

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D118/00

Profits tax – acquisition and sale of property – intention at time of purchase – burden of proof on purchaser to establish that property purchased for long term investment – whether tax chargeable upon profits derived from sale of property – what is an allowable deduction upon sale of property – sections 16(1) and 17 of the Inland Revenue Ordinance (‘IRO’).

Panel: Ronny Wong Fook Hum SC (chairman), Barry J Buttifant and Gerald To Hin Tsun.

Date of hearing: 14 November 2000.

Date of decision: 6 February 2001.

The subject ‘Lot’ was purchased by the taxpayer on 27 December 1991 for a consideration of \$50,000. At that time, he intended to build a house on the Lot and a licence to build was granted by the Government on 22 September 1992. On 5 May 1994, after having built a house on the Lot, the taxpayer sought permission from the District Lands Office to sell the Lot. Consent was subsequently granted.

The assessor was of the view that the purchase and sale was an adventure in the nature of trade although he conceded that the purchase price paid for the Lot should be deducted from the assessable profits of sale. The taxpayer objected in that he said that the Lot had been purchased to serve as his marital home but was later considered too small. Alternatively, the allowable amount to be deducted ought to have been the market price of the Lot at the time of sale rather than the price paid.

Held:

1. The only evidence before the Board was that the consideration of \$50,000 was the amount paid by the taxpayer for the Lot;
2. The following principle was adopted:

‘ The profits or loss to a trader in dealing with his stock-in-trade is arrived at for income tax purposes by comparing what his stock in fact cost him with what he in fact realised on resale. It is unsound to substitute alleged market values for what it in fact cost him’ : Craddock v Zevo Finance CO Ltd [1946] 27 TC 267, per Viscount Simon.

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3. The onus on the taxpayer is to show why a transaction is not to be considered one at arm's length. The taxpayer did not properly explain the transaction.

Appeal dismissed.

Cases referred to:

Wing Tai Development Co Ltd v CIR [1979] HKTC 1115

Julius Bendit v Dickson [1945] 27 TC 44

Craddock v Zevo Finance Co Ltd [1946] 27 TC 267

Jacgilden (Weston Hall) Ltd v Castle [1969] 45 TC 685

CIR v Lo & Lo [1984] 2 HKTC 34

Fung Chi Keung for the Commissioner of Inland Revenue.

Cheung Pak Lun of Messrs Chan & Cheung for the taxpayer.

Decision:

Background

1. By an assignment dated 27 December 1991, the Taxpayer acquired from Madam A a lot in the New Territories [' the Lot'] at a consideration of \$50,000. Madam A gave an address in Country B as her address in this assignment.

2. By an application also dated 27 December 1991, the Taxpayer applied as an indigenous villager of Village C to the District Lands Office of District D [' the District Lands Office'] for the right to construct a small house on the Lot. The Lot is one of six lots in an ' Open space plan' prepared by Mr E, authorised person. Six buildings have since been erected on these lots. Collectively the buildings are known as District F Garden.

3. On 22 September 1992, the Government, under its Small House Policy for indigenous villagers in the New Territories, issued to the Taxpayer a building licence to erect on the Lot 1 building of not more than three storeys. This building licence contained restrictions prohibiting the Taxpayer from assigning the Lot unless various conditions are complied with.

4. By letter dated 5 March 1993, the Taxpayer, through his solicitors, informed the District Lands Office that construction works for a small house on the Lot had been completed. The District Lands Office was invited to inspect the site and to issue a certificate of compliance.

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5. By letter dated 5 May 1994, the Taxpayer informed the District Lands Officer of his intention to sell the Lot by way of three equal undivided shares. The Taxpayer asked the District Lands Office for its consent and for modification of the non-partition clause in the building licence in relation to the Lot. In consideration of a premium of \$880,500, the District Lands Office granted the consent and modification sought on 2 November 1994. The Taxpayer paid the premium on 7 November 1994. By a power of attorney of the same date, the Taxpayer authorised Mr G to sell the Lot.

