INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D12/91

Profits tax – property trading – previous comprise agreement – whether previous agreement binding in future.

Panel: Henry Litton QC (chairman), Vincent To Wai Keung and Benny Wong Man Ying.

Dates of hearing: 4 March, 16 and 17 April 1991.
Date of decision: 15 May 1991.

The taxpayer owned certain properties which it subsequently sold at a profit. The period of ownership was lengthy. In previous years the taxpayer had also sold certain properties and had reached a compromise agreement with Commissioner under which it was accepted that the profits were assessable to profits tax. The taxpayer argued, inter alia, that the compromise agreement with regard to previous years did not stop the taxpayer from arguing that subsequent sales were sales of capital assets.

Held:

The compromise agreement did not bind the taxpayer in the future. However the onus of proof is upon the taxpayer. The fact that it had previously compromised similar assessments and accepted that previous transactions were trading transactions is one of the relevant facts.

Appeal dismissed

[**Editor's note**: The taxpayer has filed an appeal against this decision but withdrawn later.]

Luk Nai Man for the Commissioner of Inland Revenue.
A D Morrison of Messrs Richards Butler for the taxpayer.

Decision:

Introduction

1. This appeal concerns two years of assessment, 1987/88 and 1988/89, in the course of which the Taxpayer sold a number of properties in the following developments:

(i) **X Development:** Residential blocks erected on land which the Taxpayer had purchased in early 1960's.

(ii) **Y Development:** Residential flats acquired by the Taxpayer in late 1960's.

(iii) **Z Development:** A twenty-four storey residential and commercial building erected on a site acquired by the Taxpayer in early 1970's.

2. As can be seen from the brief facts set out above, each of the properties was held by the Taxpayer for a very long time, prior to the sales which gave rise to the assessments to profits tax in this case. It is the Taxpayer's case that, from the fact of such long ownership, there is to be inferred an intention that the Taxpayer held the properties for investment and rental income, and the assessments to profits tax were accordingly erroneous.

3. There is however, one substantial blemish in the Taxpayer's argument. It is this:

(i) The profits on the sales of units in all three developments had, in earlier years, all been put through the Taxpayer's profit and loss accounts and, in the Taxpayer's profits tax returns, had all been shown as trading profits.

(ii) In December 1980, the Taxpayer's accountants lodged on the Taxpayer's behalf applications under section 70A of the Inland Revenue Ordinance (the IRO) in respect of the profits tax assessments for some of the previous years, claiming that the returns were wrong and that the profits on sales should have been classified as capital gains. This section 70A claim (and a further objection to assessments made in 1979/80) related to the three properties now in question and also some other properties as well.

(iii) This claim was rejected by the assessor and the matter was eventually taken by the Taxpayer on appeal to the Board of Review.

(iv) However, before the hearing, the matter was compromised with the Commissioner on the basis that whilst profits made by the Taxpayer from the sales of units in other developments were capital gains, the profits under appeal at that time realised on the sale of units in the three developments were to be treated as trading profits and chargeable to tax.

(v) The terms of the compromise, as put before us, are set out in a letter dated 4 February 1985 from the accountants to the Commissioner as follows:

> 'for some business reasons, our client agrees to withdraw the appeal to the Board of Review lodged on 1 June 1983 and to withdraw the objections lodged on 21 January 1984 provided you agree that [A Building] and [B Building] are fixed assets of our client.'

(vi) The Commissioner's reply, dated 16 April 1985, was in these terms:

> 'I refer to your letter dated 4 February 1985 and advise that, in the event your client withdraws its appeal to the Board of Review … I will accept that [A Building] and [B Building] are fixed assets.
>
> In reaching this decision I have assumed that your client's "business reasons" for wishing to settle this case are not the contemplation of an early sale of the two properties concerned. Should my assumption be incorrect would you please let me know so that I may reconsider my decision. Otherwise, upon receipt of your notices of withdrawal I will ensure that assessors treat these properties as fixed assets.'

