

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D15/99

Profits Tax – profits realized from sale of property – whether for investment or trading purpose – intention of taxpayer at the time of acquisition – Inland Revenue Ordinance, Chapter 112, section 68(4).

Panel: Mathew Ho Chi Ming (chairman), Barbara Ko Fung Man and Dora Lo Lai Yee.

Date of hearing: 8 April 1999.

Date of decision: 25 May 1999.

By memorandum of sale dated 18 October 1996, the taxpayer purchased a duplex unit and a car parking space ('the Subject Property') at a price of \$7,210,300 by using a two-dollar private company which was incorporated on 12 September 1996 ('the Company'). Mr A and Madam B, who are husband and wife, were the directors of the taxpayer. The purchase was completed either on 9 or 10 December 1996 when the Subject Property was assigned to the Company. By a provisional agreement for sale and purchase dated 11 March 1997, the taxpayer sold the Subject Property for \$9,280,000. The sale was completed on 24 April 1997 when the Property was assigned to the ultimate purchaser. On 6 September 1997, the taxpayer applied to the Companies Registry to be struck off the register of companies.

On 23 February 1998, the assessor raised on the taxpayer the following profits tax assessment for the year of assessment 1997/98:

Estimated assessable profit	\$2,069,700
Tax payable thereon	\$341,500

The taxpayer appealed against the assessor's determination on the grounds (1) that the original intention of acquiring the Subject Property was for residence of Mr A and Madam B; (2) there was no speculative or trading motive and (3) the reason for disposal was that Madam B did not like the view from the bedroom and sitting room of the Subject Property which include graves and refused to move into the Subject Property.

Held:

1. The intention of the taxpayer at the time of acquisition determines whether an asset was acquired as a capital or trading asset. The intention must be genuinely held, realistic and realisable. No single test provides the answer. The taxpayer's stated intention is not decisive. The whole of the evidence,

INLAND REVENUE BOARD OF REVIEW DECISIONS

surrounding circumstances, things said and done at the time, before and after the acquisition must be considered (All Best Wishes Ltd v CIR [1992] 3 HKTC 750 applied).

2. Section 68(4) of the IRO puts the onus of providing that a tax assessment is excessive or incorrect on the taxpayer.
3. Having considered all the evidence, the Board considered that the intention of taxpayer or its directors was to acquire the Subject Property for trading purpose and the taxpayer has failed to discharge its onus or proof:
 - (1) It was odd that Madam B had never inspected the Subject Property nor seen the environment in which the Subject Property was purchased prior to the date of purchase in October 1996 or in the period from that time until after completion in early December 1996;
 - (2) Madam B mentioned that she did not inspect the building site because she was a diabetic and had pain in her feet. Mr A, however, had testified that Madam B did not go to inspect the Subject Property because she did not have the time. Even if the Board accepted Madam B's medical condition, there was no evidence that she was bedridden or incapacitated to the extent that going outdoors was a physical impossibility. If Madam B were also to live at the Subject Property, one would have thought that even a cursory inspection would have been arranged before the purchase. Further, one would have thought that living in a duplex apartment with staircases between the sitting area and bedroom would have aggravated her feet problem and medical condition;
 - (3) In addition to the Board's finding that the testimonies of the witnesses were not credible, the Board found that although Mr A testified that he did think about a replacement property and no suitable unit was identified, the search for a replacement was at best passive;
 - (4) The speed with which the taxpayer applied to be struck off the Companies Registry and the quick distribution of dividends were also relevant factors.

Appeal dismissed.

Cases referred to:

D65/95, IRBRD, vol 11, 35
All Best Wishes Ltd v CIR [1992] 3 HKTC 750

Fung Chi Keung for the Commissioner of Inland Revenue.

INLAND REVENUE BOARD OF REVIEW DECISIONS

Lau Kam Cheuk of S Y Leung & Co for the taxpayer.

Decision:

Nature of appeal

1. This is an appeal by the Taxpayer on the profits tax assessment for the year of assessment 1997/98 raised and the determination of the Commissioner of Inland Revenue dated 30 October 1998 ('Determination').

Issue

2. The basic issue is whether the acquisition of a residential property by the Taxpayer was for investment or trading purpose and therefore whether the profits earned on its subsequent sale chargeable to profits tax.