6. The following dealings took place in relation to units erected on the Lot:

- (a) By a 'Purchase agreement' dated 22 January 1994, Company H (a property agency company) as vendor sold to Mr I the second floor and the roof of the small house erected on the Lot for \$1,380,000.
- (b) By a provisional agreement dated 18 July 1994, Company H as vendor sold to Mr J the ground floor and the garden of the small house erected on the Lot at \$1,183,000. The sale was concluded by a formal agreement dated 10 November 1994.
- (c) By an undated 'Agreement of authorisation', Mr G authorised Company H to sell the first floor of the small house erected on the Lot at \$1,250,000. By a formal agreement also dated 10 November 1994, this unit was sold for \$1,160,000.

7. When completing a questionnaire about the sale of the units, the Taxpayer gave the following particulars:

- (a) The small house on the Lot was intended to be used as residence after his marriage.
- (b) 'After completion of the construction of the small house both of my fiancé and I have found that the living condition in the vicinity is so poor and so different from Country B where we both received education. I have then decided to sell the house and try to look for a suitable flat in town.'

8. By letters dated 18 March 1998, 28 September 1998 and 8 February 1999, the Taxpayer gave the following information:

- (a) He is the descendant of a reputable family in the New Territories.

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- (b) His late great grandfather [‘ Great Grandfather’] owned various pieces of land in District F including the Lot. Great Grandfather wished that his descendants would build houses on his land and live together.
- (c) The Taxpayer built the small house on the Lot because he was under his family obligations to follow the wish of his Great Grandfather. He intended to use the small house either as his main residence or one of his residences. The Taxpayer intended to occupy the ground floor and the first floor and let his younger brother occupy the second floor.
- (d) ‘ Since my uncle ... who has no son, my father ... advised us that it would be fair to pay a small sum of \$50,000 to my grandfather to buy the land. So did my father when he decided to build house there.’
- (e) His grandfather financed the construction costs of the small house. When it was completed in March 1993, the Taxpayer decided not to move into the same because the sanitary conditions of the environment were unacceptable to him. His grandfather was very upset but he respected the Taxpayer’ s wishes.
- (f) His grandfather died in December 1995 at the age of 90.

9. By her determination dated 29 February 2000, the Commissioner rejected the Taxpayer’ s contentions. She concluded that the Taxpayer ‘ has embarked on a trading adventure in the construction and sales of [the units in the small house] and the profits derived from the sale should be charged to profits tax. As regards the amount of profits chargeable to tax, I agree with the assessor that the purchase price paid for the Lot should be deducted.’

10. In his notice of appeal dated 21 March 2000, the Taxpayer made a broad challenge against the determination. At the hearing before us, Mr P L Cheung [‘ Mr Cheung’] on behalf of the Taxpayer confined the Taxpayer’ s appeal to the following grounds:

- ‘ (2) The land on which the said properties were erected was ancestral land of the [Taxpayer’ s] clan. Its redevelopment was carried out in pursuance to ancestral directives and the subsequent disposals were on account of special circumstances.
- (4) Without prejudice to the first two grounds of appeal herein mentioned and without admitting that the activities ... amounted to an adventure in the nature of trade, the amount as assessed by the Commissioner is otherwise excessive. The open market value of the said parcel of land, on the date that my client took the first positive step to redevelop, was far in excess of

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the amount of \$50,000 that the Commissioner had taken as part of the cost of redevelopment.

- (6) The determination now being appealed against is incorrect and should be set aside.’

11. In support of the remaining grounds of appeal, the Taxpayer places reliance on a valuation report by a Surveyors Company dated 6 April 2000 valuing the Lot ‘as at December 1991 and as a vacant development site’ at \$600,000. The Revenue takes issue with this valuation. The Revenue submits that the appropriate value is \$185,000 as valued by the Commissioner of Rating and Valuation. Should we decide the substantive appeal in favour of the Taxpayer, the Revenue invites us to adjourn the issue of quantum pending agreement between the parties.