4. After this compromise was reached, there was further correspondence between the accountants and the assessor, in relation to the Taxpayer's accounts for a subsequent year. In a letter dated 1 December 1986, with reference to the Taxpayer's tax liability for the year of assessment 1985/86, the accountants stated:

> 'Please refer to our previous correspondence, and in particular, our letter of 1 June 1983 to the Clerk to the Board of Review. It is always our client's intention to hold all properties, other than Z Development, as fixed assets for the purposes of producing rental income. However, we have compromised with your department and except for [A Building] and [B Building], all properties are treated as trading stock to our client for tax purposes …'

5. Pursuant to this, the proceeds arising from the further sales of units at X Development were accepted by Taxpayer as chargeable to profits tax.

6. At the hearing before us, Mr Morrison, solicitor for the Taxpayer, submitted that the compromise with the Commissioner made in 1985 only affected the Taxpayer's tax liability in the past; the scope of the compromise did not extend beyond the years of assessment then in dispute; the compromise did not prevent the Taxpayer in any way from arguing that sales of units in the future were not chargeable to profits tax. It was argued that since no undertaking of any kind was given as regards the Taxpayer's future conduct, the Taxpayer was not 'estopped' in any way from putting forward its argument in the present appeal.

7. As a proposition of law, we accept Mr Morrison's submission. In coming to a conclusion on this appeal, all the facts must be looked at including, of course, the fact that the Taxpayer had, by the compromise in 1985, accepted the factual basis for the assessments to profits tax in the previous years. The Taxpayer said this was for 'business reason', but what those reasons were, precisely, have not been explained.

8. We now proceed to examine in detail the facts surrounding the three properties in question.

X Development

9. The land was acquired by the Taxpayer in early 1960's. In a letter dated 3 April 1963, the Taxpayer's former accountants told the assessor:

'The building which will erect … is for the propose of re-sale.'

10. The development comprised more than a hundred units and, in the course of construction, the units were offered to the public for sale. The usual sales brochure was prepared, and (presumably) distributed. Prior to the building being completed, about one quarter of the units were sold and the sales proceeds were reflected in the profit and loss account. The charge to profits tax on these sales has never been disputed.

11. In the years 1967, 1968 and 1969 sales of the development were extremely sluggish owing to the riots and other unfavourable happenings at that time. Nevertheless five flats were sold in 1968 and another five in 1969. The unsold flats were reflected in the Taxpayer's financial statements at a figure below cost (representing the market value at that time): an accounting treatment which could only be consistent with the fact that the flats were treated as trading stock. This accounting treatment was explained in letters written by the Taxpayer's accountants at the time and was accepted by the assessor for profits tax purposes.

12. In 1969, in the prospectus of the parent company of the Taxpayer, the 145 flats at X Development remaining at that time were referred to as 'investment in land and buildings'. From this fact alone, Mr Morrison argued that this demonstrated a change of intention with regard to the flats at X Development. Accepting, as he did, that the evidence as regards the Taxpayer's intention prior to 1969 was overwhelmingly against him, Mr Morrison submitted that we should find that, as from the accounting date referred to in the prospectus, the X Development flats were capital assets.

13. We find the argument totally unconvincing. It appears from the prospectus that, at the date thereof, the building mortgage in relation to X Development was still not discharged. It can therefore be inferred, from this and from the statements made by the Taxpayer's accountants in letters of December 1967 and March 1968, together with the accounting treatment as referred to above, that the Taxpayer was waiting for a more favourable market in which to sell the units at X Development. The sales which were effected in few years immediately after 1969 when the alleged 'change of intention' took place were as follows:

Year ending	**Number of Flats Sold**
31-3-1970	1
31-3-1971	4
31-3-1972	9
31-3-1973	16

The profits from these sales all went through the profit and loss account of the Taxpayer and were shown as assessable profits in the returns. There is no hint from the contemporaneous acts and declarations of the Taxpayer that any 'change of intention' took place in 1969.

14. From the pattern of dealings which we have outlined above there is no discernible evidence that the Taxpayer had ever varied from its original intention with regard to the X Development flats: that is to say, to sell them in the market when the conditions were right. The fact that the Taxpayer took its time in realising its objective does not change trading stock into capital assets. The Taxpayer is a subsidiary of a publicly listed company, and one would expect its statutory books such as board minutes to be properly kept. If the Taxpayer had intended that the X Development flats should no longer be held for sale, but instead for rental income, one would have expected that change of intention to be reflected in some board minutes. None have been produced.

