Case No. D108/97

Profit tax – sale of land – whether the land was acquired as a capital asset – intention at the time of acquisition – burden of proof – Inland Revenue Ordinance section 68(4).

Panel: Christopher Chan Cheuk (chairman), Felix Chow Fu Kee and Berry Hsu Fong Chung.

Dates of hearing: 16 and 17 October 1997.
Date of decision: 12 February 1998.

The taxpayer was a private company incorporated in 1972. At all relevant times, it was wholly owned by Company E formerly known as Company F. The taxpayer carried on a godown business in the 1970's. In 1982, it ceased all its business activities and became dormant. In June 1984, Company F purchased from Company G a piece of agricultural land, the remaining portion of Lot No Y in Area V, District B at a consideration of $145,680. Before the sale and purchase of the agricultural land, Company G had already applied to the District Land Office for in-situ exchange of the agricultural land for industrial/godown land.

Company F then requested its solicitor to follow up on the in-situ exchange of land. In July 1986, a piece of land known as Lot No X in Area V, District B ('the Land') was granted to the taxpayer.

The taxpayer called witnesses to prove that it acquired the Land intending to build a godown for use by the Group for storage because there were serious traffic problems in the Group's storage spaces then. It was later discovered that it also needed to acquired the adjoining site of the Land for a joint development so as to be more cost effective. However, the Group failed to acquire the adjoining land at bidding. Finally, they sold the Land for $8,700,000 in May 1988. The taxpayer claimed that it looked for alternative sites in various places but was not successful. Later the Group found it not necessary to relocate their storage space because of change of business environment.

Held:

(1) Considering all the evidence, the Board found that the Group did not have any specific plan when the Land was acquired. The purpose was just to acquire the Land for speculation. There is a lack of contemporaneous evidence to show that the taxpayer acquired the land for use by the Group as a capital asset. The Board did not accept that the Land was acquired owing to the serious traffic problems in the storage spaces then.

(2) The taxpayer failed to show that it had genuine, realistic and realisable intention to erect the godown on the Land for use by the taxpayer and its group. (All Best Wishes v CIR, vol 3 HKTC 750 applied.)

(3) Section 68(4) of the Inland Revenue Ordinance puts the burden for proof on the taxpayer. Thus the taxpayer failed to discharge its burden of proof.

Appeal dismissed.

Case referred to:

All Best Wishes v CIR 3 HKTC 750

K A Lancaster for the Commissioner of Inland Revenue.
Thomas Lee of Messrs Ting Ho Kwan & Chan for the taxpayer.

Decision:

Appeal

1. This is an appeal by Company A, (the Taxpayer) against the determination by the Commissioner of Inland Revenue on 20 January 1997 in respect of the profits tax assessment raised on it for the year of assessment 1988/89 relating to the profits derived from sale of the land registered in the Land Registry as Lot No X in Area V in District B ('the Land').

Proceedings

2. The Taxpayer called two witnesses and produced a bundle of documents of 223 pages whilst the Revenue representative Mr Lancaster for the Revenue also prepared its own bundle of 98 pages, many of which overlap those of the Taxpayer. Since there are so many documents which are common and are not in issue, we wonder why the representatives could not agree a common bundle. At this time environmental protection is a critical problem : everyone has the duty to see that nothing is wasted. We hate to see hundred sheets of paper have been wasted just because the parties do not take the effort of agreeing the documents for production before hearing or communicating with each other on the subject to sort out the problem. Further, the practice of each side compiling its own documents leads to confusion; the documents are marked differently and no concordance of the two sets of numbering has been prepared. The Board has to make constant reference from one to the other. We see no reason why the case should be managed in such chaotic manner. Our past experience was that in almost every case before us the documents had been well organized and paginated and supplied to the Board long before hearing. But in this case the Board members received the Revenue bundle a week before hearing and at the

hearing the Taxpayer's tax representative produced another bundle which contained nearly all the documents of the Revenue's bundle. Such waste of effort and resources should be discouraged.

3. Apart from the documentary evidence the Taxpayer at first intended to call three witnesses. When the first witness was called Mr Lee produced a witness' statement and intended to treat the statement as testimony of the witness in examination in chief. The Board was very loath to accept it unless the other side consented to this method. Mr Lancaster rightly objected to it as he had not had the opportunity to study it and prepare himself for cross examination. After the morning break when Mr Lancaster had the chance of studying the witness statement in detail he indicated to the Board that he agreed to treat the witness statement as evidence of the first witness in the examination in chief. By consent the witness statement of Mr C was admitted as his testimony in examination in chief. Similarly, the witness statement of Mr D was submitted as his testimony in examination in chief. On each occasion the witness was subject to cross examination by Mr Lancaster for the Revenue. The case was set down for hearing about two months ago and it is very difficult for us to understand why the representatives could not communicate with each to facilitate and expedite the hearing.

