

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D145/98

Profits Tax – acquisition and sale of properties – intention of purchaser at time of acquisition – burden of proof on purchaser – whether tax chargeable on the profits of sale – burden on taxpayer to establish that assessment was incorrect.

Panel: Audrey Eu Yuet Mee SC (chairman), Anna Chow Suk Han and Peter R Griffiths.

Dates of hearing: 16 and 22 December 1998.

Date of decision: 13 January 1999.

Mr A was a national of Country B and came to Hong Kong to work in November 1986 until September 1992 when he moved to Country C. He first purchased a property in Hong Kong on 21 November 1992 for \$5,000,000 which he registered in his own name. He subsequently sub-sold the Property to Company E for the same price. On 19 November 1993, Mr A purchased the taxpayer (a shelf company) and acted as its alter ego. He used the taxpayer to acquire the Property from Company E for \$5,210,000. Sometime later, on 29 June 1994, the taxpayer entered into an agreement to sell the Property for \$10,500,000. Mr A returned to Country B in July 1995.

In respect of the disposal of the Property, the Commissioner determined additional profits tax assessment for the years of assessment 1994/95 and 1996/97. The taxpayer claimed, *inter alia*, that the Property was a capital asset, not trading stock, and should not be chargeable to profits tax. The Revenue represented, *inter alia*, that such a short period of ownership was one of the factors indicative of trade.

Held:

- (1) Although the Property was of a type that would not attract a typical speculator and the accounting treatment of the Property by the taxpayer was consistent with it being a fixed capital asset, the crux of the matter was not why Mr A decided to sell the Property but rather why he decided to buy it;
- (2) A long-term investment is a capital asset and not a trading asset. Profit arising from the sale of a capital asset is not taxable while profit arising from a sale of a trading asset is taxable. It is not possible for an asset to be both trading stock and a long term investment. Trading requires an intention to trade (Simmons v CIR 53 TC 461, 491 per Lord Wilberforce);
- (3) The Property was purchased in the name of the taxpayer which made it difficult for Mr A to recover possession if he wanted to reside in it. What the

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estate agent had told Mr A to the contrary should have been double-checked by Mr A before purchase. Further, there was no credible reason why Mr A purchased the Property in the name of the taxpayer rather than his own name. It was also unbelievable that Mr A did not keep his mind on the state of the property market at the time of selling the Property.

- (4) Accordingly, Mr A's credibility was seriously affected. The taxpayer failed to discharge its onus.

Appeal dismissed.

Case referred to:

Simmons v CIR 53 TC 461

Ma Wai Fong for the Commissioner of Inland Revenue.
M C Chiu of Messors W M Sum & Co for the taxpayer.

Decision:

The appeal

1. The Taxpayer appeals against the determination of the Commissioner of Inland Revenue dated 28 July 1998 in respect of the additional profits tax assessment for the years of assessment 1994/95 and 1995/96 raised on it. The Taxpayer claims that the profits it derived from the disposal of a property in the later year should not be chargeable to profits tax and that it should be granted rebuilding allowance in respect of that property in the earlier year. Both questions depend on whether the property was acquired as capital asset or trading stock.

The background facts

2. The parties have helpfully provided a statement of agreed facts, most of which can be summarized as follows.

3. The Taxpayer was incorporated on 22 July 1993 with Mr A and his wife as the only shareholders. Mr Chiu for the Taxpayer described Mr A as the *alter ego* of the Taxpayer. It is not in dispute that the intention of Mr A was the intention of the Taxpayer.

4. Mr A is a national of Country B and a chartered accountant. He worked in Country B for some years before coming to Hong Kong in November 1986. He worked for a few companies in Hong Kong before he joined Country C in September 1992 as the chief financial officer. Country C did not provide Mr A with any accommodation.

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5. By an agreement dated 21 November 1992, Mr A purchased a flat and car parking space at District D ('the Property') for the price of \$5,000,000. By a sub-sale agreement dated 19 December 1992, Mr A sold the Property to an associate company of his then employer, Company E at the same price.

6. On 1 November 1993, Mr A went to work for Company F. This new employer offered him a much more attractive pay package including an up front inducement fee of \$3,000,000.

7. Having received this inducement fee, on 19 November 1993, Mr A purchased the Taxpayer as a shelf company and used it to acquire the Property from Company E for \$5,210,000. Mr A advanced \$2,710,000 to the Taxpayer and obtained a mortgage of \$2,500,000 from a bank. The mortgage loan was to be repaid by 120 monthly instalments of \$30,996 each and this could be covered by the rental of \$36,500 a month generated by the tenant of the Property.

