

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D13/02

**Profits tax** – whether the sale of a property was trading in nature – definitions of ‘trade’ and ‘trading asset’ are well settled – necessary to ascertain the intention of the taxpayer at the time of acquisition of the property – mere declaration of intention is of limited value – subjective intention has to be tested against objective facts and circumstances – a quick sale of an asset at a substantial profit is per se indicative of a trading activity – no supporting documentary evidence – the circumstances and facts of the case cast doubt on the veracity of the taxpayer – burden of proof on the taxpayer – sections 2, 14(1) and 68(4) of the Inland Revenue Ordinance (‘IRO’).

Panel: Patrick Fung Pak Tung SC (chairman), Ng Yin Nam and William Tsui Hing Chuen.

Date of hearing: 14 March 2002.

Date of decision: 16 May 2002.

The taxpayer, a government principal ambulanceman, who was going to be retired in a few months’ time from the date of hearing, appealed against a profits tax assessment for the year of assessment 1997/98 arising out of his sale of a property.

The taxpayer had acquired four properties between 1993 and 1997, namely Property A, Property B, Property C and Property D. Property A and Property B were the places of residence of the taxpayer and his family.

Mortgages and loans were taken on various periods for the acquisition of Property C and Property D. Property C was acquired when it was still under construction. It was sold two months after completion. Property D was acquired five days after the taxpayer had entered into an agreement to sell Property C.

The sole issue in the appeal was whether the taxpayer was liable to profits tax from the sale of Property C by having entered into an adventure in the nature of trade (sections 14(1) and 2 of the IRO).

The facts appear sufficiently in the following judgment.

#### **Held:**

1. The law on the interpretation and application of sections 14(1) and 2 of the IRO

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regarding 'trade' and 'trading asset' was well settled in both England and Hong Kong.

2. In deciding whether a property was a capital asset or trading asset, it was necessary to ascertain the intention of the taxpayer at the time of acquisition of the property: per Lord Wilberforce in Lionel Simmons Properties Ltd v CIR [1980] 1 WLR 1196 at 1199.
3. A mere declaration of intention was of limited value. Subjective intention had to be tested against objective facts and circumstances. The intention must be genuinely held, realistic and realizable: per Mortimer J in All Best Wishes Limited v CIR 3 HKTC 750 at 771.
4. A quick sale of an asset at a substantial profit was per se more indicative of a trading activity than an acquisition as a long term investment.
5. In the present case, the completion of the property and the agreement to sell took place in a gap of only two months. The profit was about 82% of the cost price. Such a substantial profit over such a short time already put the transaction into the 'suspect' category. In such circumstances, the taxpayer was naturally obliged to put forward convincing evidence to support his allegation that he acquired the property as a long term investment.
6. Having considered all the evidence, the Board was not convinced that the taxpayer acquired the property with the intention at the time that it should be a long term investment.
7. There was evidence which cast doubt on the taxpayer's financial ability to pay off the two mortgages concerned especially after his retirement, which was due to take place in a few months' time.
8. There was no evidence that the sons of the taxpayer would be back in Hong Kong and earning enough money to help repay the mortgage instalment payments by October 2002 when the taxpayer was due to retire.
9. Besides, if the taxpayer were minded to acquire a future home for his sons and if he were the type of person who would pay much attention to his sons' wishes, the Board would expect him to have consulted his sons before making the purchase.
10. The Board also found the allegations that the sons were maintained by a family friend in England, that there was no need for the taxpayer to maintain them other than to send them the occasional few hundred pounds and that they could work

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part-time and earn enough to keep themselves whilst studying full-time, to be unconvincing. No other evidence had been adduced to support such allegations on the part of the taxpayer.

