Case No. D116/02

Profits tax – whether the sale of a property was trading in nature – it was crucial to ascertain the intention of the appellant at the time of acquisition of the property – the stated intention of the taxpayer was not decisive – actual intention had to be determined objectively – direct evidence of those involved at the time of the acquisition would be highly relevant – burden of proof on the appellant – incumbent on the appellant to substantiate its contention – section 68(4) of the Inland Revenue Ordinance ('IRO').

Panel: Ronny Wong Fook Hum SC (chairman), Benjamin Chain and Kenneth Leung Kai Cheong.

Dates of hearing: 2 and 25 November 2002.
Date of decision: 21 January 2003.

The appellant was a private limited company incorporated in Hong Kong on 27 January 1987. It was a member of a group of companies headed by Group I which became 'a fully-fledged developer' in 1990. The minutes of a meeting of the board of directors of the appellant held on 10 September 1991 showed that the directors of the appellant resolved to purchase Property 1 for $6,700,000. The minutes shed no light on the intention of the appellant leading to this acquisition. The appellant financed this purchase by an instalment loan of $2,550,000 extended by a bank repayable by 60 monthly instalments.

The issue before the Board was whether the appellant was liable for profits tax on the gains it made through its dealings with Property 1.

The crucial question was the intention of the appellant at the time of the acquisition of Property 1 and direct evidence of those involved at the time of the acquisition would be highly relevant.

Correspondence was exchanged between the appellant and the Revenue between January 1998 and December 2001, during which the appellant had modified, changed and shifted its stance regarding its intention in the acquisition of Property 1.

The facts appear sufficiently in the following judgment.

Held:

1. The applicable principles were well-known. The intention of the appellant at the time of acquisition of Property 1 was crucial: per Lord Wilberforce in Simmons v IRC (1980) 53 TC 461.

2. An intention to hold property as a capital investment must be definite. The stated intention of the taxpayer was not decisive. Actual intention could only be determined objectively: guidance was given by Mortimer J in All Best Wishes Ltd v CIR (1992) 3 HKTC 750.

3. Under section 68(4) of the IRO, the onus of proving the assessment appealed against was excessive or incorrect was on the appellant.

4. In D11/80, IRBRD, vol 1, 374, the Board pointed out that:

> *' When an owner of land exploits it by the development and construction of a multi-storey building and in the course of construction or shortly thereafter he sells units in the building, the inference that would be drawn is that the building was not erected for retention as an investment but for the purpose of resale. If the owner's case is that he intended to retain the property as a long term investment but supervening events outside his control forced him to dispose of the property, then before such a claim can succeed he must satisfy the Board that it was his intention to keep it as an investment or capital asset'.*

5. The appellant placed reliance on the manner whereby Property 1 was treated in its account. In Shaford v H Fairweather & Co Ltd 43 TC 291 Buckley J pointed out at page 299 that:

> *' The way in which the Company keeps its accounts must, I think, be admissible evidence to show what, in the view of the Company's directors and auditors at that time, was the intention or view of the Company; but it is only evidence in that way, which must be weighed against the other evidence available to the tribunal that has to decide the nature of the transaction ...'*

6. The Board would consider the case by reference to the badges of trade as identified in Marson v Morton [1986] 1 WLR 1343.

7. The transaction in question was not a one-off transaction. The appellant purchased the Road M Units for trading purposes two months after its purchase of Property 1. The appellant disposed of the Road M Units after holding the same for two years and paid profits tax on the gains arising from such disposal.

8. Viewed in the context of Group I, apart from Plaza H, there was little evidence to demonstrate that Group I held any redeveloped residential property for long term rental income. Plaza H was the headquarters of Group I.

9. Property 1 was an old building ripe for development. The Board rejected the initial case of the appellant that Property 1 was purchased for rental potential in its then state. The appellant did not give any explanation as to why such case was put forward in the first place.

10. As far as the current case of the appellant was concerned, the general manager of Company I accepted that Property 3 was vital for any viable redevelopment. However, Company C had staked its interest even before the arrival of the appellant. The bidding of Mr F's interests in two units at Property 3 indicated that there were other strong competitors in the market. There was therefore no assurance that the proposed redevelopment was a 'realisable' one and subsequent disposal of Property 1 in its then current state was an alternative that could not be ruled out.