8. On 29 June 1994, the Taxpayer entered into an agreement to sell the Property for \$10,500,000. The sale was completed by an assignment dated 24 August 1994.

9. Mr A remained working for Company F until he completed 18 months which was the minimum period of employment he had to complete before he could keep a pro rata portion of the \$3,000,000 up front inducement. He gave notice to resign and he left on 31 July 1995. He had to repay \$900,000, being a portion of the up front inducement fee, to Company F because he had only worked 21 months instead of the entire 3 years in order to earn the full amount.

10. By a letter dated 14 April 1995, Company G from Country B offered Mr A the position of executive director and he returned to Country B in July 1995.

The determination

11. The Commissioner of Inland Revenue upheld the assessment of additional profits tax on the basis that the Taxpayer did not have the intention to hold the Property as a long term investment. The reasons for his determination are summarised by Mr Chiu for the Taxpayer as follows.

- (a) there is no evidence that at the time of sale of the Property Mr A had a fixed intention to leave Hong Kong;
- (b) there is no evidence that Mr A was offered a job by Company G in March 1994;
- (c) the Commissioner found that a fax from company H to Mr I dated 13 April 1994 is of no assistance to the Taxpayer's case;

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- (d) Mr A did not have a firm intention to leave Hong Kong as indicated by the fact that he continued to be a director of Company C during the year of assessment 1995/96 and he returned to work for Company C in November 1996;
- (e) Mr A's termination of employment with Company F was not a reason for selling the Property as the same was sold one year before Mr A resigned from Company F;
- (f) the short period of ownership of the Property (7 and a half months) by the Taxpayer;
- (g) there is no documentary evidence substantiating the intention of holding the Property for long term investment;
- (h) Mr A's job nature at Company F was already observable when or before he commenced work at Company F.

The Taxpayer's case

12. The Taxpayer called two witnesses in support of its case. Both of them had prepared witness statements which were put in as part of the evidence in chief. We would like to record our appreciation for the provision of these witness statements which help to shorten the proceedings significantly.

13. Mr I was called as the first witness. He is a qualified accountant from Country B. He came to Hong Kong to give evidence in this appeal. In 1990, he commenced working for Company J as a general manager in charge of operations and finance. In 1993, Company J was taken over by the Company F. He was asked to stay on. Soon he was joined by Mr A. They worked in different divisions at opposite ends of the same office. Being fellow nationals, Mr I and Mr A naturally got together from time to time to discuss matters relating to their work and the situation in Country B. Both of them were unhappy with their mutual boss Ms K who was very aggressive and putting a lot of pressure on them. Mr I had on going discussions with Mr A about returning to Country B since the beginning of 1994. They spoke about job prospects, accommodation, general living and working conditions in Country B. Mr I said he was quite keen on returning to Country B and, from his discussions with Mr A, so was he. In April 1994, Mr A asked Mr I about property in Country B. Mr I contacted his friend who would have the information. This friend had her own business in the name of Company H. When Mr I received the reply fax from Company H, he passed it to Mr A. He marked on the fax Mr A's initials and signed with his initials. He cannot remember if he personally handed it to Mr A. He said he could have passed it to Mr A through their respective secretaries. He explained that there was a reference to Mr A's initials and that he got the information specifically for Mr A. He said that the information requested related to bungalows for about a million dollars each and that they were outside his own price range. Mr I said that Mr A did not explain why he wanted to make the inquiry but he was looking at the prices to see if they were reasonable. When asked if these

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bungalows would be regarded as good investments he said they were not as there were not many people in Country B that could afford million dollar properties. The original of this fax was produced from the possession of Mr A and we have no hesitation in accepting this to be a genuine fax. It is thus strong evidence that Mr A had requested for information relating to bungalows in Country B in April 1994.

14. Mr A gave evidence. In September 1992, he left Company L and joined Company C. His new job did not provide him with any quarters but he stayed on the flat provided by his previous employer until December 1992. In October 1992, he began looking for alternative residential accommodation on a more permanent basis and he contacted various estate agents.

15. He viewed a number of flats, mostly with vacant possession. He was asked by the estate agent to view the Property. He was told that the Property was tenanted but the lease was expiring in April. He saw the flat and liked it. It was the only property he saw he felt he would like to live in. He thought he could live in a service apartment for a few months until the tenant moved out at the end of April 1993. He did not mind having his things put in storage for a few months. He signed the provisional sale and purchase agreement on 9 November 1992 and the formal sale and purchase agreement on 21 November 1992.

