

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D77/96

Profits tax – joint purchase and sale of flat by three persons – whether adventure in nature of trade – claim by one of the taxpayers that flat was purchased as his residence – whether partnership existed between the persons assessed to profits tax – IRO sections 2(1), 14 and 22(1).

Panel: Andrew Halkyard (chairman), William Chan Wai Leung and Douglas C Oxley.

Date of hearing: 24 October 1996.

Date of decision: 13 December 1996.

In February 1991 three persons ('the taxpayers') purchased a flat which was then under construction. The occupation permit was issued in May 1991. In June 1991 the taxpayers, as confirmors, sold the flat at a profit. None of the taxpayers ever resided in the flat.

The taxpayers were assessed, as a partnership, on the profits arising from the sale of the flat. The assessor considered that they had engaged in an adventure in the nature of trade.

On appeal, only one of the taxpayers ('Mr X') appeared before the Board. He claimed that the flat was acquired for his residence, that the other two taxpayers (who each advanced a one-third share of the purchase price) would be paid out on completion, and that he only agreed to sell the flat in a surging property market because he could not otherwise repay those loans. After a further period of five months, Mr X purchased a second flat which was used as his residence.

On appeal, the Commissioner argued that the badges of trade, especially the short period of ownership, supported the assessment. Particular emphasis was given to the contention that Mr X was financially unable to meet the costs of refinancing the flat once it was ready for occupation. In other words, the Commissioner argued that Mr X's intention to purchase the other taxpayers' interest in the flat upon completion was simply a contingent hope which was not reasonably capable of fulfillment.

Held:

(1) Mr X purchased the flat for residential purposes and entered into an unusual, but explicable, agreement with the other taxpayers to achieve his goal. The purchase by Mr X of the second flat, which was used as his residence, was not determinative; but equally it was not irrelevant. It was a factor which was

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considered in weighing his evidence to determine whether his actions and demeanour were those of a property dealer or whether this was more a case of a young person trying very hard to improve his condition in life by purchasing his own residence. The Board concluded it was the latter.

(2) The above conclusion, which involved accepting Mr X's evidence, withstood objective testing by reference to the so-called 'badges of trade'. However significant the factor of short-term holding can be, and in many cases it is a critical factor, it can be neutralised by a cogent reason for sale. The cogent reason in this case was that, in the surging property market following the purchase, Mr X simply could not afford to purchase the other taxpayers' interest in the flat upon completion. This factor was not anticipated at the time of purchase.

(3) Notwithstanding the Board's acceptance of Mr X's evidence, it agreed with the Commissioner's contention that in order to succeed in the appeal Mr X must show that, at the time of purchase, he had the ability to carry out his claimed intention to refinance the flat upon completion. In this regard, his refinancing plans which were brought out in evidence before the Board were not simply a contingent hope and that, when judged at the time of purchase, he had the means to bring them to fruition (All Best Wishes Ltd v CIR [1992] 3 HKTC 750 considered).

(4) Mr X had not engaged in an adventure in the nature of a trade. Therefore the assessment, which assessed Mr X as a member of a partnership carrying on trade or business with a view to profit, must be annulled.

Per curiam Although Mr X had not entered into a partnership which carried on business with a view to profit, the Commissioner may wish to review the position of the remaining two taxpayers who chose not to give evidence before the Board.

Appeal allowed.

Cases referred to:

Simmons v IRC (1980) 53 TC 461
Marson v Morton [1986] 1 WLR 1343
All Best Wishes Ltd v CIR [1992] 3 HKTC 750
D11/80, IRBRD, vol 1, 374
D8/90, IRBRD, vol 5, 113

Cheung Mei Fan for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

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Messrs X, Y and Z (hereinafter referred to as 'Mr X', 'Mr Y' and 'Mr Z' individually and 'the Taxpayers' collectively) objected to the profits tax assessment for the year of assessment 1991/92 raised on them. The Taxpayers claimed that the profit derived by them from disposal of a property was capital in nature and not chargeable to tax. The Taxpayers' objection to the assessment was rejected by the Commissioner of Inland Revenue. Mr X has now appealed to the Board of Review from the determination of the Commissioner.