Grounds of Appeal

4. The grounds of appeal are well set out in the letter dated 19 February 1997 to the Clerk to the Board of Review from Ting Ho Kwan & Chan which can be briefly summarized as follows:

(a) That the gain derived by the Taxpayer from the sale of the Land is capital in nature and not chargeable to profits tax;

(b) Alternative to (a) above, if the Taxpayer is liable to profits tax in respect of the sale of the Land, the gain as assessed was excessive since the Taxpayer acquired the Land as capital asset and only changed its intention with respect to the Land from capital asset to trading stock when the Taxpayer failed to acquire the plot of land adjacent to it in a public auction.

Brief Facts of the Case

5. At the hearing Mr Lee for the Taxpayer produced a Statement of Agreed Facts for Mr Lancaster to agree. After discussion some paragraphs were deleted and the rest of them were admitted as Agreed Facts. The Statement as amended was produced as agreed evidence and marked as Exhibit 'A2'. With some adaptation, we reproduce the Agreed Facts as follows:

(a) The Taxpayer was incorporated as a private company in Hong Kong on 11 January 1972. At all relevant times, the Taxpayer was a wholly owned subsidiary of Company E formerly known as Company F.

(b) The Taxpayer carried on a godown business in the 1970's. In 1982, it ceased all its business activities and became dormant.

(c) On 7 June 1984, Company F purchased from Company G the land registered in the Land Office as the remaining portion of Lot No Y in Area V, District B ('the Agricultural Land') at a consideration of $145,680. Before the sale and purchase of the Agricultural Land, Company G had already applied to the District Land Office ('DLO') for in-situ exchange of the Agricultural Land for industrial/godown land.

(d) Immediately following the purchase of the Agricultural Land, Company F requested its solicitor, Messrs Foo & Li to follow up on the in-situ exchange of land with DLO.

(e) In June 1985, Company F advised DLO that is was prepared to accept the terms and conditions of the exchange of land and the amount of premium payable.

(f) In August 1985, Company F requested DLO to register the exchanged land in the name of the Taxpayer.

(g) To implement the exchange as requested Company F assigned the Agricultural Land to the Taxpayer on 24 September 1985 at the same price it paid for the Agricultural Land.

(h) An Agreement and Conditions of Exchange for the exchanged land at Lot No X in Area V ('the Land') was signed between the Government as grantor and the Taxpayer as grantee on 28 July 1986.

(i) On 30 May 1988, the Taxpayer, as a vendor, entered into an agreement for the sale and purchase of the Land with Company H, as purchaser, at a consideration of HK$8,700,000. The sale and purchase was completed on 2 July 1988.

(j) On 14 February 1995, the assessor raised a profits tax assessment with assessable profits of HK$6,715,175 on the Taxpayer treating the gain from disposal of the Land as profits chargeable to tax.

(k) The Taxpayer lodged an objection against the profits tax assessment. After extensive exchange of correspondence, the assessor was not prepared to accept that the gain from the disposal of the Land was non-taxable.

(l) The Commissioner of Inland Revenue on 20 January 1997 issued a determination revising the taxable profits to HK$6,555,175.

(m) The Taxpayer appealed against the Commissioner's decision as stated in paragraph 1 above.

The Taxpayer's Case

6. The Taxpayer called witnesses to supplement the above agreed facts. Its director, Mr C was called as the first witness. He told us the history of the Land as outlined above. He emphasized that the Taxpayer intended to build a godown for use by the Group. Its calculation was that as the site area after exchange was about 10,000 square feet with a plot ratio of 5, the floor area of the new godown would be 50,000 square feet.

7. Since 1983, Company L and its associate companies ('the Group') had experienced rapid increase in sales in the three years before the exchange: 1983 - $101,000,000, 1984 - $141,000,000 and 1985 - $152,000,000. The level of stock kept was correspondently increased: $30,797,736, $39,731,874 and $44,147,499 respectively. As the Group was dealing in heavy machinery, the space required for storage was significantly increased from 44,000 square feet in 1982 to 95,000 square feet in 1986. In the last three years all the storage spaces were located in District I. As at 1986, the Group obtained a licence from one of its customers, Company J to use 20,000 square feet of open yard at a site opposite to Building K. The arrangement was that Company J could at any time terminate the licence upon notice. Similar arrangement was made with another associate company of Company F in respect of the 4th and 5th floors of Building K totalling 60,000 square feet. The remaining 15,000 square feet located on the ground floor of Building L was acquired by a subsidiary of Company F in 1986.

8. The witness tried to justify the acquisition and exchange for the Land by giving us the following reasons:

(a) As the Group's turnover was then rapidly increasing, there was a strong need for storage space.

(b) The Land was situated in District B, close to the border with good road system and not having so heavy traffic as the then only bridge. The area was also, less populated than District M and District N. It would facilitate transportation with China mainland as well as other parts of Hong Kong.