16. When cross examined, Mr A said that his intention in purchasing the Property was to live in it. The tenant was a corporation and he could get vacant possession easily for self use. However it was pointed out to him that the tenant had an option to renew the tenancy for another two years. He agreed that he had looked at the tenancy agreement before he signed the provisional sale and purchase agreement. When it was put to him that with the option clause, he could not live in the Property until two years later, he said this: 'Number one, yes, I know this particular clause. I believe that if I were to live in it myself I could claim to have this Property back for myself. That is the point.' He claimed that this was what the estate agent had told him and he took the estate agent's word. He never checked it. In this connection, we note that in a letter dated 3 October 1996 from the Taxpayer's accountants, it was said that Mr A had met the tenants who appeared very happy to live there and would not mind continuing the tenancy after its expiry.

17. After several inquiries with the banks, he found that he could raise at most a mortgage for half of the value of the Property. He was unable to pay for the balance. He spoke to his boss, Mr M who arranged for an associate company in the group, Company E, to purchase the Property at the same price. The sub sale agreement was dated 19 December 1992.

18. He was asked why he did not buy another flat for his residence. He said that was not something he could accomplish in two weeks. Instead he found a property in District N which he rented for his residence on a one year lease with an option to renew for another year. He moved into the flat at District N in January 1993.

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19. In about mid 1993, the Company F took over Company J. Ms K, the chief executive officer of Company F, met Mr A in a chance meeting through a mutual friend. Ms K later approached Mr A in August 1993 with a view to inducing Mr A to join Company F as an executive director.

20. Ms K and Mr A met two or three times. This included a dinner with Ms K and Mr O, the head of Company F in China. Mr A said he was aware of the nature of the proposed job in general terms. He was expected to head the corporate finance division. He had to execute mandates for the issue of 'B' shares and he knew that a certain amount of travelling was required.

21. The pay package offered by Company F was very attractive, much more so than his job with Company C. In addition, he would get a housing allowance, a company car and an up front inducement fee of \$3,000,000. The full amount of the up front inducement fee was refundable should Mr A resign within the first 18 months of employment. The refundable amount would be reduced by \$100,000 for each completed month of service should Mr A resign after 18 months and before 3 years of employment. The offer letter was dated 23 September 1993. Not surprisingly, Mr A decided to take the offer.

22. He tendered his resignation to Mr M of Company C. They parted on amicable terms. According to the agreed facts, Mr A remained a non-executive director from 1 April 1994 to 31 March 1995 for a total of \$150,000.

23. When Mr A left Company C, Mr M said there were two things Mr A had to have [安居樂業] (*an ju le ye*) 'security in abode and happiness in the job'. Since Mr A had a good job he must have security of abode. He invited Mr A to buy back the Property for his residence. With the up front inducement fee, Mr A could afford to buy the Property from Company E. Mr A said in evidence: 'That is why I bought it, because I got a good job or I had a good job, I thought, what is missing is there was a place, a secure place to live.'

24. By then, the tenant had apparently exercised the option to renew. There was however some delay in signing the new agreement due to a dispute over the new rental. Eventually the new tenancy agreement was signed on 22 November 1993 between the tenant and Company E.

25. Mr A purchased the Property in the name of the Taxpayer company. He was asked why this time round, he did not purchase the Property in his own name. He explained: 'Well, I think one takes advice. It was something that, no different from me personally buying, or me and my wife personally buying and it is just the done thing, I was advised, and a lot of people do that.' He did not know that this might prevent him from being able to recover possession of the Property from the tenant for self use. The Property was assigned to the Taxpayer on 25 November 1993 and the tenant signed a novation agreement with the Taxpayer as the new owner and Company E as the old owner.

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26. The Property was financed for more than 50% by a loan from Mr A to the Taxpayer. The balance came from the mortgage. The instalments would be covered by the rental income.

27. In January 1994, Mr A put in an application for permanent resident status as soon as he qualified by virtue of his 7 years residence here. He said that even if he had made up his mind to leave, he would have put in the application because he has earned it and it was a useful thing to have. However, he had at the time not reached any definite intention to leave Hong Kong. His application came through in April 1994.

28. In addition to the statement of agreed facts, the parties also agreed on two schedules of Mr A's travel outside Hong Kong, one showing his travel whilst employed by Company C and the other showing his travel whilst employed by Company F. In the first month of his employment with Company F, Mr A went to the mainland for 14 days, almost half of the time. In December, he travelled to the mainland for 7 days and in January for 9 days. This went down to 2 days for February and 3 days in March.