11. The Board found the claim by the taxpayer that he had paid commission to an agent on the purchase of Property C to be extraordinary, bearing in mind that he was purchasing from the developer direct. Neither was such claim supported by any receipt nor had the Board been told the name of the agent and the circumstances under which such commission had to be paid.
12. The Board was equally puzzled by the claim that the taxpayer expended \$150,000 to decorate Property C, bearing in mind his evidence that he had already decided to sell it when his sons expressed displeasure about the location during the Christmas holiday of 1996, that completion took place on 16 June 1997 and that he signed the agreement to sell on 19 August 1997. Again, no documentary or other evidence had been adduced to support such claim.
13. The claims of having to pay commission and the decoration fees cast serious doubt on the veracity of the taxpayer.
14. The fact that the acquisition of Property D contained more indicia about the intention to acquire it as a long term investment did not necessarily mean that Property C was also acquired with that intention.
15. The onus of proving that the assessment appealed against was excessive or incorrect shall be on the appellant (section 68(4)).
16. In order to succeed, the taxpayer bore the burden of satisfying the Board on the balance of probabilities that he did have the intention of acquiring Property C for the purpose of a long term investment and not of a trade at the time of such acquisition.
17. In all the circumstances, the Board found that the taxpayer had failed to discharge his burden of proof in this appeal.

### **Appeal dismissed.**

Cases referred to:

Lionel Simmons Properties Ltd v CIR [1980] 1 WLR 1196  
All Best Wishes Limited v CIR 3 HKTC 750

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Wong Kai Cheong for the Commissioner of Inland Revenue.  
Simon C Y Fung of Messrs Adrian Yeung & Cheng for the taxpayer.

### **Decision:**

1. This is an appeal by the Appellant ('the Taxpayer') against a profits tax assessment for the year of assessment 1997/98 raised on him. An objection was lodged by the Taxpayer against such assessment. The original assessment dated 27 June 2000 was on the basis of assessable profits of \$1,109,855 with tax payable in the sum of \$149,830. By his letter dated 24 August 2001, the Respondent ('the Commissioner') made a determination and rejected the Taxpayer's objection. By the same letter, the Commissioner further increased the assessable profits to \$1,277,573 with tax payable in the sum of \$172,472. The Taxpayer has brought this appeal against such determination ('the Determination').

### **The facts**

2. The Taxpayer was at all material times and is a principal ambulanceman in the Government. He joined the Government in 1966. He is currently aged 54 years and is due to retire in October 2002.

3. The Taxpayer is married to his wife Madam A who is aged 47 years. They have two sons. The elder son, Mr B, was born in May 1977 and is now aged almost 25 years. The younger son, Mr C, was born in June 1978 and is now aged almost 24 years.

4. Although the Taxpayer and his family originally lived in Government quarters, they subsequently ceased to do so.

5. Mr Simon Fung representing the Taxpayer very helpfully handed to the Board a written submission whereby he indicated that the Taxpayer would adopt the basic facts as set out in the Determination as background. It will therefore be convenient for us to adopt such agreed facts in the decision by extracting them from the Determination as follows:

- ' (3) The Taxpayer purchased the following properties during the period from 1993 to 1997:

<b>Location</b>	<b>Acquisition</b> (Date of Formal Agreement) Date of Assignment	<b>Disposal</b> (Date of Formal Agreement) Date of Assignment
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	Consideration	Proceeds
[Address 1] [“Property A”]	(02.06.93) 12.08.93 \$1,763,100	(01.06.96) 02.08.96 \$2,138,000
[Car-park 1]	12.06.95 \$375,000	(01.04.97) 22.05.97 \$395,000
[Address 2] [“Property B”] and [Car-park 2]	(26.04.95) 07.12.95 \$2,133,000	Not yet sold
[Address 3] [“Property C”]	(20.11.96) 16.06.97 \$1,771,800	(19.08.97) 29.09.97 \$3,230,000
[Address 4] [“Property D”]	(27.08.97) 03.10.97 \$2,100,000	Not yet sold