The facts

The following facts are not in dispute.

1. On 20 February 1991, the Taxpayers entered into a provisional agreement to purchase a property ('Property A') for a consideration of \$1,142,000. At the time of purchase, Property A was under construction. The occupation permit for Property A was issued on 10 May 1991.
2. On 18 June 1991, the Taxpayers entered into a provisional agreement to sell Property A for a consideration of \$1,500,000. On 12 September 1991, the Taxpayers, acting as confirmors, assigned Property A to the purchaser and completed the transaction. None of the Taxpayers ever occupied Property A.
3. The assessor was of the opinion that the purchase and sale of Property A by the Taxpayers amounted to an adventure in the nature of trade and raised an estimated profits tax assessment for the year of assessment 1991/92 on them showing assessable profits of \$336,000.
4. The Taxpayers objected to the assessment on the ground that Mr X acquired Property A with the intention of using it as his residence and that Mr Y and Mr Z acquired Property A for the purposes of investment and financing Mr X. They claimed that, after an unexpected surge in property prices, the property was sold because Mr X realised that he could repay the loans from Mr Y and Mr Z with the sale proceeds and at the same time obtain sufficient funds to purchase another smaller property.
5. In reply to the assessor's enquiries concerning the purchase and sale of Property A, the Taxpayers supplied the following information:
 - (a) Mr X wanted to purchase Property A in early 1991 for self residence. To enter into this transaction he had to make a downpayment of \$114,200. He did not have sufficient money. He therefore sought financial assistance from his former work colleagues, Mr Y and Mr Z, who agreed that each of them would assist Mr X by contributing one-third of the purchase price for Property A.

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- (b) In order to secure the investment of Mr Y and Mr Z in Property A, the Taxpayers agreed to sign the sale and purchase agreement as tenants in common. Mr X intended to buy back Mr Y's and Mr Z's interest in the property at the prevailing market price when he was qualified to apply for a housing loan from his employer in early 1992 (see further, fact 6).
 - (c) The amount of downpayment advanced by Mr Y and Mr Z was \$38,066.66 each. Subsequently, the Taxpayers obtained an equitable mortgage from Bank U secured over Property A in the amount of \$1,027,800. The Taxpayers contributed equally towards the monthly mortgage repayments during the period April to June 1991. The monthly mortgage repayment was approximately \$10,000. There were no specific terms of repayment agreed by Mr X for the amount advanced by Mr Y and Mr Z.
 - (d) After the disposal of Property A, Mr X bought another property ('Property B') for self residence (see further, fact 22), Property B was smaller, and less conveniently located for travelling to and from Mr X's place of work, than Property A.
 - (e) Subsequently, Mr X sold Property B and bought another property ('Property C') also for self residence.
 - (f) Mr X purchased Property C to replace Property B in order to improve his living conditions. Property C was larger and more conveniently located for travelling to and from his place of work.
 - (g) The Taxpayers shared equally the balance of the sale proceeds from Property A.
 - (h) Mr X's place of work was in District V.
6. Mr X was notified by his employer on 27 February 1992 that a housing loan of \$100,000 had been granted to him. The terms of the housing loan scheme stated that employees were required to complete two years' service with the employer before they could apply for a loan and that the maximum amount of a loan was \$100,000. Mr X commenced employment with his employer on 16 January 1990.
7. On 29 April 1992, Mr Y executed an assignment of Property B to Mr X for a consideration of \$1,350,000.
8. On 3 July 1993, Mr X entered into a provisional agreement to sell Property B for a consideration of \$1,500,000.
9. On 10 July 1993, Mr X entered into a provisional agreement to purchase Property C for a consideration of \$1,975,000.

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10. After taking into account the expenses incurred in buying and selling Property A, the Taxpayers derived a profit of \$293,603.