11. According to the 23 January 1998 letter from the accountants' firm, the transaction was carried out in the absence of any feasibility study.

12. The appellant changed its stance in the final quarter of 2001 and submitted various projections.

13. At the hearing before the Board, the appellant placed considerable emphasis on the need to maintain secrecy in order to preserve the viability of the project.

14. The Board rejected the documents submitted by the appellant in the final quarter of 2001. The Board was not satisfied that those documents were contemporaneous documents produced in September 1991.

15. The appellant's reliance on those documents was inconsistent with its claim for paramount secrecy. It followed that there was no evidence before the Board to demonstrate any estimated rental yields in the completed redevelopment. In the absence of such evidence, the claim that Property 1 was purchased as long term investment for rental yields from the proposed redevelopment was difficult to accept.

16. The Revenue challenged the financial capability of the appellant to undertake the proposed redevelopment. The general manager of Company I did not provide the Board with any figure on the proposed budget for the acquisition of the adjoining units nor could she shed any light on how the project would be financed.

17. The appellant held Property 1 for five years between September 1991 and September 1996. During that period, Property 1 yielded meagre income. No work was done to Property 1 prior to its resale and the resale was effected in one integral lot.

18. Given the presence of a strong competitor in September 1991, the Board was of the view that only limited weight should be attached to this factor. The general manager of Company I admitted that there were two distinct possibilities: the appellant would either buy out Company D or Company D would take over the appellant's interests.

19. The appellant did not call any of its then directors to give first hand testimony of the appellant's then intention.

20. The role of the general manager of Company I was a limited one. Her task was to maximize the appellant's stake in Street A where Property 1 was located. She could not assist on the appellant's intention in relation to the redevelopment. The evidence of Mr E (the director of a company owning the adjourning properties in Street A) and Mr N (a partner of a solicitors' firm as well as an independent non-executive director of Group I) was not relevant to this issue.

21. Weighing all the aforesaid factors together, the Board was not persuaded by the appellant that Property 1 was not purchased by them with a trading intent.

22. For these reasons, the Board dismissed the appellant's appeal.

Appeal dismissed.

Cases referred to:

Simmons v IRC (1980) 53 TC 461
All Best Wishes Ltd v CIR (1992) 3 HKTC 750
D11/80, IRBRD, vol 1, 374
Shaford v H Fairweather & Co Ltd 43 TC 291
Marson v Morton [1986] 1 WLR 1343

Cheung Mei Fan for the Commissioner of Inland Revenue.
Taxpayer represented by its financial controller.

Decision:

Background

1. The Appellant is a private limited company incorporated in Hong Kong on 27 January 1987. At all material times, its authorised and paid up share capital was $10,000 divided into 10,000 shares of $1 each.

2. According to the minutes of a meeting of the board of directors of the Appellant held on 10 September 1991, the directors of the Appellant resolved to purchase Property 1 on Street A, Kowloon for $6,700,000. The minutes shed no light on the intention of the Appellant leading to this acquisition. The Appellant financed this purchase by an instalment loan of $2,550,000 extended by a bank ('the Bank') on 21 November 1991. That loan was repayable by 60 monthly instalments of $54,809.45 each.

3. As at September 1991, Property 1 consisted of a four storeys' building of over 30 years old erected on a site of about 943 square feet. The ground floor was vacant but the first to third floors were tenanted yielding rent at $5,000 per month for the first floor; $2,050 for the second floor and $2,857 for the third floor.

4. Property 1 was one of the five low rise buildings along Street A.

(a) Property 2 on Street A with site area of 898 square feet:

(i) As at September 1991, this entire block was held by a Mr B.

(ii) Mr B held his interests since December 1966.

(b) Property 3 on Street A with site area of 948 square feet:

(i) The ground and the first floors: Company C acquired these units before 1991. Company C transferred these units to Company D on 6 April 1994. Mr E was then a representative of Company C and Company D.

(ii) Prior to 4 May 1992, the second and the third floors were held by Mr F. Mr F sold these units to Company G on 4 May 1992 for $5,900,000.