- (4) Property A and Property B were the places of residence of the Taxpayer and his family. The saleable floor area of Property A and Property B are about 776 square feet and 797 square feet respectively. Both properties are of 3 bedrooms.
- (5) On 1 November 1996, the Taxpayer obtained a mortgage loan of \$1,600,000 from [Bank D] which was secured by Property B. The loan was repayable by 216 monthly instalments of \$15,487 each.
- (6) By a memorandum for sale dated 16 November 1996 [Appendix A], the Taxpayer acquired Property C from the developer. The saleable floor area of Property C was 522 square feet. There are 2 bedrooms in Property C.
- (7) At the time of purchase, Property C was still under construction. The acquisition of Property C was partially financed by an equitable mortgage of \$1,240,000 granted by [Bank E] on 20 December 1996. The loan was repayable by 240 monthly instalments of \$10,762 each.
- (8) On 27 February 1997, the Taxpayer obtained a loan of \$206,500 from Financial Secretary Incorporated by a second legal charge on Property B. The loan was repayable by monthly instalments of \$3,851.13.
- (9) By a provisional agreement dated 7 August 1997, the Taxpayer agreed to sell Property C. A copy of the provisional agreement is at Appendix B.

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- (10) Acquisition of Property D was partially financed by a mortgage loan of \$1,000,000 granted by [Bank E] which was repayable by 300 monthly instalments of \$8,307 each.
- (11) In his 1998/99 tax return, the Taxpayer declared that he had leased out Property D throughout the year and derived rental income of \$81,600.
- (12) At the request of the Assessor, the Taxpayer completed a questionnaire on the purchase and disposal of Property C. The Taxpayer computed the profits on disposal of Property C as follows:

	\$	\$
Sale proceeds		3,230,000
<u>Less: Purchase cost</u>		<u>1,771,800</u>
		1,458,200
<u>Less: Legal fees on purchase</u>	11,750	
Stamp duty	26,577	
Commission to agent on purchase	17,718	
Bank interest	100,000	
Decoration	150,000	
Legal fees on sale	10,000	
Commission to agent on sale	<u>32,300</u>	<u>348,345</u>
Net profits		<u><u>1,109,855</u></u>

- (13) In reply to queries raised by the Assessor, the Taxpayer informed that:
  - (a) Property C was left vacant during the period of ownership.
  - (b) He has been working in [the Government] over 10 years with remuneration over \$30,000 per month, so he can afford the down payment and monthly mortgage instalments of Property C.
  - (c) The proceeds on disposal of Property C was applied for the acquisition of Property D.
- (14) In his tax returns for 1996/97 and 1997/98, the Taxpayer declared his salaries incomes were \$345,536 and \$381,941 respectively.
- (15) The Assessor considered the profits on sale of Property C is chargeable to Profits Tax. He raised on the Taxpayer the following 1997/98 Profits Tax assessment:

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	\$
Assessable profits [Fact (12)]	<u>1,109,855</u>
Tax Payable thereon	<u>149,830</u>

- (16) The Taxpayer objected against the 1997/98 Profits Tax assessment claiming that the profit from disposal of Property C should not be subject to Profits Tax.
- (17) The Taxpayer claimed that:
- (a) He bought Property C for the residential use of his sons when they came back Hong Kong after graduation.
  - (b) On their summer holidays during 1997, his sons complained that it was inconvenient for them to go downtown, so the Taxpayer acquired Property D to replace Property C.
- (18) In respect of the alleged decoration expenses spent on Property C, the Assessor requested the Taxpayer to provide the following information and documents:
- (a) Name and address of decoration company.
  - (b) The period in which the decoration work was carried out.
  - (c) Details of decoration.
  - (d) Copies of bank transaction records showing the withdrawals for settlement of the decoration expenses.
- In reply, the Taxpayer stated that he could not recall the interior decorator and he could not find out the quotation and receipts for the decoration charges.
- (19) The purchaser of Property C confirmed that the property was not newly furnished at the time of purchase.
- (20) The Assessor was of the view that the 1997/98 Profits Tax assessment should be revised as follows:

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	\$
Profits per questionnaire [Fact (12)]	1,109,855
<u>Add:</u> Commission on purchase	17,718
Decoration	<u>150,000</u>
Assessable profits	<u>1,277,573</u>
Tax Payable thereon	<u>172,472</u>

6. The Taxpayer gave evidence on affirmation to support his own case. He was the only witness called. He gave evidence on factual matters in addition to what has been set out above. We shall deal with the same below.