11. On 19 January 1996, the Commissioner issued a determination rejecting the Taxpayers' objection. He determined that the assessable profits for the profits tax assessment for the year of assessment 1991/92 raised on them should, however, be reduced to \$293,603 (fact 10 refers) with tax payable thereon of \$44,040.

12. On 2 February 1996, Mr X appealed to the Board of Review against the Commissioner's determination. Mr X contends that he did not purchase Property A for the purpose of resale at a profit.

The evidence of Mr X

Mr X appeared before us and gave sworn evidence. We found him to be a competent witness. On the basis of Mr X's testimony and further documents produced to the Board, we find the following additional facts.

13. During 1991 Mr X shared a flat in District W with his friend.

14. At all relevant times, Mr X contributed money to support his elderly parents. He did not pay them any fixed amount and then only paid them when he had money to spare. He had no other family financial commitments.

15. Mr X first saw that Property A was available for sale towards the end of 1990. The property was advertised for sale by the developer on a first-come first-served basis.

16. When Mr X approached Mr Y and Mr Z to finance the purchase of Property A, they stated that they would not simply lend him the money. However, they were prepared to take a 'share' in Property A. In the event, the Taxpayers purchased Property A as tenants in common. The Taxpayers agreed that, subject to unforeseen circumstances, the interest of Mr Y and Mr Z in Property A would be purchased by Mr X at the prevailing market price as at the time of completion. If the market price fell below cost price, Mr Y and Mr Z would then accept a lower pay out figure calculated by reference to that market price. No written agreement was entered into by the Taxpayers in relation to these various matters.

17. Mr X expected to complete the purchase of Property A in late 1991.

18. During the first half of 1991 the property market suddenly surged and prices rose on average by between 20-30%.

19. The effect of the price surge in fact 18 was not anticipated by Mr X. By June 1991, this led Mr X to reconsider whether he could afford to complete the purchase of Property A at the end of 1991 by buying out the interest of Mr Y and Mr Z. Also around this time, that is, June 1991, Mr Y and Mr Z indicated to Mr X that they wanted to sell Property A if Mr X could not afford to purchase their interest upon completion.

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20. During 1991 Mr X's average monthly salary was approximately \$16,000. He had no other source of income. In light of facts 18 and 19, Mr X concluded that he could not afford to purchase Mr Y's and Mr Z's interest upon completion and, with the agreement of all parties, Property A was sold on 18 June 1991. By way of explanation, Mr X stated that Property A would only be advertised for sale if he could not afford to complete the purchase by buying out Mr Y's and Mr Z's interest. Although this is what ultimately happened, he reiterated that the increase in property prices which caused this situation was much larger than he had expected. Mr X also stated that he could afford to buy out Mr Y's and Mr Z's interest in June 1991 and, although he could not predict the future trend of property prices, he felt he would still have enough money left over to purchase a smaller flat in his own name.

21. After selling Property A, Mr X then considered whether to purchase another property for use as his residence. He initially hesitated because of the heated nature of the property market and he heeded Government's announcements that buyers should be wary in such market conditions.

22. Mr Y purchased Property B in 1989. Around November 1991, he asked Mr X whether he wanted to purchase this property. At that time, banks were only prepared to finance 80% of the market value of property by way of first mortgage. This can be contrasted with the position in early 1991 when banks were prepared to finance 90% of the market value of property. Mr X again approached Mr Z to help him finance the purchase of Property B. Mr Z agreed to this request and on 5 November 1991 they entered into a sale and purchase agreement to purchase Property B from Mr Y as tenants in common. In this way Mr X was able to obtain sufficient funds to make a downpayment to Mr Y for part of the purchase price of Property B. With the agreement of Mr Y, he was able to delay completion until 29 April 1992.

23. On 27 February 1992, Mr X qualified for a housing loan from his employer in the amount of \$100,000 (see further, fact 6). He used this money, together with his savings and an advance from his father (who had received a long service payment upon retirement), to complete the purchase of Property B. He repaid Mr Z upon completion and became the sole registered owner of this property.

