HCIA 1/2015

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE
INLAND REVENUE APPEAL NO 1 OF 2015)

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BETWEEN

COMMISSIONER OF INLAND REVENUE Appellant

and

CROWN BRILLIANCE LIMITED Respondent

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Before: Hon G Lam J in Court
Date of Hearing: 21 September 2015
Date of Judgment: 14 October 2015

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J U D G M E N T

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1. This is an appeal by way of case stated against a decision of the Board of Review brought by the Commissioner of Inland Revenue pursuant to section 69 of the Inland Revenue Ordinance (Cap 112) ("the Ordinance"). The underlying dispute for the purpose of this appeal concerns whether a property purchased and subsequently sold by Crown Brilliance Limited ("the taxpayer") in 1997 was a capital asset or its trading stock. The background facts may be summarised as follows.

2. The taxpayer is a private company incorporated in Hong Kong on 10 January 1997, with an authorised share capital of HK$10,000 divided into 10,000 shares of $1 each of which 2 shares were, at all material times, issued to and held by Mr Daniel Hui and Eastern Pride Enterprises Limited. Eastern Pride is a company incorporated in the British Virgin Islands. The directors of the taxpayer were Mr Hui and his wife.

3. In its profits tax returns for the relevant years of assessment, the taxpayer described its principal activity as "investment in properties for rental purposes".

4. By a provisional agreement for sale and purchase dated 23 January 1997, the taxpayer agreed to purchase the property in question which was a flat in Broadview Villa, 20 Broadwood Road, Hong Kong ("Broadview Property") at a consideration of HK$30.8 million, with completion to take place on 30 May 1997. The Broadview Property was purchased subject to an existing tenancy which was based on a tenancy agreement dated 28 December 1995 for a term of 2 years commencing 1 December 1995. By a provisional agreement for sale and purchase dated 10 June 1997, the taxpayer sold the Broadview Property for a consideration of HK$39.5 million. The property was sold with the existing tenancy with completion on 28 July 1997. Subsequent to the sale of the Broadview Property, the taxpayer had become dormant.

5. The taxpayer had therefore made a substantial gain from the sale of the Broadview Property, which amounted to HK$7,100,930. The taxpayer's accounts for the year ended 30 June 1998 recorded this gain as an exceptional item. The taxpayer did not offer the gain derived from the sale of the Broadview Property for assessment to profits tax.

6. Upon enquiries made of the taxpayer by the assessor, the taxpayer's tax representative made representations in writing, in which it was claimed (as recorded in the Deputy Commissioner's decision):

> "(i) The Taxpayer's original intention was to hold the property for investment purposes. The purchase was partly financed by an instalment loan of HK$18.48 million granted by Hang Seng Finance Limited. The loan was repayable by 180 monthly instalments. The balance of the purchase cost came from internal funds, including HK$10 million from the holding company, Eastern Pride, which in turn borrowed from its directors; and HK$3,350,120 advanced by Mr Daniel Hui, one of the directors, from his personal assets. Mr Hui had no problem providing the loan, as his investment income ran into millions annually. For the two years ended 31 March 1997, Mr Hui received dividends from Song Ling Investment Co Ltd in the total amount of HK$8.221 million. The loans from Eastern Pride and Mr Hui were without any fixed terms of repayment.
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> (ii) The property was generating monthly rental income of HK$90,000 and the tenancy agreement was due to expire on 30 November 1997. The

Taxpayer estimated at the time that the monthly rental on a renewal of tenancy or new letting to be between HK$156,700 and HK$172,300 (ie $50 and $55 per square foot on 3,314 square feet). Any shortfall would be financed by Mr Hui, who was also the guarantor on the bank loan, through his substantial investment and other income. The fact that Hang Seng Finance Limited, a very reputable lender, was willing to lend the loan ofHK$18.48 million to the Taxpayer with a repayment term over 15 years spoke for itself as the Taxpayer's repayment ability.