### **The issue**

7. There is only one issue in this appeal. It arises out of section 14 of the IRO.

8. Section 14(1) of the IRO reads as follows:

*‘ Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.’*

9. Section 2 of the IRO defines ‘trade’ to include:

*‘ every trade and manufacture, and every adventure and concern in the nature of trade.’*

10. Mr Fung for the Taxpayer agrees with the Commissioner that the issue in the appeal is whether Property C was acquired by the Taxpayer as capital assets or trading stock. He further says in paragraph 3 of his written submission the following:

‘3. To determine this issue, the Appellant agrees with the CIR (as stated in paragraph (2) of the Reasons Therefor”) that test is to ascertain objectively the intention of the Appellant at the time of acquisition of the property, by taking into account all the facts, documents and circumstances at the time.’



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11. Whilst we agree that the formulation of the test in Mr Fung's written submission is by and large correct, we think that it is unduly restricted by the expression 'at the time' at the end of the formulation.

### **The law**

12. The law on the interpretation and application of sections 14(1) and 2 of the IRO regarding 'trade' and 'trading asset' is well settled in both England and Hong Kong.

13. First, in deciding whether a property is a capital asset or trading asset, it is necessary to ascertain the intention of the taxpayer at the time of acquisition of the property. In Lionel Simmons Properties Ltd v CIR [1980] 1 WLR 1196, Lord Wilberforce at page 1199 said:

*' One must ask, first, what the Commissioners were required or entitled to find. Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of 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?'*

14. Secondly, a mere declaration of intention is of limited value. Subjective intention has to be tested against objective facts and circumstances. The intention must be genuinely held, realistic and realisable. In All Best Wishes Limited v CIR 3 HKTC 750, Mortimer J said at page 771:

*' 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. Indeed, decisions upon a person's intention are commonplace in the law. It is probably the most litigated issue of all. It is trite to say that intention can only be judged by considering the whole of the surrounding circumstances, 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.'*

15. We shall be guided by these principles when we come to consider the evidence.

### **The case of the Taxpayer**

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16. The Taxpayer's case is that, at the time he purchased Property C, he intended to hold the same as a long term investment to provide a residence for his two sons in due course when they returned from their studies in England. He was not thinking of re-selling the same in order to make a profit. The timing of the purchase was as a result of his seeing that property prices were rising rapidly in 1996. He thought that if he did not commit himself to buying a property then, property prices would go so high that soon the market would be out of his reach. The choice of location of the subject-matter of the purchase, namely, Property C, was prompted by the fact that it was close to his own home, Property B. The idea was that eventually his sons would be living near him and his wife and also that, if in the meantime the property was to be let out, he and his wife would be able to look after the same from nearby. This was confirmed by the Taxpayer in evidence.

17. The Taxpayer further gave evidence to the following effect:

- (a) He and his family were all given British passports and United Kingdom citizenship in about 1992 on application by him in his capacity as a Government servant.
- (b) In 1993, Mr B went to England to study. He studied in boarding school for a very short while and found that life was intolerable. He therefore left and studied in a day school which charged practically no school fees because of Mr B's British citizenship. Mr B at first stayed with a family friend who provided food and lodging and who charged nothing for it. Subsequently Mr B found other lodgings which he shared with friends. Mr B is now studying economics in University F and will return to Hong Kong after his studies.
- (c) Mr C went to England to study in 1996. He is now doing a degree course in information systems in University G.
- (d) Throughout the stay of the two sons in England, the Taxpayer has not had to send any money to support them, other than the occasional few hundred pounds. When Mr B (or probably Mr B and Mr C) was in boarding school, a substantial part of the school fees was paid by the Government. Further, the sons were able to do part-time work which produced enough money for their own support. Mr B has also been able to obtain a loan to finance his university study.
- (e) Furthermore, the Taxpayer did not need to pay for the airfare of his sons when they returned to Hong Kong on holiday visits because the same was paid by the Government.