24. Upon obtaining the housing loan, Mr X had to repay to his employer approximately \$1,000 per month.

25. Mr X lived in Property B for about one year. He had received a promotion at his work, he had some savings, and he then decided to sell Property B and purchase a larger and more convenient property, Property C, which he then used as his residence (see further, facts 8 and 9).

26. In response to questions whether (a) he could afford to purchase Mr Y's and Mr Z's interest in Property A as contemplated, and then whether (b) he could afford to finance the mortgage over Property A from his own resources, Mr X responded as follows:

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- (a) At the time he purchased Property A he expected that he could refinance Property A and obtain 90% of its estimated market value as at the date of completion. He estimated that this mortgage would amount to approximately \$1,134,000 (that is, \$1,142,000 [historical cost] x 10% [expected rate of increase in value] x 90% [expected amount of financing bank would allow upon first mortgage]). The amount of extra finance obtained in this way, when added to the housing loan obtained from his employer in February 1992 of \$100,000, would only leave him with a relatively small amount to pay out of his own pocket to purchase the interest of Mr Y and Mr Z. Mr X stated that if the value of Property A increased as he expected it would, that is, increase by approximately 10% during 1991, his completion of the purchase of Property A was dependent upon his obtaining a housing loan from his employer (fact 6 refers). Mr X admitted that he did not really consider what would happen if, as ultimately transpired, the property market increased at a rate greatly in excess of his estimated increase of 10%. When questioned as to source of finance between the expected date of completion (late 1991) and the date when he would obtain the expected housing loan from the employer (February 1992), Mr X responded that he could obtain temporary financing, perhaps by way of an overdraft or a personal loan, to cover any shortfall. He stated that he expected that this bridging finance would only be needed for a short period of time.
- (b) After Property A was refinanced, he could afford to make the new mortgage repayments himself because (1) his monthly salary (\$16,000) was greater than his anticipated liability under such mortgage (\$11,322) as well as the amount he had to repay his employer under the housing loan (\$1,000), (2) he expected his economic circumstances would improve as his salary and promotion prospects increased and (3) his parents would have been prepared to assist him in repayment since, among other things, he had previously given them money in accordance with family custom. Mr X also reiterated that he was sure he could refinance later in 1991 because when Property A was purchased banks were prepared to lend 90% of the purchase price to the purchaser without proof of income (see further, fact 22). He also stated that his salary did indeed increase and that by mid-1992 he was earning approximately \$20,000 per month.

Preliminary issue before the Board

Mr X was the only one of the Taxpayers who appeared before the Board. He confirmed that he appeared on behalf of himself only and that neither Mr Y nor Mr Z would contest the appeal. In response to questions from the Board, the Representative of the Commissioner, Ms Cheung Mei-fan, informed us that the assessment under appeal had been raised on the Taxpayers as a partnership¹ and that if we were to uphold Mr X's contentions,

¹ Under section 22(1) of the Inland Revenue Ordinance.

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we should annul the assessment. As this did not prejudice Mr X, we decided to proceed on this basis.

On reflection, it appears to us that Ms Cheung was correct. If we accept Mr X's contentions that he was not carrying on a trade (let alone a business in common with a view to profit²) in the purchase and sale of Property A, it must follow that the three persons designated collectively as 'the Taxpayers' for the purposes of the assessment in dispute were not in partnership. In this event, whether any other partnership existed between Mr Y and Mr Z is an interesting question. However, it is not one which is before us.

The Taxpayer's contentions

In essence, Mr X reiterated his grounds of appeal. He argued that at the time of purchase he intended to use Property A as his residence and that he only sold it in order to repay the loans from Mr Y and Mr Z and to obtain funds for acquiring another smaller, but affordable, property which he did use for residential purposes.

The Commissioner's contentions

Ms Cheung contended that the Taxpayers purchased Property A jointly with the intention of resale at a profit when the opportune time arose. She argued that Mr X's submissions as to his intention for purchasing Property A as a residence should not be accepted and that the objective facts show that the property was purchased as trading stock. Ms Cheung supported her contention with specific arguments which we deal with below.

