed repayment terms.

- 8.
- (1) The choice of the words 'fundamental uncertainty' was entirely that of Messrs K L Yeung & Co. Consideration of the question whether disclosure was adequate implied that disclosure was necessary, despite the shareholders' undertaking to provide financial support.
 - (2) However, at the appeal hearing before us, Messrs K L Yeung & Co sought to convince us that, despite the fundamental uncertainty as a going concern, the appellant intended to acquire and hold both the Residential Unit and the Office Unit on a long term basis as investment properties and had the financial ability to do so.
 - (3) It will take a lot of convincing for us to adopt what seems like a schizophrenic approach.

Authorities on onus of proof and on capital or trading/business issue

9. The relevant authorities were set out in paragraphs 35 to 46 in D58/09, (2010-11) IRBRD, vol 25, 54. We agree with these paragraphs and adopt them as setting out the relevant authorities.

Board's decision

10. It is clear from paragraphs 5 to 7 above that the appellant itself was financially unable to:

- (1) fund the acquisition of the Residential Unit contracted on 21 December 2002 and assigned to the appellant on 5 March 2003; or

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- (2) fund the acquisition of the Office Unit contracted on 13 June 2003 and assigned to the appellant on 21 July 2003; or
- (3) hold the Residential Unit or the Office Unit on a long term basis.

11. The acquisitions were funded wholly by loans. As for the Residential Unit, the appellant had to borrow a further sum of \$1,000,000⁴ in addition to the mortgage loan to fund the acquisition. As for the Office Unit, the appellant had to borrow a further sum of \$853,000⁵ in addition to the mortgage loan to fund the acquisition. Loans are liabilities, not assets, and have to be repaid. Nothing or precious little was said about repayment of such loans.

12. The appellant relied on rental income from the 2 properties to make monthly mortgage repayments. The appellant made no claim that they did not know that the inherent probabilities were that there would not be 100% occupancy of and rental income from both the Residential Unit and the Office Unit. Even on the assumption of 100% occupancy and rental income, the rental income from the 2 properties was insufficient to pay instalment payments for both properties. There was a deficit of \$680 per month. That may be a small amount, but with a meagre turnover of \$3,757 for the year ended 31 March 2003 and the same meagre amount apart from rental income for the subsequent financial year, the appellant simply had no funds to make up the shortfall.

13. The appellant contended that the shareholders could afford to lend \$680 per month. Assuming for the moment that that was true, a loan remained a loan and would have to be paid off at some stage by the appellant which had a shareholders' deficit.

14. Mr Joseph Law Shek Hung produced evidence of some assets of the shareholder and director who gave evidence at the hearing and contended that he had the financial ability to fund the acquisition and holding of the 2 properties on a long term basis. As the Board has said many a time, a person's financial strength is not proved by merely adducing evidence of some assets of that person, without also disclosing that person's liabilities. In the absence of credible evidence on the witness' financial net worth, we are not satisfied on the balance of probabilities that the witness had the financial ability to fund the appellant's acquisition and holding of the 2 properties as investment assets.

15. Moreover, on such evidence as we have seen, we are not satisfied that the witness was a reliable source of financial support for the appellant. Ms Lau Wai Sum sought to produce the composite tax return of the witness for the 2002/03 year of assessment. As the appellant sought to rely on the witness's financial strength and as there was no allegation or evidence of any prejudice to the appellant, we, in the exercise of our discretion, admit this document in evidence. The appellant's return claimed rental income of \$144,000, salary income of \$295,100, interest payments of \$57,939 and dependent parents' allowance

⁴ \$2,100,000 - \$1,100,000.

⁵ \$1,853,000 - \$1,000,000.

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in respect of the witness' parents. Despite the witness' claim that he was supporting his dependent father, Mr Joseph Law Shek Hung felt proper to ask in re-examination the question 'if you need money could you ask your father to give you assistance'. The witness admitted under cross-examination that he had been indebted to his employer for about \$1 million since 1999 or before and asserted in re-examination that apart from his instalment payments of loans for his residence, his monthly living expenses was about \$40,000 to \$50,000⁶. Mr Joseph Law Shek Hung proved that the witness was living beyond his means.