(iii) In June 1997, the Taxpayer received an unsolicited offer from a real estate agent for the purchase of the property which was considered to be very generous and worth taking. The estate agent first contacted the Taxpayer by phone with an unsolicited verbal offer and then visited the Taxpayer to follow up. The Taxpayer resolved to sell the property after receiving this unsolicited offer and considering its merits. The Taxpayer did not offer the property for sale either by appointing an estate agent or any other form of advertisement. The Taxpayer had no idea how the purchasers, who had no relationship with the Taxpayer, were solicited. The selling price was determined by the offer submitted by the estate agent to the Taxpayer which was accepted.

(iv) The sale proceeds were used to repay the mortgage loan from Hang Seng Finance Limited and the loan from the Taxpayer's holding company, etc.

(v) The Taxpayer did not trade or purchase any property in replacement after the disposal of the property because the Asian financial turmoil of 1997 resulted in unreasonably high interest rate and volatility in the financial market, which made new investments extremely difficult.

(vi) The intention of the Taxpayer to purchase the property for long term investment purpose was supported by the fact that the property was purchased with an existing tenancy. The tenant's right of tenancy under residential leases was protected by law in Hong Kong. Tenants could stay for as long as they wish if they paid their rent. Since such properties were not very marketable, it would be foolhardy for the Taxpayer to purchase the property for anything other than long term investment purposes. Furthermore, there was a substantial penalty on the early repayment of the bank loan, which also acted as a deterrent to any quick sale."

7. After considering the representations made on behalf of the taxpayer, the assessor took the view that the Broadview Property was the taxpayer's trading stock, and the profit derived from its sale should be chargeable to profits tax. The assessor issued to the taxpayer a revised loss computation for the year of assessment 1997/98 and a profits tax assessment for the year of assessment 1998/99 on that basis.

8. The taxpayer disagreed with the 1997/98 loss computation and objected to the 1998/99 profits tax assessment on the ground, *inter alia*, that the Broadview Property was an investment property, not trading stock. The taxpayer's tax representative put forward the following contentions in support of its objection:

> " Year of assessment 1997/98
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> (a) The Broadview Property is an investment property and classified under Fixed Assets. At the same time, the property was receiving rent during the period. Rebuilding allowance should be allowed under section 36 of the Inland Revenue Ordinance.
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> Year of assessment 1998/99
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> (b) The Broadview Property was purchased as long-term investment with an existing rental agreement. Through numerous previous correspondence with the Revenue, the Taxpayer has affirmed repeatedly that their original intention regarding the purchase of this property was to hold it for long-term rental income.
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> (c) Up to the time the unsolicited purchase offer was received, the Taxpayer had no intention of selling this property. Their intention to hold this property for long term was clearly demonstrated by the following facts:
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> (i) They have arranged for long term financing for the property which involved the payment of a hefty early repayment penalty if the loan was repaid within a short period of time;
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> (ii) The subject property, with an existing tenant at the time, was not really a marketable commodity for sale when compared with a property with vacant possession because the tenant's right to renew the tenancy was protected by law. This would be a major deterrent to any potential purchaser who may consider acquiring the property for self use and these are the overwhelming majority of the potential purchasers in the market and
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> (iii) They had not taken any decision to sell this property nor had they taken any steps to market this property.
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> (d) If the Taxpayer's intention was otherwise, they could reasonably be expected to have taken the following steps:
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> (i) They should have arranged for some financing arrangement with minimal repayment penalty on early repayment,

(ii) They should have purchased a property with vacant possession which would have a much greater marketability and

(iii) They should have taken active steps to market their property such as advertising and appointing sales agent etc to increase the property's exposure to the market in order to enhance the chance of selling the property quickly and obtaining a good selling price.

The Taxpayer did none of the above because they did not have any intention of selling their property at the time.

(e) Between the time the Taxpayer purchased the Broadview Property and the time they received the unsolicited purchase offer in June 1997 the property market in Hong Kong had gone through a period of explosive and unusual activities and this explained why such a generous unsolicited offer was received. This unsolicited offer was the REASON that persuaded the Taxpayer to change their intention regarding this property because the offer was simply too generous to be passed over. As a result, the property was only held for a relatively short period of time but this was not intended.