The relevant law

On the basis that this appeal was argued before us, the question for decision is whether Mr X is assessable to profits tax by having entered into an adventure in the nature of trade jointly with Mr Y and Mr Z (section 14, section 2(1) definition of 'trade' and section 22(1) dealing with the assessment of a partnership). To determine whether a property is a capital asset or a trading asset, the purchaser's intention at the time of acquisition is crucial. In Simmons v IRC [1980] 53 TC 461, Lord Wilberforce stated at 491:

'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?'

An intention to hold property as a capital investment must be definite and not simply a wish incapable of fulfilment. Moreover, the stated intention of a person is not decisive. Actual intention can only be determined objectively (usually on the basis of the so-called 'badges of trade', see Marson v Morton [1986] 1 WLR 1343 at 1348-1349).

² This is the definition of 'partnership' for the purposes of the Partnership Ordinance.

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In All Best Wishes Ltd v CIR [1992] 3 HKTC 750, Mortimer J stated at 771:

'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.'

A similar statement is found in D11/80, IRBRD, vol 1, 374 where the Board of Review held at 379:

'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 arrangements or taken any steps to enable such intention to be implemented.'

Finally, the onus of proving the assessment appealed against is excessive or incorrect is on the appellant, Mr X (section 68(4)).

Analysis

We considered very carefully the evidence of Mr X, particularly as it was given in the absence of corroborating evidence from either Mr Y and Mr Z. We note that the evidence was consistent with Mr X's grounds of appeal and other documentary evidence supplied by the Taxpayers to the Inland Revenue Department. We also note that Mr X gave his evidence in a straight forward and confident manner and, despite being subject to detailed cross-examination by Ms Cheung, his credibility remained.

The overall impression we gained was that, as a young man, Mr X wanted a place of his own and entered into an unusual but explicable arrangement with Mr Y and Mr Z to achieve his goal. In short, we accept his evidence that he purchased Property A with the intention of residing in it but had to sell the property in totally unforeseen circumstances. Indeed, within a short period of time, he used the sale proceeds to buy a place of his own and resided there. We agree with Ms Cheung that this latter point is not decisive; but we reject the argument that it is irrelevant. It is one of the factors which we considered in weighing Mr X's evidence to help determine whether his actions and demeanour were those of a property dealer or whether this was more a case of a young person trying very hard to improve his condition in life by the purchase of his own residence. We think it is the latter and, on this basis, we had no hesitation in accepting Mr X's evidence.

We appreciate, however, that intention must be tested objectively. We thus propose to test this by examining certain badges of trade which formed the basis of the specific arguments advanced on behalf of the Commissioner. These arguments and our comments thereon are as follows.

- (1) *Argument* The method of financing the purchase, wherein the Taxpayers became tenants in common, was both unusual (in terms of Mr X acquiring a

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residence in this manner) and inconvenient (in terms of incurring additional stamp duty and legal costs).

Comment As indicated above, we accept that the method of financing was unusual. But it would not result in significant extra costs because, upon completion, we accept that Mr Y and Mr Z could nominate Mr X as the assignee of the conveyance.³

- (2) *Argument* The claimed arrangement entered into by the Taxpayers for Mr X to buy out the interest of Mr Y and Mr Z in Property A upon completion was, in the absence of a written agreement and corroborative evidence, doubtful and should be rejected.

Comment Amongst friends and work colleagues, written agreements to record commercial transactions are not the rule. Indeed, exactly the same informal arrangement was made by Mr X with Mr Z in relation to the purchase of Property B (fact 22 refers). And it is common ground that this property was purchased and used by Mr X as his residence.

- (3) *Argument* The Taxpayers had no compelling reason for selling Property A and this suggests that it was acquired for the purpose of resale at a profit.

Comment We do not speculate on the intention of Mr Y and Mr Z. Mr X, however, had a very good reason for disposing of Property A: he simply could not afford to complete the purchase by buying out Mr Y's and Mr Z's interest in light of the surging property market.