(c) Property 4 on Street A with site area of 943 square feet:

(i) The ground floor was acquired by two gentlemen on 20 August 1990 for $750,000.

(ii) The first floor was acquired by a company on 15 June 1993 for $1,950,000.

(iii) Another company acquired the third floor on 8 November 1993 and the second floor on 17 March 1994.

(d) Property 5 on Street A:

(i) The ground to third floors were held by four different owners.

(ii) They acquired their interests between 1968 and 1979.

5. On 13 February 1996, the Appellant fully repaid the loan extended by the Bank referred to in paragraph 2 above.

6. By a provisional agreement dated 12 September 1996, the Appellant sold Property 1 for $15,200,000.

7. The issue before us is whether the Appellant is liable for profits tax on the gains it made through its dealings with Property 1.

Case of the Appellant as per correspondence exchanged between the Appellant and the Revenue prior to the hearing before us

8. In a letter dated 23 January 1998, an accountants' firm ('the Accountants' Firm), then tax representative of the Appellant, informed the Revenue that 'The original intention with respect to the acquisition of [Property 1] was for long term investment and rental income purposes'. 'No formal feasibility study has been conducted'. The disposal 'was purely due to the exceptional price offered by the purchaser'.

9. By letter dated 7 October 1998, the Appellant amplified its case as follows:

(a) 'Our company held a property for 5 years';

(b) 'During the holding period, the property had been used for rental purposes even though the rental income was not much';

(c) 'The books and accounts shown the property as a long term asset';

(d) 'After 5 years, the property was disposed with a gain'.

10. The Appellant further explained its position in its letter dated 10 March 1999:

'The annual rental income was low at the time we acquired the property due to the existence of old contract with existing tenants. In fact the old tenancy at that time does **NOT** reflect the market value at the time of acquisition of the property. Our Company should receive much higher future rental income from new tenancy since the property was located at a prime location in Mongkok, Kowloon with a total gross floor area of 3,052 square foot (4 units, each unit 763 Sq. Ft). An estimated annual market rental income is not less than HK$432,000 (say HK$9,000 per unit × 4 units× 12 months) at that time. It represents a return of approximately 6% per annum at that time which is a fair return for long term investment'.

11. In letters received by the Revenue on 30 October 2001 and 6 December 2001, the Appellant modified its stance. The Revenue was told that:

(a) 'The acquisition of [Property 1] was the first stage of our re-development project, we had to continue to acquire the nearby three properties ([Properties 2, 3 and 4]) for re-development the total site area of 3,732 square feet. For the re-development project involving acquisition and demolition of old buildings, it takes a long time period, over several years. Therefore we didn't need to remove the existing tenants on acquisition immediately. In addition, the existence of tenancy agreements with them was not critical factor for the acquisition of the subject property'.

(b) The 'Total budget investment cost' was $55,000,000 and the 'Expected annual rental income' was $3,600,000. A set of building plan, a feasibility study and various cash flow projections were submitted to the Revenue.

(c) 'Afterwards, the management approached other owners of the remaining three sites. However, no other sales and purchase agreements was reached as the counter-offer selling prices from other owners were over our budget or the owners did not willing to sell at that time'.

(d) The appellant disposed of Property 1 because:

(i) 'the re-development project had already taken 5 years for acquisition of the other sites and the acquisition had not yet completed in 1996';

(ii) 'the revised rate of return was no longer attractive as the acquisition costs of other three sites were over-budget' and

(iii) 'the Group re-arranged the resources to finance another re-development project ("[Plaza H]"). [Plaza H] commenced construction in 1994 and completed in 1996'.

12. The Appellant is a member of a group of companies headed by Group I. In support of its contentions, the Appellant placed reliance on the stance taken by the Revenue vis-a-vis its fellow subsidiary company Company J. The assessor allegedly refused to allow the loss incurred by Company J arising from disposal of properties acquired in similar circumstances on the ground that those properties were acquired as capital assets for long-term investment. The Appellant argued that the Revenue had not been consistent in its approach.

The hearing on 2 November 2002

13. Mr K, financial controller of Group I, appeared on behalf of the Appellant. Mr K elected not to call any evidence to support the position of the Appellant. Mr K laid considerable emphasis on the length of the Appellant's ownership and the alleged disparity of treatment between the Appellant and Company J.

