Case No. D13/91

Profits tax – whether profit capital or income – sale of Letters B land entitlement.

Panel: Howard F G Hobson (chairman), Ronny Wong Fook Hum and Edwin Wong.

Dates of hearing: 25, 26 and 27 March 1991.
Date of decision: 20 May 1991.

The taxpayer was a limited liability company which acquired four parcels of Letters B land entitlement. These transactions all took place in 1981. In 1986 it sold two of the parcels bought and in 1987 it sold the remaining two parcels of Letters B which it had acquired. The directors' report attached to the annual audited accounts of the taxpayer stated that its activities comprised dealing in properties. The question to be decided by the Board of Review was whether the profit arising on the sale of the Letters B land entitlements in respect of one year of assessment was a capital gain or a trading profit.

Held:

The onus of proof is upon the taxpayer. Where a taxpayer has reports signed by directors and has filed tax returns in which the taxpayer's business is described as dealing in property, it is more difficult for the taxpayer to discharge the burden of proof imposed upon it.

Appeal dismissed.

Cases referred to:

D65/89, IRBRD, vol 5, 37
D18/88, IRBRD, vol 3, 241
D55/88, IRBRD, vol 4, 20
D23/88, IRBRD, vol 3, 283
D11/80, IRBRD, vol 1, 374
Richfield International Land and Investment Co Ltd v CIR 2 HKTC 444
Hillerns and Fowler v Murray (H M Inspector of Taxes) 17 TC 77
Seaham Harbour Dock Co v Crook [1931] 46 TLR 396

Ng Kwok Yin for the Commissioner of Inland Revenue.
Stephen W T Liu of Messrs Stephen Liu & Co for the taxpayer.

Decision:

This decision was originally concerned with an appeal against two profits tax assessments made upon the Taxpayer for the years of assessment 1986/87 and 1987/88. The original 1986/87 assessment was reduced and became final and conclusive by virtue of section 70 of the Inland Revenue Ordinance but the Taxpayer sought to appeal under section 70A against that assessment on the grounds of an error. However on the penultimate day of the hearing the Taxpayer's representative withdrew that particular ground of appeal.

In essence the ground of appeal was that the profits concerned were capital gains not trading profits.

1. BACKGROUND

The following are the essential features of the undisputed facts extracted from the determination of the Deputy Commissioner of Inland Revenue to which we have added some unchallenged material adduced in evidence.

1.1 Two spinsters ('the landowners') owned a plot ('the plot') of vacant land at a village: at the hearing no evidence was made available as to the area of this plot. By a Power of Attorney in early 1980 they jointly appointed Mr X, a local village 'elder', their attorney with wide powers in relation to the plot, which included letting, selling and negotiating with government departments.

1.2 In late 1980 the Taxpayer was incorporated with an authorized capital of $10,000 which was raised to $300,000 in January 198l and again raised to $400,000 in April 1981 and at each stage the issued capital was the same as the authorized. Its three shareholders, namely Mr X, Mr Y and Mr Z, respectively held 25% ($100,000), 25% ($100,000) and 50% ($200,000) of the issued capital. These persons also comprised the board of directors.

1.3 In early 1981 the Taxpayer bought two parcels of Letters B, representing an entitlement of 3,540 square feet for $708,000.

1.4 In mid-1981 the Taxpayer bought two further parcels of Letters B, representing an entitlement of 1,307 square feet for $636,110.

1.5 The purchases, which totalled $1,344,110, were financed partly out of the capital referred to at paragraph 1.2 above and the remainder by interest free loans from Mr Z ($900,000) and Mr Y ($134,160).

1.6 In 1986 the two parcels bought in mid-198l were sold for a total of $1,115,100.

1.7 In 1987 the two parcels bought in early 1981 were sold for a total of $718,900.

1.8 The Taxpayer made no profits or income of any kind for the years of assessment since incorporation until 1986 when the sales referred to at paragraph 1.6 above were made.

1.9 The principal activity of the Taxpayer was described as follows in the Taxpayer's accounts (the periods for which corresponded to Hong Kong's fiscal years) and 'nil' tax returns. The Taxpayer engaged various auditors which we identify numerically below.

Year of Assessment	Directors' Report	Profits Tax Return	Auditors
1981/82	Dealing in Properties	Dealing in Properties	No. 1
1982/83	Dealing in Properties	Dealing in Properties	No. 2
1983/84	Dealing in Properties	Investment	No. 3
1984/85	Dealing in Properties	Investment	No. 3
1985/86	Dormant	Investment	No. 2
1986/87	Dealing in Properties	Dealing in Properties	No. 2
1987/88	Dealing in Properties	Dealing in Properties	No. 2

The Taxpayer was represented before us by an accountant who did not audit the accounts of the Taxpayer for any of years referred to above.