- (4) *Argument* The purchase of Property B by Mr X was an independent transaction and is irrelevant in ascertaining the Taxpayers' intention at the time of purchasing Property A. This is particularly so given the period of some five months which elapsed between the sale of Property A and Mr X's purchase of Property B. The fact that Mr X's profits from sale of Property A were used to purchase Property B for use as a residence is equally irrelevant (see D8/90, IRBRD, vol 5, 113 at 116).

Comment As indicated above, we do not regard this factor as irrelevant. Indeed, D8/90 is no authority to the contrary. It simply indicates that investment in a non-trading transaction of trading profits does not *thereby* stamp those profits as arising from something other than trade. In this case, we consider that the use of the Property A profits in purchasing Property B corroborates Mr X's evidence. We accept that in a rising market it *is* possible for Mr X to be a trader in February and an investor in November. However, his purchase of a residence in November, when allied with his stated intention in

³ At the time the Taxpayers purchased Property A, agreements in normal form for the sale of residential property were not subject to stamp duty.

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purchasing and then selling Property A, lends support to his claim that at all relevant times he was looking to purchase a home rather than to make a profit upon resale. In this regard, we also note that, prior to purchasing Property A, Mr X had no history of purchasing and selling property.

In relation to the time lapse of five months between the sale of Property A and the purchase of Property B, we agree with Mr X that his hesitation in purchasing his residence immediately was reasonable. In light of the heated nature of the property market at the relevant time, and given that a decision to purchase is not one to be taken lightly by a young man seeking to own his first residence, Mr X's evidence was believable.

- (5) *Argument* The short period of ownership of Property A, that is, four months, gives a strong presumption of trading. This is particularly so given that the Taxpayers sold as confirmors prior to execution of a formal assignment of the property. Such a sale is the hallmark of a property speculator.

Comment We accept the strength of Ms Cheung's submission. Yet, however significant a short-term holding can be (and in many cases it is a critical factor), it can be neutralised by a cogent reason for sale. As indicated above, we accept Mr X's evidence that there was a cogent reason in this case.

- (6) *Argument* In any event, Mr X's alleged intention to purchase Mr Y's and Mr Z's interest in Property A upon completion was simply a contingent hope. It was dependent upon him obtaining a new mortgage loan (assumed to be \$1,134,000 with monthly interest of \$11,322: fact 26) and obtaining a housing loan from the employer (assumed to be \$100,000 with monthly repayment of \$1,000: fact 24). The total monthly liability under these loans was a significant proportion of Mr X's monthly income. In the circumstances, his application for a new mortgage loan would be unlikely to succeed. Without refinancing Property A, Mr X would not have sufficient funds to put his claimed intention into effect.

Comment Notwithstanding our extended commentary on, and acceptance of, Mr X's evidence, we agree with Ms Cheung that Mr X must convince us that he had the ability to carry out his claimed intention (see All Best Wishes Ltd v CIR and D11/80). It is this issue which has caused us most concern. Indeed, we must record that Mr X's answers in cross-examination in relation to the issues of source of financing for completing the purchase of Property A and the availability of bridging finance were not hallmarks of clarity. However that may be, Mr X maintained the accuracy of his statements set out at fact 26 and, despite vigorous questioning, he was not shaken. On the balance of probabilities, we have decided to accept that his refinancing plans were not simply a contingent hope and that, when judged as at 20 February 1991, he had the means to bring them to fruition.

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Conclusion

Having heard and considered Mr X's evidence, and on the facts found by us, we conclude that his stated intention for purchasing Property A has been substantiated. We also conclude that, in purchasing Property A, Mr X had not engaged in an adventure in the nature of trade. Whatever may have been the position of Mr Y and Mr Z (and the Commissioner may wish to review this), Mr X was not a member of a partnership which carried on business in common with a view to profit.

For the above reasons, we order that the appeal be allowed and that the assessment in dispute be annulled.