29. Mr A said that his job nature, duties and responsibilities at Company F turned out to be quite different from what he had expected. He said that as 'B' shares were in vogue, frequent travels to the mainland were necessary to bid for these issues. Besides frequent visits to major cities in China, he had to go to other cities. Once this involved a 36 hour journey by rail from one city to another. These trips involved meetings in smoke filled rooms, entertaining and heavy drinking which he did not like. He said that his Chinese was not that good and it added to the stress. Whilst his former boss in Company C was also from mainland China, and he also travelled during that job, he said that Chinese from major cities were different and trips then were pleasant. He added that he was younger whilst in his previous jobs.

30. Whereas in the past, he was at the 'buy' side of the business and was much sought after, when he worked for Company F, he went to the 'sell' side. The market was very competitive. He had to adopt a very pro active approach all the time, to chase deals and to take the initiative to approach and entertain. On top of that he had a very demanding boss who was giving him a lot of pressure. He was under a lot of mental stress.

31. He said there was an incident in China in February when he felt that he was not treated professionally. He did not go into details of the incident. He said it made him very angry. That strained his relationship with Mr O, the head of Company F in China.

32. By March, April 1994, Mr A formed a definite intention to return to Country B. He explained that he had so many jobs during his time in Hong Kong he did not relish the prospect of looking for another job in Hong Kong. He was looking to Country B or Country P.

33. In March, Mr Q of Company G came to Hong Kong. He was an old friend who was grateful for the help he once received from Mr A. They met for lunch. When Mr Q

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learnt that Mr A was unhappy with his job, Mr Q said that any time Mr A wanted to go back to Country B, there would be a job waiting for him at Company G.

34. Between 1 and 5 April 1994, Mr A returned to Country B to gauge the employment prospects there. The visit confirmed his impression that there were quite a lot of job opportunities in Country B. Although the remuneration would be less, he would be enjoying a more relaxed life style.

35. During his conversations with Mr I, Mr A knew that Mr I was also thinking of leaving. He learnt that Mr I had a friend who could provide information on the real estate market in Country B and he obtained the fax from Company H through Mr I. However he did nothing about the fax. He did not follow up with further enquiries save that he got some newspaper cuttings of real estate advertisements through his brother at around the time or shortly thereafter. According to Mr I, Mr A went to Country B at one stage and they went looking at properties together.

36. Once he formed the intention to leave, Mr A decided to get rid of the Property. He thought it was illiquid asset which might even take a year to sell. Further it tied up a significant portion of his asset. It was a huge burden on him. This is what he said: 'I made up my mind in March, April, and I just want out. If I waited I could probably get better money. I suppose, but that is not important, I want out. It is the emotional stress, and if I got rid of it, and I had really enough stress in the job, if I got rid of it, I have one less problem and all I need to do is concentrate on finishing the term of my employment, what is left of it, to take my up front payment and at least mentally I feel more relaxed.'

37. Towards the end of April 1994, he placed the Property with an estate agent for sale. He was asked whether the agent told him how much the Property would fetch in the market. His answer was 'No, not until later, I just say I want to sell this property and see what he can get.' He was asked whether he gave the estate agent any guidance as to the price he wanted to get. He replied: 'No I wasn't aware of what is the market but as I said, I thought it was an illiquid asset and I want to get out.' He was further asked if he could recall what the property market was like at the time. He said that he could not remember. When it was suggested to him that the property market was booming at the time, he said he was not sure.

38. He was pleasantly surprised when he got an offer in two months' time. The sale and purchase agreement was dated 29 June and the completion was on 24 August 1994.

39. After the Property was sold, at a price that was almost double the original purchase price, he did not take any steps to look for alternative accommodation. He did not follow up with inquiries into the property market in Country B because he was going back in a year's time and he could not buy a property so far away without actually spending some time and looking for something he would really like.

40. He remained with Company F until 31 July 1995 so that he could keep a pro rata portion of the up front inducement fee. He said he did not leave immediately when the

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minimum 18 months were up because he had to serve notice of his resignation and he did not want there to be any dispute as to whether the 18 months should count up to the time of the notice or the actual departure.

41. Mr A produced an offer letter from Company G dated 14 April 1995. He accepted the offer in April and commenced working for them in August.

42. There was quite a lot of evidence about the building order on the Property. Both sides tried to make use of it in whatever way they thought will assist their case. We were provided with a copy of the order dated 11 February 1993. This was said to supersede a previous order dated 14 October 1992. It related to some work on a nearby slope. The cost would have to be borne proportionally by all the owners in the building. From the available evidence, there is every indication that the share to be borne by the Property was not more than \$50,000. We find that the existence of this building order could have minimal effect on the value of the Property. Mr A described it as a “caveat” on the Property that affected its saleability. We find this to be a caveat of a very minor nature and is not a factor either way.