16. The appellant then put forward a new case of financial support by the witness' wife and her salaries' tax assessment for the 2003/04 year of assessment was produced. The assessed income was \$565,488, with deduction of \$44,420 on account of interest, \$60,000 as children's allowance and \$60,000 as dependent parent/grandparent allowance. Adding the disclosed income of both the witness and his wife, they were living beyond their means.

17. In the absence of any evidence on the financial net worth of the witness or his wife, we are not satisfied that either or both had the financial strength to support a long term holding of either of the 2 properties.

18. More importantly, the appellant put forward no case on how it could:

- (1) repay the loan(s) for the shortfall of \$1,000,000⁷ for the acquisition of the Residential Unit; and
- (2) repay the loan(s) for the shortfall of \$853,000⁸ for the acquisition of the Office Unit.

19. We conclude and find as a fact that the appellant did not have the financial ability to acquire and hold either of the 2 properties as investment property. The appellant's case of acquisition of the Residential Unit as investment property for rental income fails on the facts and its case of acquisition of the Office Unit as investment property for rental income also fails on the facts.

20. We turn to the badges of trade summarised by McHugh NPJ in Lee Yee Shing:

- (1) Whether the appellant has frequently engaged in similar transactions:

No. These 2 acquisitions within 6 months are the only transactions known to us. The 2 properties were not acquired at a time when the appellant had spare cash and was looking for investment opportunities, but at a time when there was a shareholders' deficit and there was fundamental uncertainty about its being a going concern.

⁶ or \$480,000 to \$600,000 each year.

⁷ See paragraph 11 above.

⁸ See paragraph 11 above.

- (2) Whether the appellant has held the asset or commodity for a lengthy period:

The relevant periods are set out in paragraph 4 above. They are neither short nor long.

- (3) Whether the appellant has acquired an asset or commodity that is normally the subject of trading rather than investment:

Landed property could be acquired for trading or investment.

- (4) Whether the appellant has bought large quantities or numbers of the commodity or asset:

The Residential Unit and the Office Unit are the only 2 known to us. On the facts of this case, it could not afford either property.

- (5) Whether the appellant has sold the commodity or asset for reasons that would not exist if the taxpayer had an intention to resell at the time of acquisition:

The only reason given for the sale of the Residential Unit was the termination of the tenancy agreement by the tenant. If the Residential Unit were acquired as investment property, the appellant would have made allowance for vacant periods in between 2 tenancies and the Residential Unit would not be sold within a short period of 2 months from the termination of the tenancy agreement. There was no evidence of any attempt to put the Residential Unit on the rental market after the appellant had received notice of the tenant's exercise of the option to terminate the tenancy agreement.

The only reason given for the disposal of the Office Unit was the attractiveness of the offer from the buyer. According to information supplied by the estate agent through which the Office Unit was sold, the appellant put up the Office Unit for sale on 4 March 2004, that is within 8 months of the completion of its acquisition on 21 July 2003. The witness asserted in his brief witness statement that he permitted the estate agent to test the market price⁹. Testing the price indicated that the appellant was doing a deal instead of acquiring an investment property. The witness asserted under cross-examination that he 'did not have much, an eager intention to sell the property'. This assertion, even taken at its face value, evidenced some intention to sell the property.

⁹ 「代為試價」。

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- (6) Whether the appellant has sought to add re-sale value to the asset by additions or repair:

No.

- (7) Whether the appellant has expended time, money or effort in selling the asset or commodity that goes beyond what might be expected of a non-trader seeking to sell an asset of that class:

Within 8 months from the completion of the acquisition of the Office Unit, it engaged an estate agent to sell the Office Unit.

- (8) Whether the appellant has conceded an actual intention to resell at a profit when the asset or commodity was acquired:

Subject to sub-paragraph (4) above, no.

- (9) Whether the appellant has purchased the asset or commodity for personal use or pleasure or for income:

Not for personal use or pleasure. Its case is for rental income. As seen from paragraph 12 above, the total rental income was insufficient to pay off the mortgage loans instalments, not to mention other expenses of the appellant.

- (10) Source of finance:

Wholly by borrowed funds at a time when there was a shareholders deficit.

21. Upon a holistic consideration of the circumstances of this particular case, we conclude that the appellant acquired:

- (1) the Residential Unit as a trading stock; and
- (2) the Office Unit as a trading stock.

22. The appeal fails and falls to be dismissed.

Disposition

23. We confirm the assessment appealed against and dismiss the appeal.