The applicable provisions in the IRO

12. Section 16 of the IRO provides:

- ‘ (1) *In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period ...*’

13. Section 17 of the IRO provides that for the purpose of ascertaining profits in respect of which a person is chargeable to profits tax, no deduction shall be allowed in respect of a list of items.

Contentions of the Taxpayer

14. The Taxpayer did not attend the hearing. Mr Cheung asserts on behalf of the Taxpayer that:

- ‘ The suggestion to pay \$50,000 for a lot of land was made by the appellant’s father in a family gathering. When he fixed the sum of \$50,000, he did not know how much a small house lot would be worth at that time, the market value was not important to him, he was of the opinion that \$50,000 would ease the minds of the other descendants.’

15. Reliance is placed on Wing Tai Development Co Ltd v CIR [1979] HKTC 1115

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16. The authorities cited by the Revenue, namely, Julius Bendit v Dickson [1945] 27 TC 44; Craddock v Zevo Finance Co Ltd [1946] 27 TC 267 and Jacgilden (Weston Hall) Ltd v Castle [1969] 45 TC 685 are inapplicable as those cases do not relate to acquisition made on a non arm's length basis; when there was no commercial disposal and when the disposal was not a genuine trading transaction.

Contentions of the Revenue

17. The Revenue does not accept the bare assertion by Mr Cheung on behalf of the Taxpayer as to the circumstances leading to the adoption of the figure of \$50,000 as the consideration for the Lot.

18. The Revenue relies on the following principles:

- (a) In ascertaining a person's assessable profits, one should deduct from his total receipts all allowable deductions. Sections 16 and 17 of the IRO provide exhaustively for allowable deductions in the computation of assessable profits; permitted deductions are confined to outgoings and expenses incurred in the production of taxable profits. 'Expenses incurred' is not confined to sums actually paid by the taxpayer but includes a sum which there is an obligation to pay, that is to say, an accrued liability which is undischarged. CIR v Lo & Lo [1984] 2 HKTC 34 is cited in support of this proposition.
- (b) Where a trader in the course of his trade purchases trading stock at a cost different from its then market value, the allowable deduction is the cost incurred by him and not the market value. This principle applies where the market value exceeds the cost (for example, Julius Bendit v Dickson and Jacgilden (Weston Hall) Ltd v Castle) and where the market value is below cost (for example, Craddock v Zevo Finance Co Ltd). Its application is not affected by the fact that the acquisition was made from or through related parties.

19. Wing Tai Development Co Ltd v CIR is clearly distinguishable. The issue in the present appeal is whether the cost incurred by the Taxpayer to acquire the Lot (\$50,000) or the market value of the Lot (valuation yet to be agreed) is the allowable deduction in computing the Taxpayer's assessable profits. On the other hand, the issue in Wing Tai was the value of the trading shares as at the date of acquisition.

Our decision

20. We are of the view that the Taxpayer fails at the initial hurdle. On the face of the assignment dated 27 December 1991, the Taxpayer acquired the Lot from Madam A, a resident in

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Country B. We have no evidence as to the relationship between Madam A and the ancestral trust contended by the Taxpayer. The Taxpayer accepts throughout that the consideration depicted in this assignment [\$50,000] was the sum that he paid. No evidence has been adduced to explain why, in this context, the assignment should not be taken on its face value and why the transaction should be viewed other than at arm's length. The onus is on the Taxpayer to adduce credible evidence to explain the circumstances of this vital transaction. The Taxpayer made no attempt to discharge his burden.

21. In these circumstances, we are of the view that the principle succinctly summarised by Viscount Simon in Craddock at page 178 is applicable:

' The crucial transaction, albeit in a reconstruction, is a transaction of sale and purchase, and the proper figure to be debited in respect of the purchased investments is the cost thereof to the [taxpayer] ... To put the matter in its simplest form, the profit or loss to a trader in dealing with his stock-in-trade is arrived at for Income Tax purposes by comparing what his stock in fact cost him with what he in fact realised on resale. It is unsound to substitute alleged market values for what it in fact cost him.'

22. For these reasons, we dismiss the Taxpayer's appeal and confirm the assessment.