15. In terms of accounting classification, the properties were reflected under various headings; the most favourable of which, from the Taxpayer's point of view, was 'investment properties'. However, this term is neutral, and no reliance can be placed on the financial statements to support the Taxpayer's case since the sales, whenever they took place, were always (except for the year of assessment 1979/80 when the section 70A application had already been lodged) reflected in the profit and loss account.

16. In our view the X Development flats at all times remained trading stock, despite the fact that for five years (31-3-1982 to 31-3-1986) there were no sales.

Y Development

17. As to these properties, we can deal with them relatively briefly. In late 1960's the Taxpayer purchased eleven flats from its parent company. Three of these flats were sold within a relatively short period of time. The Taxpayer had, prior to late 1960's traded in respect of two flats in the same development, and the sales were brought into the profit and loss account. The fact that the profits on those early sales were chargeable to tax has never been challenged.

18. In the year ending 31 March 1979 one more flat was sold, and in the year ending 31 March 1980 two more flats were sold. These sales were also put through the profit and loss account and were then later claimed in the section 70A application as having been wrongly so treated.

19. The intention to be imputed to a limited company can only come from the acts and declarations of those in control of its affairs at the relevant time. The fact is that all previous sales of flats in Y Development made by the Taxpayer, prior to December 1980, were reflected in its profit and loss accounts. These accounts were signed by the directors who, in their reports, say that the accounts were correct. The surplus on sale was returned as chargeable to profits tax. The attempt made by the accountants in December 1980 'to correct' the returns failed and the appeal to the Board of Review was 'compromised' without the point being further pursued. The Taxpayer has adduced no oral evidence before us in this case. Quite apart from the fact that section 68(4) of the IRO places the onus of proof on the taxpayer, there is simply nothing before us to counteract the point that, in all its previous statements prior to December 1980, the Taxpayer has treated the Y Development properties as trading stock. A mere attempt to 'correct' the returns, not pursued on appeal, can hardly be regarded as evidence favourable to the Taxpayer on this appeal.

20. After 1980 there were no sales until the year ending 31 March 1989 when the remaining flats were sold. It is not for us to speculate why there was this gap, but we cannot infer from this fact alone that the Taxpayer had changed its intentions.

Z Development

21. This was a typical development of a property dealer. The site was acquired by the Taxpayer in early 1970's and the development comprised a mixed residential and commercial consisting of over a hundred units. The units which were eventually sold in the two years in question were the remnants of the commercial units left unsold from the early 1970's. All the residential units were sold in the year ending 31 March 1973, as were some of the commercial units. Many of these were sold before the issue of the occupation permit. The profits on sale all went through the profit and loss account and were returned as assessable profits.

22. As we have already noted in paragraph 4 above, in writing to the assessor in December 1986, the accountants did not include Z Development in their assertion that the properties were the Taxpayer's 'fixed assets for the purposes of producing rental income'.

Conclusion

23. In 1988 the control of the Taxpayer changed hands with the result, so Mr Morrison argues, that the Taxpayer is unable now to adduce viva voce evidence of the intention in relation to the three properties at the relevant times; that is, when it was in the control of the old management. Mr Morrison therefore says that the Taxpayer is constrained to rely on such documentary evidence as exists. This is the reason, so Mr Morrison explained, why no viva voce evidence has been called in this appeal. We make no observation on the Taxpayer's alleged difficulties in presenting its case on this appeal, beyond pointing out what must be obvious: that the Board of Review has powers under section 68 to order persons to attend before it to give oral evidence. No such application was made in this case.

24. At the end of the day, beyond the fact that the properties in question had, as things transpired, been held by the Taxpayer for considerable periods of time, and that for long periods there were no sales, there is scant evidence of any intention to hold the property for investment. The receipt of rent is not inconsistent with an intention to sell. The evidence of past dealings is overwhelmingly against the Taxpayer's present contention. On top of that, the burden of showing that the assessments appealed against were incorrect falls on the taxpayer. This the Taxpayer has singularly failed to discharge. The appeal is accordingly dismissed.