(f) Whether a business project is commercially viable would be best left to the judgments of the enterprise involved and its bankers. ... The Taxpayer's judgment was obviously agreed to by their lender, Hang Seng Finance Limited, one of the most respectable financial institutions in Hong Kong, as it was satisfied with the repayment ability and the staying power of the Taxpayer and was willing to lend to the Taxpayer more than HK$18 million over a term of fifteen years. We believe this attested to the "long term" viability of the project."

9. The Deputy Commissioner of Inland Revenue, having considered the taxpayer's objection, determined pursuant to section 64 of the Ordinance that the objection failed. Pursuant to section 66, the taxpayer appealed to the Board of Review.

10. By a decision dated 10 October 2014, the Board of Review allowed the taxpayer's appeal so far as it concerned the Broadview Property. It ordered that the loss computation for the year of assessment 1997/98 should be revised to allow the deduction of the rebuilding allowance and that the profits tax assessment for the year of assessment 1998/99 should be revised to exclude the gain on the sale of the Broadview Property. It is common ground that rebuilding allowance under s. 36 of the Ordinance only arises if the Broadview Property was a capital asset.

11. By a case stated by the Board on 25 March 2015 on the application of the Commissioner, 3 questions of law have been stated for the determination by the Court of First Instance as follows:

> "(1) Whether, when it came to the making findings of fact (as distinguished from those facts agreed by the parties), the Board of Review misdirected itself in law and/or erred in law in relying on and/or giving undue weight to the Taxpayer's representatives' assertions or representations which were unsupported by any evidence or were not adduced as evidence, in circumstances where
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> (i) the Taxpayer, despite the invitation by the Board, chose not to call any witness to give oral testimony on its behalf and be tendered for cross-examination by the Commissioner of Inland Revenue and for questioning by the Board; and
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> (ii) the veracity of those assertions or representations was not supported by evidence (oral or otherwise).
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> (2) Whether as a matter of law and based on the evidence adduced before the Board, the true and only reasonable conclusion is that the Taxpayer purchased the Broadview Property as a trading stock, and that the Board erred in law in concluding that the Broadview Property was purchased by the Taxpayer as a capital asset.
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> (3) As a corollary from the answers to the questions above, whether as a matter of law, the true and only reasonable conclusion in respect of the Taxpayer's claim for rebuilding allowance in respect of the Broadview Property is that it should be disallowed."

12. The first question has arisen in this way. A number of letters had been written by the tax representative of the taxpayer to the Inland Revenue Department, both before and after the assessment by the assessor, and before the determination by the Deputy Commissioner. These letters set out, *inter alia*, the taxpayer's reasons for contending that the gain on the sale of the Broadview Property was not assessable to profits tax. A number of factual statements were made, as can be seen from the summaries quoted in paragraphs 6 and 8 above. For example, it was stated in those representations that the taxpayer took no step at all, after entering into the agreement to purchase the Broadview Property, to market it for sale, and that the eventual sale was made pursuant to an unsolicited offer received in June 1997 which the taxpayer considered too good to be missed.

13. No witness statement had been put in by either side for the hearing before the Board of Review. For reasons and in circumstances that are not entirely clear to me for I do not have a transcript of the hearing, the taxpayer's representative was invited by the Board to but decided not to give oral evidence at the hearing.

14. For the purpose of the appeal to the Board, certain facts had been admitted as agreed facts between the parties, but they did not include the contentious matters contained in the representations made by the tax representative. Nevertheless, in coming to their decision on the intention of the taxpayer at the time – a crucial question of fact, the Board appears to have treated the representations made by the taxpayer's tax representative as evidence. Thus in the draft case prepared by the Board, as quoted in paragraph 11 of the case eventually stated, the Board stated:

> "… the Board of Review is not bound by the rules of evidence governing admissibility and can consider and if though fit, rely on any evidence, oral of documentary, adduced before it by a party. The Appellant's tax representative's representations in response to the assessor's enquiries (including the enclosures) had been placed before this Board of Review. They were part of the agreed facts which this Board had found as facts. Mr Daniel Hui, the representative of the Appellant at the hearing, confirmed with this Board that the Appellant would rely on the representations made by its tax representative in response to the assessor's enquiries, and in support of the its *(sic)* objection to the 1998/99 Profits Tax assessment. Plainly, the Appellant's tax representative's representations were part of the evidence adduced before this Board and relied on by the Appellant in support of its appeal. Further, the Appellant's tax representative's representations were supported by enclosures sent at the same time. They included, in relation to the Broadview Property, the provisional purchase agreement dated 23 January 1997, the provisional sale agreement dated 10 June 1997, and the installment loan facility letter dated 30 April 1997 from Hang Seng Finance Limited. These documentary enclosures were part of the documentary evidence adduced before this Board. The facts stated in these documentary enclosures were supported by the facts stated in the formal purchase agreement dated 5 February 1997 and the formal sale agreement dated 25 June 1997 that the Commissioner had obtained from his own investigation and produced before this Board."