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- (f) The Taxpayer, having signed the agreement to purchase Property C (which was still in the process of construction) on 20 November 1996, mentioned to his sons on their return to Hong Kong during the Christmas holiday in 1996 that he had purchased Property C for their future use. The response from the sons was very negative because of the location. They thought it was very inconvenient, especially when they were to return home late at night. It was far away from downtown and the modes of transport available were limited. The Taxpayer therefore decided to sell Property C.
- (g) The Taxpayer, however, could not sell Property C at that stage because the development had not been completed yet.
- (h) The occupation permit for Property C was issued in April 1997. The Taxpayer completed the purchase on 16 June 1997. He entered into an agreement to sell Property C on 19 August 1997 and completed the sale on 29 September 1997.
- (i) In the meantime, he located Property D and entered into an agreement to purchase the same on 27 August 1997 which was near the shop called 'Company H' run by his wife at Address 5. The purchase of Property D was completed on 3 October 1997.
- (j) Both Property C and Property D consisted of two bedrooms, although Property C was larger than Property D. The smaller accommodation was compensated by the fact that Property D was nearer to town.
- (k) Property D has been let out to a tenant.

18. The Taxpayer was cross-examined extensively by Mr Wong representing the Commissioner on his financial resources and ability with a view to showing that, on the basis of the information as disclosed, the Taxpayer would not have been able to finance the mortgage of Property C in the long term, especially after his retirement in October 2002.

19. The evidence which came out on this aspect can be summarised as follows:

- (a) The mortgage on Property B was repayable by 216 monthly instalments of \$15,487 each [see fact (5) set out in paragraph 5 above], although the Taxpayer said that the monthly instalment became a bit less because of reduction of the interest rates.
- (b) The mortgage on Property C was repayable by 240 monthly instalments of \$10,762 each [see fact (7) set out in paragraph 5 above], although again the

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Taxpayer said that the monthly instalment became a bit less for the same reason.

- (c) The loan of \$206,500 from the Financial Secretary Incorporated in February 1997 was repayable by monthly instalments of \$3,851.13 each. The figure might have been reduced to \$3,783.
- (d) Thus the total outgoings by the Taxpayer just for the repayment of loans per month secured by Property B and Property C would amount to about \$30,033 or a bit less.
- (e) Before his retirement, the Taxpayer could expect a monthly income of about \$39,500, consisting of \$32,000 by way of salary and \$7,500 by way of rental from letting out Property C.
- (f) This would leave about \$10,000 for the use of the Taxpayer and his family.
- (g) After his retirement and on the basis that he was still having Property C, he would have to make mortgage instalment payments on Property B and Property C in the sum of about \$26,000 per month.
- (h) His income after retirement would consist of his pension of about \$15,000 and the rental of \$7,500 from letting out Property C which would amount to about \$22,500 in total and which would not cover even the \$26,000 repayment referred to in (g) above, let alone the upkeep of the family.

20. When the Taxpayer was cross-examined specifically on whether he did not realise at the time when he agreed to purchase Property C that he would have difficulty coping with making payment of the mortgage instalments on Property B and Property C after his retirement, he said that he and his wife had a little bit of saving and that he would expect his sons to be working by then. He also said that he did not make such a detailed calculation at that time. He just wanted to do something for his family whilst he could.

21. The Taxpayer further said that the fact that he had not sold Property D but had let it out was in support of his contention that he had acquired Property C as a long term investment.