14. We explained to the Appellant that the crucial question is the intention of the Appellant at the time of the acquisition of Property 1 and direct evidence of those involved at the time of the acquisition would be highly relevant. With the consent of the Revenue, we adjourned the hearing so that Mr K could re-consider the position of the Appellant.

The resumed hearing on 25 November 2002

15. With the consent of the Revenue, the Appellant called three witnesses to give sworn testimony before us.

16. Mrs L is the general manager of Group I. She told us that:

(a) Group I became 'a fully-fledged developer' in 1990. The group had its own 'full serviced architectural and construction section, project management section, acquisition section and leasing section'.

(b) She herself has extensive experience in property re-development having been involved in the re-development of more than 100 buildings.

(c) 'The scale of our acquisitions and developments usually cover a number of old buildings each with 3 to 5 or 6 storeys. We would first acquire quite a number of individual units, say for example one whole building so that we can have a

status in the coming negotiation with the owners of the adjoining buildings. At the end, the area of the site would normally be larger than 2000 square feet'.

(d) Due to the number of competitors in the acquisition market, she had to ensure that the steps taken by her were 'kept in top secret and nothing would be reduced into writing until we confirm that we can control the whole picture'.

(e) She gave by way of illustration the efforts she made in acquiring the interest of Mr F in the second and the third floors of Property 3. Mr F was then residing in the States. She persuaded Mr F to return to Hong Kong to sell his interests for $4,000,000. This became known to Company G. Biddings were held in a solicitors' office for Mr F's interest. The price went up. She further discovered that Company G was related to Mr E of Company C. She therefore withdrew her bid.

(f) She held numerous discussions with Mr E on the possibility of a joint development. Various proposals involving the acquisitions of Properties 2 and 4 were considered. Those discussions did not yield fruit.

(g) She accepts that Company D was on the scene before the Appellant and Property 3 was the most important unit in the proposed re-development.

(h) She was asked to comment on the building plan, the feasibility study and the cash flow projections submitted by the Appellant in the final quarter of 2001. She told us that she had nothing to do with the finance section of the group and she has no knowledge of these documents probably prepared by that section. As the group had an in house architectural section, building plans were regularly produced and revised. Apart from these documents, she could not identify any other head of evidence to indicate that the Appellant intended to redevelop Property 1 and hold the units in the redevelopment for long term rental purposes.

(i) She was invited to identify other property redeveloped by the group and thereafter held for rental purposes. Apart from Plaza H, she could not give us any other example. The Appellant purchased various units in No XX of Road M ('the Road M Units') in November 1991 for $11,000,000. The Appellant disposed of the Road M Units in December 1993 for $47,000,000. It withdrew its objection to the Revenue's assessment of the gains arising from its disposition of the Road M Units on 22 January 1997. Mrs L could shed no light on the intention of the Appellant pertaining to the Road M Units.

17. Mr E is the representative of Company C and Company D. He confirmed that numerous discussions were held with the Appellant with the view of undertaking a joint re-development. The parties failed to reach any concluded agreement.

18. Mr N, a solicitor and a partner of a solicitors' firm, is an independent non-executive director of Group I. His firm acted for Group I in its acquisition of units in old buildings. He confirmed that little documentation would be exchanged between the parties prior to the conclusion of any binding agreement for fear that other parties might intervene and frustrate the process of acquisition.

The law

19. The applicable principles are well-known. The intention of the Appellant at the time of acquisition of Property 1 is crucial. As stated by Lord Wilberforce in Simmons v IRC (1980) 53 TC 461

> *'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?'.*

20. An intention to hold property as a capital investment must be definite. The stated intention of the taxpayer is not decisive. Actual intention can only be determined objectively. In All Best Wishes Ltd v CIR (1992) 3 HKTC 750 Mortimer J gave the following guidance:

> *'The intention of the taxpayer, at the time of acquisition, and at the time when he is holding the asset is undoubtedly of very great weight. And if the intention is on the evidence, genuinely held, realistic and realisable, and if all the circumstances show that at the time of the acquisition of the asset, the taxpayer was investing in it, then I agree. But as it is a question of fact, no single test can produce the answer. In particular the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of the evidence ... It is trite to say that intention can only be judged by considering the whole of the surrounding circumstance, 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'.*

21. Under section 68(4) of the IRO, the onus of proving the assessment appealed against is excessive or incorrect is on the appellant.