The Revenue’s case

43. The Revenue emphasized the short period of ownership. Miss Ma submitted that unless there is cogent reason for the sale, such short period of ownership is a strong indicator pointing towards trading. She dealt almost exclusively with Mr A’s reasons for sale and provided reasons as to why these are not credible.

The law

44. The applicable legal principles are well established and not in dispute. The onus is on the Taxpayer to prove that the assessment appealed against is incorrect. In considering whether an asset is a capital or trading asset, the crucial question to be asked is what the person’s intention is at the time of acquisition of the asset. **Simmons v CIR 53 TC 461.**

45. Mr Chiu for the Taxpayer referred us to a number of other decisions. It suffices to say that each case turns on a combination of the facts in that case.

46. Both Mr Chiu and Miss Ma took us through the various badges of trade. These are general indicators that may or may not apply in every case. We do not think it is necessary for us to go through all the badges as some kind of ritual. It suffices to say that we have considered each of the factors urged upon us.

Reasons for determination

47. We have considered the detailed and careful submissions of Mr Chiu for the Taxpayer. We accept that the nature or characteristics of the Property was not what would attract a typical speculator. It was some 30 years old and only a 50% mortgage could be

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raised. We note that Mr A in effect purchased the same property twice, although he did so the second time in the name of his company. We also note the accounting treatment of the Property by the Taxpayer. It is consistent with the Property being held as a fixed capital asset. But this is to be expected of an accountant who has also taken the advice of his own accountant.

48. Much of the evidence related to the disposal of the Property. The main reason for the change of intention was Mr A's unhappiness with the job at Company F. It was said that whereas Mr A used to be at the buy side of the business, the tables were turned and he was at the sell side. We find it difficult to accept that, given Mr A's experience and qualifications, he would not have appreciated the difficulties of the other side of the business or that he could have underestimated the competitiveness of the market or the situation for doing business in China. However we accept that the working environment might be very different with a new company and a new boss. In particular, we note that Mr A did give notice as soon as the 18 months were up and he had to repay \$900,000 of the up front inducement fee. Thus we accept that he was unhappy with the job but for reasons we give below we cannot be sure as to the precise time he made up his mind to leave.

49. We find Mr I a credible and honest witness. He corroborates Mr A's evidence. The fax from Company H also supports Mr A's evidence. But this is not conclusive as to when Mr A formed a definite intention to leave. A prudent person could be making all sorts of inquiries to keep his options open.

50. In the end, the crux is not why Mr A decided to *sell*, but rather why Mr A decided to *buy*. As can be seen from the above evidence, Mr A's primary intention was to reside in the Property. The rental return was really incidental. Here we find Mr A's evidence totally at odds with his proposed intention.

51. In November 1992, when Mr A purchased the Property the first time, the tenancy agreement had an option for another two years from April 1993. It might be that, in his eagerness to push the Property, the estate agent gave Mr A the wrong advice and told him that he could recover possession if he wanted it for his own residence. Mr Chiu said that Mr A might have made a mistake in believing the estate agent. We do not accept that. Mr A strikes us as a highly intelligent businessman and accountant. If he had really purchased the Property for his own residence, at \$5,000,000; we do not believe that he would just have relied on the word of the estate agent and did not even check or confirm it in any way.

52. In November 1993, when Mr A in effect purchased the Property for the second time, he went to the trouble of acquiring the Taxpayer company and taking the advice from his accountant. Yet when asked about it, he said it was 'the done thing' and it made no difference whether he acquired the Property in the name of himself, his wife or his company. This seems rather odd for a man of his experience and qualification. However the law on a company's ability to recover possession of its premises for the use of its director may not be generally known and we are prepared to accept the explanation for this second mistake.

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53. What we find most odd is the contrast between what Mr A portrayed as his carefully considered attitude when buying the Property and his apparent attitude when he decided to sell the Property. We have set out in paragraph 37 above Mr A's evidence when he was asked whether he was aware of the Property market at the time and whether the estate agent told him the price he could get for it. We find his evidence on this matter less than frank. The Property was self sufficient. In fact, it was generating a small income. Its value had been steadily going up. There was no suggestion that the property market at the time was going down hill. Yet Mr A described this property as giving him 'emotional stress' which he needed 'to get rid of'. If it was truly giving him emotional stress, he could not have been so cavalier in his 'see what he can get' attitude with the estate agent. Since he has paid quite a substantial sum of money for this property, it is difficult to believe that he did not even bother to find out what the property market was like when he tried to sell it. Such inconsistent and contradictory attitude seriously affected his credibility.

54. In the circumstances, we find that the Taxpayer has failed to discharge its onus and we would dismiss the appeal accordingly.