(c) All the storage could be centralized in one building instead of scattering at different places. It would be good for security and safety, and would also save labour costs. The Group would also have greater flexibility in making arrangement for storage.

9. After the exchange in about July 1986 C L Tsang and Associates, a firm of chartered surveyors, was instructed to do the planning for construction of the new building. It was then discovered that the net usable floor area was only 45,000 square feet, of which only 6,000 square feet on the 1st and 2nd floor was available for storage of heavy machinery. The Group was *'so frustrated with the traffic problem that it contemplated to move the whole of the storage operation to the new site at District B.'* C L Tsang, the surveyor, suggested to negotiate with the Government to acquire the adjoining site so that

the two plots of land could be amalgamated for a joint development which would solve the Group's storage problem. The unit building costs could be reduced by 10% to 15%. It would also enhance the total usable floor area for heavy machinery as well as the general usable storage space. The surveyor also advised that the price for acquiring the adjoining site was about $2,800,000. On that basis the surveyor was instructed to approach the Government. It was the Government's policy that it would not enter into agreement by private treaty but would put up the land for public auction.

10. In the auction held on 27 July 1987 the bidding went *'at a very fast pace'* which soon passed the Group's target price of $3,000,000 and reached $9,000,000 offered by the successful bidder, Company O. The witness described the failure to acquire the adjoining land as *'a heavy blow'* to their plan and they had no immediate alternative plan on how to make use of the Land. On the suggestion of Mr D, the second witness for the Taxpayer, that it would be more cost effective to sell the Land than to develop it, the Taxpayer agreed to put up the Land for auction which took place on 22 September 1987. The successful bidder, Company P, agreed to purchase at a price of $10,400,000, of which a deposit of $1,000,000 was paid and the balance of $9,400,000 was to be paid on completion within one month. In October the stock market collapsed and Company P failed to complete the purchase. The deposit was forfeited. Through the effort of Mr D, the Land was ultimately sold to Company H at a lesser price of $8,700,000 in May 1988.

11. The Taxpayer also claimed that it looked for alternative sites in various places but was not successful. Later, the Group found it not necessary to relocate their storage space. *'Because of the June 4th incident, business slowed down a bit. After 1990, the opening up of China had also created more export channels for Chinese products. The keen competitions pushed down the prices of machinery from China a lot and sales of Company T, which took over the business of Company F in 1988, and Company Q experienced stagnancy in their business growth. The opening up of more ports and improvement of transports in China meant that goods could now be shipped directly from overseas to China. Further, the formation of joint venture to produce machine tools and mass exodus of the Hong Kong factories into China resulted in less stock being stored in Hong Kong since most of the deliveries to customers, though originally from Hong Kong, are now directly to their factories in China. Besides there was a good supply of new godown buildings in other part of Region R in Hong Kong which were vacant. The average selling prices and rentals were not expensive. If needed, Company F could easily lease more spaces. So we decided to shelve the plan to build a centralized storage area because of the mentioned factors.'* Adding to the above the bridge of District I was opened in November 1987 and did ease the traffic congestion to a tolerable level.

12. Mr D, the surveyor, was called to support the Taxpayer's case. His evidence did not add much to what has been stated in the above. By agreement the Statement of the general manager and director of Company S was admitted as evidence and marked as Exhibit 'A6', the purpose of which was to support what had been said by the first witness, Mr C. Because of the lack of cross-examination the Board is difficult to assess the credibility of the contents thereof but to accept it as truth.

Analysis of the Evidence

13. Mr Lancaster for the Revenue pointed out to us that in the examination in chief Mr C, director and chief accountant of the Taxpayer that the purpose of acquiring and exchanging for the Land was to build a godown on the Land which had an area of about 50,000 square feet. But, in the two letters respectively dated 25 October 1995 and 18 September 1993 to the assessor it tended to show a different intention at the time of acquisition: the building of the godown depended very much upon the success in acquiring the adjoining site. In the first letter which was found on page 61 of Exhibit 'R1', at items (6) & (7) on page 62 the tax representative wrote as follows:

> *'… As explained in our previous letter (paragraph 4) dated 10 March 1995, the Building & Lands Department (BLD) recommended our client for the term of exchange. … Our client added that it accepted the condition of exchange on the assumption that it would obtain the adjacent lot for joint development through public auction …'*

The 10 March 1995 letter was not produced by either party and the Board did not know the exact contents thereof. But, the point about intention was also mentioned in another letter dated 18 September 1993 at page 83 of Exhibit 'R1' which states as follows:

> *'The intention was to construct godowns for letting to affiliated companies and to third parties. In pursuance of this intention, an application was made to the Director of Buildings and Lands with a view to acquiring the adjacent lot for joint development. It was felt that the new Lot No X was unadequate (sic. inadequate) for constructing and operating a godown …'*

The statements in the two letters clearly contradicted what Mr C told us before the Board. In his testimony he unequivocally stated that the Taxpayer did not do any planning before the exchange. The company simply relied on the simple calculation : the site area of 10,000 square feet multiplied by the plot ratio of 5. Even if we were to accept that a company of its size had not done any planning before paying a sum of over a million dollars as premium for the exchange, it does not appeal to reason why the tax representative wrote the two letters which contradicted what the witness told the Board.