2. TESTIMONY

Mr Y testified on oath to the following effect. For the past twenty-eight years he had worked for banks and is now holding a senior position. In 1980 Mr X approached him and Mr Z with the idea of entering into a joint venture with the landowners (from whom he, Mr X, had a Power of Attorney) for building five village-type houses on the plot. Mr X had been advised that it should be possible to let the flats (one per storey) for about $2,500 per month (that is $7,500 per house), and that the landowners would get one house in return for providing the plot. The income from four houses would therefore be about $360,000 per annum. Mr X calculated the building costs at $300,000 per house. Mr X recommended a

firm of solicitors ('the firm of solicitors') to handle the formation of the Taxpayer. That firm advised them to buy Letters B which could be surrendered to the government in exchange for the premium thereby saving about 10%. Mr Y himself prepared the interim document and the memorandum about the time of incorporation of the Taxpayer for Mr X to put before the landowners. These documents, he said, were based upon the verbal agreement of the landowners as indicated to him by Mr X. Mr Y was in regular touch with Mr X, and with Mr Z, though less often because he lived in Malaysia. In early 1981 the two parcels of Letters B at paragraph 1.3 above were bought through the firm of solicitors and in mid-198l the other two parcels (refer paragraph l.4 above) were bought in the same way.

Sometime in 1981 – presumably after the mid-1981 purchase of the two parcels of Letters B – Mr X told Mr Y and Mr Z that the landowners wanted to increase their consideration from one house to two houses and retain control and management over the development. Mr Y said that attempts by Mr X to dissuade the landowners concerning this new proposal went on for some time but by December 1981 the directors decided to abandon the deal with the landowners and instead to look around to see if they could find a substitute landowner willing to enter into a similar arrangement. Mr X made approaches to various people in the locality of the plot but without success. Mr Y mentioned that he also made some enquiries but was not forthcoming with any names or details. Finally in 1986 the directors decided to and did sell the two parcels of Letters B bought in mid-1981 through the firm of solicitors and likewise in 1987 the two parcels bought in early 1981 were sold.

Mr Y said that the directors' original intention was to take title to the plot, pay the redevelopment premium with Letters B, develop the plot and convey one house to the landowners, retain the other four and let the twelve flats out as a long term investment. There was never any intention to trade in Letters B.

In cross-examination Mr Y sought to explain why persons who could give first hand supporting evidence were not called. He said the person at an estate agency who wrote the 23 March 1991 letter to the effect that they had told Mr X in 1980 that they would be able to let the houses for about $7,500 each was not present because no one asked for his attendance. Mr Z did not attend because he lived in Malaysia and was presently in Europe on a pleasure trip and the absence of Mr X was due to the fact that he had to go to China frequently regarding his textile/garments business. He did not know why the landowners were not called but thought it was because it was unnecessary.

The following points of consequence were also brought out in further cross-examination. No surveyor was appointed to negotiate with the government because Mr X as a village elder knew the development plan was feasible having assisted in such negotiations for the sons of villagers. Mr Y's attention was drawn to a newspaper article which indicated that the prices for Letters B in late 1980 were at an index high of 460 but dropped steadily from 1981 to reach a low through 1983, 1984 and 1985 of around 90 on the index with recovery beginning in 1986 to a new high in May 1987 of 500. Mr Y denied however that these factors played any part in the retention of the Letters B or their ultimate sale.

He acknowledged that he had signed the 1986/87 tax return in which the nature of the Taxpayer's business was described as 'dealing in property' and a profit on the first resale of the Letters B was shown. The only explanation Mr Y could offer for these entries was that the form was filled up by his secretary in accordance with a request by the accountant. He said the directors decided to buy the Letters B (for a total price of $1,344,110) before ensuring the landowners would sign the interim agreement because they believed Mr X's assurance that the landowners would proceed. As to the attempts to find substitutes for the landowners he and Mr Z relied upon Mr X.

Of the five copied directors' minutes produced to us (save for one signed by Mr Z relating to Mr Y's shareholder's loan) all were signed by this witness.

3. SUBMISSIONS

As mentioned, in the course of his submission the Taxpayer's representative withdrew the appeal against the year of assessment 1986/87, accepting the Deputy Commissioner's ruling that by virtue of section 70, it was final and conclusive and that there was no error or omission of the kind contemplated by section 70A. However though conceding this technical point the representative did not concede that this factor should affect the merits concerning the year of assessment 1987/88.

Regrettably many of the submissions on the merits made by the Taxpayer's representative were baseless, no evidence has been adduced to support them (nor would it seem that any such attempt was made). Of the remainder the following are worth mentioning.