22. In D11/80, IRBRD, vol 1, 374, the Board pointed out that:

> *'When an owner of land exploits it by the development and construction of a multi-storey building and in the course of construction or shortly thereafter he sells units in the building, the inference that would be drawn is that the building was not erected for retention as an investment but for the purpose of resale. If the owner's case is that he intended to retain the property as a long term investment but supervening events outside his control forced him to dispose of the property, then before such a claim can succeed he must satisfy the Board that it was his intention to keep it as an investment or capital asset'.*

23. The Appellant placed reliance on the manner whereby Property 1 was treated in its account. In Shaford v H Fairweather & Co Ltd 43 TC 291 Buckley J pointed out at page 299 that:

> *'The way in which the Company keeps its accounts must, I think, be admissible evidence to show what, in the view of the Company's directors and auditors at that time, was the intention or view of the Company; but it is only evidence in that way, which must be weighed against the other evidence available to the tribunal that has to decide the nature of the transaction ...'*

Our decision

24. We would consider the case by reference to the badges of trade as identified in Marson v Morton [1986] 1 WLR 1343.

25. The transaction in question is not a one-off transaction. The Appellant purchased the Road M Units for trading purposes two months after its purchase of Property 1. The Appellant disposed of the Road M Units after holding the same for two years and paid profits tax on the gains arising from such disposal.

26. Viewed in the context of Group I, apart from Plaza H, there is little evidence to demonstrate that Group I holds any redeveloped residential property for long term rental income. Plaza H is the headquarters of Group I.

27. Property 1 was an old building ripe for development. We reject the initial case of the Appellant that Property 1 was purchased for rental potential in its then state. The Appellant did not give any explanation as to why such case was put forward in the first place. As far as the current case of the Appellant is concerned, Mrs L accepts that Property 3 was vital for any viable redevelopment. However, Company C had staked its interest even before the arrival of the Appellant. The bidding of Mr F's interests indicates that there were other strong competitors in the market. There was therefore no assurance that the proposed redevelopment was a 'realisable' one and subsequent disposal of Property 1 in its then current state was an alternative that could not be ruled out.

28. According to the 23 January 1998 letter from the Accountants' Firm, the transaction was carried out in the absence of any feasibility study. The Appellant changed its stance in the final quarter of 2001 and submitted various projections. At the hearing before us, the Appellant placed considerable emphasis on the need to maintain secrecy in order to preserve the viability of the project. We reject the documents submitted by the Appellant in the final quarter of 2001. We are not satisfied that those documents were contemporaneous documents produced in September 1991. The Appellant's reliance on those documents is inconsistent with its claim for paramount secrecy. It follows that there is no evidence before us to demonstrate any estimated rental yields in the completed redevelopment. In the absence of such evidence, the claim that Property 1 was purchased as long term investment for rental yields from the proposed redevelopment is difficult to accept.

29. The Revenue challenged the financial capability of the Appellant to undertake the proposed redevelopment. Mrs L did not provide us with any figure on the proposed budget for the acquisition of the adjoining units nor could she shed any light on how the project would be financed.

30. The Appellant held Property 1 for five years between September 1991 and September 1996. During that period, Property 1 yielded meagre income. No work was done to Property 1 prior to its resale and the resale was effected in one integral lot. Given the presence of a strong competitor in September 1991, we are of the view that only limited weight should be attached to this factor. Mrs L admits that there were two distinct possibilities: the Appellant would either buy out Company D or Company D would take over the Appellant's interests.

31. The Appellant did not call any of its then directors to give first hand testimony of the Appellant's then intention. Mrs L's role was a limited one. Her task was to maximise the Appellant's stake in Street A. She could not assist on the Appellant's intention in relation to the redevelopment. The evidence of Mr E and Mr N is not relevant to this issue.

32. Weighing all these factors together, we are not persuaded by the Appellant that Property 1 was not purchased by them with a trading intent.

33. For these reasons, we dismiss the Appellant's appeal.