15. In my respectful opinion, it is clear in this case that the representations made on behalf of the taxpayer were not agreed facts. Indeed Mr Cheung who appeared on behalf of the taxpayer on this appeal (but not before the Board) did not contend otherwise. What was agreed was the fact that the taxpayer made those representations, or "claims", to the Revenue. There was no agreement that the contents of the representations were in fact true and correct. Nor, in my view, were the representations made by the tax representative in themselves evidence supporting the truth of their contents.

16. Under the Ordinance, the onus of proving the assessment is excessive or incorrect lies on a taxpayer: s. 68(4). Where the facts are in dispute, it is for the Board to make findings on the basis of the evidence adduced before it. As Blair-Kerr J said in *Commissioner of Inland Revenue v The Board of Review, ex parte Herald International Ltd* [1964] HKLR 224, 237:

> "… If the facts are agreed, and only points of law are involved, no difficulty should arise. If certain facts are not agreed, the onus of introducing evidence before the Board in the first instance lies upon the taxpayer. If he gives no evidence, the Board should deal with the case on the material before it. The assessor is entitled to have his assessment confirmed unless it is satisfactorily challenged by the taxpayer and shown to be excessive. If the taxpayer has given *prima facie* evidence of disputed facts, the assessor will be entitled to introduce evidence in rebuttal; and the Board will then resolve any conflict of evidence in the ordinary way on the basis of the evidence before them – not on the basis of evidence called by the Commissioner. It is the Board of Review which states the case for purpose of any subsequent appeal to a judge on a point of law. No tribunal can resolve disputed questions of fact except by evidence called before itself."

Although Fuad VP cautioned in *Commissioner of Inland Revenue v Nina T H Wang* [1993] 1 HKLR 7, 23 that *ex parte Herald International Ltd* was decided when s. 64 of the Ordinance was in a somewhat different form, the context of *Nina T H Wang* was quite different and it seems to me the passage quoted above remains valid as an explanation of the fact-finding process by the Board. It has been referred to by Deputy Judge To (as To J then was) in explaining the operation of s. 68(4) of the Ordinance in *Commissioner of Inland Revenue v Common Empire Ltd (No 2)* [2007] 3 HKLRD 75 at §19.

17. As to the power of the Board to admit evidence, s. 68(7) provides:

> "At the hearing of the appeal the Board may, subject to the provisions of section 66(3), admit or reject any evidence adduced, whether oral or documentary, and the provisions of the Evidence Ordinance (Cap 8), relating to the admissibility of evidence shall not apply."

18. The above features of the procedure of an appeal before the Board were, I believe, understood by the Board. Where it went wrong, with respect, was in treating the representations that had been made by the tax representative in letters to the Revenue as agreed facts or effectively unchallenged evidence, when those matters were in fact contentious.

19. In the present context, I accept the submission of Mr Leung, who appeared for the Commissioner on this appeal, that a fact is not proved by its assertion in argument. It is proved by evidence, oral or documentary. The representations and oral submissions made by the tax representative, without more, do not amount to evidence. This has been the practice of the Board itself: see *Board of Review Decisions Nos. D7/08* at §64, *D35/10* at §§12-13, *D18/13* at §50 and *D28/12* at §§16-17. Mr Leung accepted that the contemporaneous documents submitted by the tax representative, at any rate those documents whose authenticity is not in dispute, may be considered by the Board as admissible documentary evidence. But the assertions and submissions that are not

supported by the undisputed contemporaneous documents stand on a different footing and ought not, without more, to be treated as evidence.