14. In his testimony Mr Cheng explained that Company G sold the Agricultural Land because one of the shareholders emigrated from Hong Kong. It happened that Company G and Company F had a common shareholder. This leaves us with an impression that the latter purchased it as it if were a matter of expedience. When the exchange came, the Group reactivated the Taxpayer company for holding the Land but not at the time of acquisition. The sequence of events suggested that the Group did not have any specific plan. The purpose was just to acquire the Land first, and the Taxpayer as well as the Group adopted a *'wait and see'* attitude. The Board needs more concrete evidence before it could accept the Taxpayer's intention of acquiring the Land for use by its Group as a capital asset. Mr Lancaster rightly pointed out that there is a complete lack of contemporaneous evidence:

no directors' minutes, no plan for development of the site and no feasibility study before exchange.

15. One of the main reasons, the Taxpayer put forward, why the Group wanted to exchange for the Land and build its own godown at District B was, as quoted by Mr Lee in his submission in repeating what the witness had said: 'there were serious traffic problems in District I, especially in District N leading to the bridge linking District I and District N, mainly because at that time the road system was not as good, and there was only one bridge between District I and District N. He said that they lost a lot of labour and transportation time moving goods to and from District I, since all the goods were transported on land and the pier at District I was not used. *Mr C estimated that the cost of transportation of goods from China was 20% more expensive by reason of the traffic congestion.'* We doubt whether the traffic was as bad as described. But, even if it were so, we were not informed why the Group used millions of dollars through its subsidiary to acquire an additional area of 15,000 square feet in District I in 1986, the year when the exchange took place and it was also the year before the public auction of the adjoining site. This piece of evidence also indicates:

(a) that the intention of moving to District B was, at least, not definite;

and (b) that it is doubtful whether the Group had the intention of centralizing the storage spaces together in one place. If they had really minded to build the Land with the adjoining site, why purchased a ground floor area in District I?

16. We believe that the Taxpayer knew full well, at the time of acquisition of the ground floor site, that the traffic congestion would be eased. The bridge to District I was not built in a day; we were told by Mr Lee that the bridge was completed and open for traffic in November 1987. We can also safely conclude that at the time of exchange on 28 July 1986 the Taxpayer and its Group were aware of the construction of the bridge.

17. In passing we wish to bring out one point, which may be overlooked by practitioners, that we are bound by evidence. We cannot accept allegations which are not supported by facts. Mr Lancaster in his submission tried to bring in evidence which should have been put to the Taxpayer in cross-examination but he had not done so. He said: *'On 18 December it (Company G) had acquired another five lots in Area V. All the land was agricultural land. In 1980 and 1981 Company G had disposed of all the land except for lot No Z. Disposal had been by way of either resumption, sale, surrender or letter B exchange.'* This piece of information had never been adduced as evidence by the Revenue. It might be relevant and very useful to rebut the Taxpayer's case. As no such evidence was adduced and the Taxpayer was deprived of the chance to explain why the disposal took place, the Board has decided to ignore the allegation. We are not sure whether the omission was intentional for the sake of catching the other side by surprise. If it were so, such tactics should not be adopted by the Revenue and should never be allowed by any tribunal. If it were an accidental omission, such oversight was serious and should be avoided. However, we must say the omission does not affect the outcome of this case.

Conclusion

18. Section 68(4) of the Inland Revenue Ordinance puts the burden of proof on the Taxpayer. The Taxpayer must show to us, which is a common ground, that the intention must be genuine, realistic and realisable. In making assessment, as decided by Mortimer J in All Best Wishes v CIR, vol 3 HKTC page 750 at 771, *'the actual intention can only be determined upon the whole of the evidence.'* Having considered all the evidence before us we have great reservation and have grave doubt that the Taxpayer or the Group had genuine, realistic and realizable intention to erect the godown on the Land for use by the Taxpayer and its group. The Taxpayer has failed to discharge its burden of proof.

19. As we have found that the Taxpayer or the Group did not acquire and exchange for the Land as capital asset, it is not necessary to rule on the alternative ground set out in paragraph 4(b) above.

Decision

20. For reasons set out above the Board dismisses the appeal and upholds the determination of the Commissioner that the taxable profits for the year of assessment 1988/89 be $6,555,175 with tax thereon of $1,114,379.