22. Whilst there is a certain ring of truth in the Taxpayer's assertion of his reasons for the purchase of Property C and the circumstances under which he made the purchase, we have to assess the situation in light of all the evidence and in accordance with the guidelines enunciated in the cases cited above.

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23. To begin with, a quick sale of an asset at a substantial profit is per se more indicative of a trading activity than an acquisition as a long term investment. Here, completion took place on 16 June 1997 and the agreement to sell was signed on 19 August 1997 – a gap of only two months. The profit was \$1,458,200, or about 82% of the cost price. Indeed, such a substantial profit over such a short time (even counting from November 1996 when the agreement to purchase was signed by the Taxpayer) already puts the transaction into the ‘suspect’ category. In such circumstances, the Taxpayer is naturally obliged to put forward convincing evidence to support his allegation that he had acquired the asset as a long term investment.

24. Having considered all the evidence, we are not convinced that the Taxpayer acquired Property C with the intention at the time that it should be a long term investment. We set out our reasons below.

25. First, there is the evidence referred to in paragraphs 19 and 20 above, which at least casts doubt on the Taxpayer’s financial ability to pay off the mortgages on both the mortgages on Property B and Property C, especially after his retirement. There is no evidence which suggests that his sons will be back in Hong Kong and earning enough money to help repay the mortgage instalment payments on Property C by October 2002 when the Taxpayer is due to retire.

26. Secondly, if the Taxpayer were minded to acquire a future home for his sons and if he is the type of person who would pay much attention to his sons’ wishes, we would expect him to have consulted his sons **before** making the purchase.

27. Thirdly, we find the allegations that the sons were maintained by a family friend in England, that there was no need for the Taxpayer to maintain them other than to send them the occasional few hundred pounds and that they could work part-time and earn enough to keep themselves whilst studying full-time, to be unconvincing. No other evidence (documentary or oral) has been adduced to support such allegations on the part of the Taxpayer.

28. Fourthly, we find the claim by the Taxpayer that he had paid \$17,718 as commission to an agent on the purchase of Property C to be extraordinary, bearing in mind that he was purchasing from the developer direct. Such claim is not supported by any receipt nor have we been told the name of the agent and the circumstances under which such commission had to be paid.

29. Fifthly, we are equally puzzled by the claim that the Taxpayer expended \$150,000 to decorate Property C, bearing in mind his evidence that he had already decided to sell Property C when his sons expressed displeasure about the location during the Christmas holiday of 1996, that completion took place on 16 June 1997 and that he signed the agreement to sell on 19 August 1997. Why would he still decorate Property C if he was going to sell soon after completion? This is to be viewed also in light of facts (18) and (19) set out in paragraph 5 above

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which are agreed facts. Again, no documentary or other evidence has been adduced to support such claim.

30. We further take the view that the claims referred to in paragraphs 28 and 29 above cast serious doubt on the veracity of the Taxpayer.

31. We should add that the fact that the acquisition of Property D contains more indicia about the intention to acquire it as a long term investment does not necessarily mean that Property C was also acquired with that intention.

32. We should further add that the Taxpayer did not appear to be very forthcoming when he was questioned as to whether he owned a motor car.

### **Conclusion**

33. Section 68(4) of the IRO provides that:

*‘ The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant. ’*

34. In order to succeed, the Taxpayer (and not the Commissioner) bears the burden of satisfying us on the balance of probabilities that he did have the intention of acquiring Property C for the purpose of a long term investment and not of a trade at the time of such acquisition.

35. On our view of the totality of the evidence, we have come to the conclusion that the Taxpayer has not discharged this burden.

36. Accordingly, we dismiss the appeal of the Taxpayer and confirm the Determination by the Commissioner that the assessable profits in respect of the Taxpayer for the year of assessment 1997/98 are \$1,277,573 with tax payable in the sum of \$172,472.