20. It is not in dispute that there can be an error of law where the Board has relied, to a material extent, on matters which were not properly adduced as evidence: see *Wong Ning Investment Co Ltd v Commissioner of Inland Revenue* (unreported, HCIA 1/99, 3 July 2000). This is in essence what has happened in this case. On behalf of the taxpayer, Mr Cheung has taken a neutral stance on Question 1.

21. Accordingly I answer Question 1 in the affirmative.

22. Having arrived at that conclusion, which means that there was a material error in the decision-making process of the Board, in the ordinary course I should have thought the natural order would be to remit the matter to the Board for its decision on the proper evidence. Mr Leung submitted, however, that I should answer Questions 2 and 3 also. I have some hesitation in doing so, because on behalf of the taxpayer Mr Cheung submitted that the taxpayer should be given an opportunity to argue the matter before the Board including possibly adducing further evidence. He asserted that in deciding that Mr Hui would not give oral evidence, the taxpayer had been misled into thinking that the representations that had been made in writing by its tax representative would nonetheless be taken into account by the Board. I do not know whether that was the case, but just by looking at paragraph 4 of the case I cannot exclude that possibility. Nor have I heard any submissions on whether or not, if the matter was remitted, the Board would have the power and, if so, should exercise it, to allow further evidence to be adduced – a question on which I express no opinion. There are passages in the Court of Appeal's decision in *Commissioner of Inland Revenue v Board of Review and Indosuez W I Carr Securities Ltd* (unreported, CACV 57/2006, 27 April 2007) at §§28 & 31 that might suggest the Board had no power to hear further evidence when a case was remitted to it by the court, although the situation that had happened in the present case was not before the Court of Appeal in that case.

23. In any event, having considered the documentary evidence, it seems to me the question of the taxpayer's intention has to be one for the Board. So far as circumstantial evidence is concerned, Mr Cheung pointed to the fact, among others, that (i) the Broadview Property was purchased subject to tenancy; (ii) under the law applicable at the time there was protection of the tenure of the tenant, subject to payment of market rent; (iii) the taxpayer obtained a mortgage loan on terms which penalised and discouraged early repayment; and (iv) the taxpayer actually took the assignment of the property and paid all stamp duty and legal costs before entering into an agreement to sell the property. These matters, he submitted, tend to show an intention to hold the property on a long-term basis as investment, rather than as trading stock.

24. But not only was there circumstantial evidence of the taxpayer's intention, there was actually a copy of the minutes of the meeting of the board of directors of the taxpayer dated 25 January 1997 which stated it was resolved that the company "shall purchase the property … as an investment property …". This was included in the material

before the Board as Appendix E to the Deputy Commissioner's determination and was, as I understand Mr Leung's submission, a document properly to be treated as admissible documentary evidence. As far as I understand the Commissioner's position, there is no suggestion that it was anything other than a genuine document created at the time. It is arguable – and I need put it no higher than that – that the phrase "investment property" would suggest that the property was purchased as capital asset rather than trading stock. As such, the document, albeit created by the taxpayer's own directors, could, in my view, be regarded as evidence of the intention of the taxpayer at the time. What weight should be put on it is a question open to debate, but within the bounds of rationality, weight is of course a question for the Board as the tribunal of fact.

25. On the basis of the evidence properly adduced before the Board, I am unable to say that no reasonable Board of Review properly directing itself could possibly come to the conclusion that the Broadview Property was purchased and then held by the taxpayer as a capital asset rather than trading stock. I shall accordingly answer Question 2 in the negative.

26. It is not in dispute that on this basis the answer to Question 3 must also be "No".

27. My answers to the three questions set out in the stated case are therefore: (1) Yes; (2) No; (3) No. There will be an order pursuant to s. 69(5) of the Ordinance that the case be remitted to the Board with the opinion thereon expressed in this judgment.

28. I direct that, in the absence of agreement on the appropriate order, the parties do lodge brief submissions on costs within 21 days hereof.

(Godfrey Lam)
Judge of the Court of First Instance
High Court

Mr Paul H M Leung, instructed by the Department of Justice, for the appellant
Mr Ivan Cheung, instructed by Wong & Associates, for the respondent