From the Rating and Valuation Department's 1989 Property Review, it was clear that domestic property prices declined steeply from a price index of 150 down to 100 by 1984 whereafter it began to rise to a price index of about 180 in 1988; rents followed a similar if less dramatic graph. This, it was argued, supported for Mr Y's evidence concerning the difficulty the Taxpayer experienced in attempting to find a substitute for the landowners. We were urged to ignore the fact that the directors had categorized the Taxpayer's activities as 'dealing in property' in their reports and returns because in the financial statements themselves the Letters B were treated in a manner more consistent with long term investments. Unfortunately the only full sets of accounts before us were those for the years ending 31 March 1987 and 31 March 1988. In the latter there is no reference to Letters B, both parcels have been sold. In the former although the sale of the second parcel of Letters B had taken place, the first parcel is shown in the balance sheet as 'investments' and the footnote states 'investments represent certain Letter B entitlements in the New Territories and are stated at cost less provision' – the provision is shown as a substantial diminution of value. It was argued that this diminution treatment was itself indicative of a long term asset. We have part of the accounts for the year ending 31 March 1983 which shows a 'loss after extraordinary item of $705,510' but we were not shown how this figure was arrived at. It is therefore impossible for us to attribute anything to this entry,

particularly as it appears immediately after a statement that the 'principal activities' of the Taxpayer during the year was 'dealing in property'.

The representative went on to say that the fault as to categorization lay with the previous auditors, but no questions were asked of Mr Y on this aspect although he was one of the signing directors: nor was any explanation offered as to why such auditors were not called. Indeed Mr Y said that the tax returns were prepared by his secretary on his instructions based on the accountant's figures. The only point of value made on this subject was that the Taxpayer filed no tax computation when filing the tax returns. We only had the 1986/87 tax return before us so we cannot be sure what was presented with the earlier returns. However, even if no computation was made, this would tend to be neutral rather than favourable to the Taxpayer, because until the Letters B were sold, whether they were held as a long term investment or for trading, no profit could be made, hence the tax computation would be nil and of little evidentiary value. We did have correspondence before us which indicated that when the 1986/87 return was filed it showed a gross profit before losses carried forward of $398,739, being the difference between the sale of the second parcel of Letters B for $718,900 and cost after diminution of $320,161; however, following representation by the Taxpayer's then tax representative, the diminution was ignored thereby reducing the profit to $49,266 and the taxable profit to $37,806 after taking into account losses brought forward. In our view it is noteworthy that, Mr Y having realized the profit had been overstated and having drawn this to the attention of that tax representative, neither he nor that representative immediately took the point that the profits were the result of a capital gain and made a submission to the Revenue accordingly.

Next it was pointed out by the Taxpayer's representative that if the directors intended the Taxpayer to trade in Letters B they would have sold them much earlier. However, as already mentioned, in cross-examination the Revenue's representative had drawn attention to the drop in Letters B prices which appears to have started shortly after the Taxpayer's second purchase in mid-1981 and continued until the new high in 1987. Notwithstanding Mr Y's denial we believe this state of affairs could account for holding on to the Letters B at least until the rise began to match the purchase prices or went into profit.

Before closing this chapter concerning the submissions of the Taxpayer's representative we should perhaps mention that he sought to persuade us that the categorization of the Letters B in the Taxpayer's accounts as an 'investment' being consistent with the Standard Accounting Practice Statement No 2.113 was binding on the Commissioner because he was a member of the Hong Kong Society of Accountants. We think this point has no validity. In any event as will be seen from paragraph 1.9 above the categorization lacks consistency. The representative also referred us to D65/89.

We do not need to deal in depth with the many and largely valid points made by the Commissioner's representative. He urged us to note and take into account that the letter from the estate agency was not a contemporaneous record and the writer was not called to give evidence and that neither Mr X nor the landowners were called to give evidence.

The Commissioner's representative referred to a number of cases namely D18/88, D55/88, D23/88, D11/80, Richfield International Land and Investment Co Ltd v CIR 2 HKTC 444, Hillerns and Fowler v Murray (H M Inspector of Taxes) 17 TC 77 and Seaham Harbour Dock Co v Crook [1931] 46 TLR 396. We think it is only perhaps worthwhile repeating a statement appearing at page 465 of the Richfield decision:

> ' ... It is also clearly established that on appeal to the Commissioners [which are equivalent to the Hong Kong Board of Review] the burden is on the taxpayer to displace the assessment, and in these circumstances the burden in the present case clearly on the taxpayer to establish that the sales in question gave rise to a surplus on capital account and not to a trading profit.'

4. CONCLUSION

The onus is upon the Taxpayer to convince us, on the balance of probabilities, that the year of assessment 1987/88 was incorrect. The only first hand evidence is the testimony given by Mr Y. He struck us as a fairly sophisticated individual accustomed to working with figures. It is therefore somewhat difficult to accept that he blithely signed directors' reports and filed tax returns in which he described the Taxpayer's business as 'dealing in property' and that when he instructed his then tax representative to correct the 1986/87 tax return by eliminating the diminution factor he failed to point out that the profit was a capital gain. We do not think therefore that we can blindly accept his uncorroborated testimony. As for the 18 January 1981 minutes (assuming it to be genuinely contemporary) certainly shows an intention to develop the plot by building five village houses but it is silent as to what is to be done with them when built. Moreover the very fact that neither of the other directors, nor the landlords nor any person from the estate agency were called to cast such grave doubts on the Taxpayer's case as to render it unacceptable. We therefore conclude that the Taxpayer has not discharged the onus of proof and find as a matter of fact that the Letters B were bought with the intention of resale and accordingly we dismiss this appeal.