Agreed facts

3. The parties have agreed to the facts set out under this heading.

4. The Taxpayer was incorporated as a private company in Hong Kong on 12 September 1996. At all relevant times, the authorized and paid-up share capital of the Taxpayer were \$10,000 and \$2 respectively. Mr A and Madam B, who are husband and wife, were the directors of the Taxpayer.

5. By memorandum of sale dated 18 October 1996, the Taxpayer purchased a duplex unit and a car parking space in Private Housing Estate C at District D ('Subject Property') at a price of \$7,210,300. The purchase price was to be settled in the following manner:

	\$	
Deposit	700,000	Upon signing the memorandum of sale
Further deposit	21,030	On or before 25 October 1996 and upon signing the agreement for sale and purchase
Balance	721,030	On or before 6 November 1996
- ditto -	<u>5,768,240</u>	On or before 31 December 1996
	<u>7,210,300</u>	

The purchase was completed either on 9 or on 10 December 1996 when the Subject Property was assigned to the Company.

INLAND REVENUE BOARD OF REVIEW DECISIONS

6. By provisional agreement for sale and purchase dated 11 March 1997, the Taxpayer sold the Subject Property for \$9,280,000. The sale was completed on 24 April 1997 when this property was assigned to the ultimate purchaser.

7. On 6 September 1997, the Taxpayer applied to the Companies Registry to be struck off the register of companies.

8. On 23 February 1998, the assessor raised on the Taxpayer the following profits tax assessment for the year of assessment 1997/98:

Estimated assessable profits	\$2,069,700
------------------------------	-------------

Tax payable thereon	\$341,500
---------------------	-----------

9. Messrs S Y Leung & Company ('Representative'), on behalf of the Taxpayer, objected against the assessment on the ground that it was an estimated assessment and that the gain on disposal of a leasehold property was a capital gain not chargeable to profits tax.

10. To validate the objection, the Taxpayer filed its profits tax return and financial statements for the year of assessment 1997/98. The financial statements showed that the Taxpayer derived a profit of \$1,677,933 on disposal of the Subject Property, which was wholly distributed by way of dividend, after deduction of some expenses. It did not offer the said profit on disposal for assessment.

Taxpayer's case

11. Mr A and Madam B both gave evidence. The Taxpayer's grounds for the appeal were that:

- a. The original intention of acquiring the Subject Property was for the residence of Mr A and Madam B. Mr A stated in his oral testimony that:
 - i. At the material times, Mr A and Madam B have lived in a unit in Private Housing Estate E at District F by Company G of which they are directors and shareholders. Company G runs a business operation in District F.
 - ii. Mr A happened to inspect Private Housing Estate C (the development in which the Subject Property is situated) when he went to see it with a friend who was inspecting another unit there.
 - iii. While he was there, he met another friend, Mr H, in the lobby who offered the Subject Property to him. He inspected it and he liked it because:

INLAND REVENUE BOARD OF REVIEW DECISIONS

- (1) it was closer to his other business which had a factory in China.
 - (2) he liked the greenery and the club house.
 - (3) he has never lived in a duplex apartment (note : the Subject Property was a duplex apartment) and he wanted to live in one.
- iv. Mr A stated that the intention was to use the Subject Property as residence for himself and Madam B. He consulted his wife who told him that if he liked the Subject Property, then he could proceed. Madam B confirmed this.
 - v. He asked his friend Mr H to reserve the Subject Property for several days after which he purchased the Subject Property by using a company (the Taxpayer).
- b. There was no speculative or trading motive. Completion of the purchase took place 22 days earlier than the contracted completion date and the price was fully paid with no mortgage which showed Mr A's eagerness to obtain possession. Mr A had stated in his evidence that he wanted an early completion to ensure that decoration of the Subject Property would be finished before the Chinese New Year.
 - c. The Taxpayer had the financial ability to hold the Subject Property as the purchase price was paid in full. The Representative conceded that it was Mr A who had the financial ability rather than the Taxpayer since the Taxpayer was granted loans from Mr A to finance the purchase of the Subject Property by the Taxpayer. He submitted that in return for not asking for repayment of the loan, the Taxpayer would allow Mr A to reside at the Subject Property. This fact did not come out in the evidence.
 - d. The reason for disposal was that Madam B did not like the view from the bedroom and sitting room of the Subject Property which include graves and refused to move into the Subject Property. The oral testimonies of Mr A and Madam B were that shortly after obtaining the keys (upon completion of the purchase by the Taxpayer) in early December, Mr A took Madam B to look at the Subject Property. Madam B saw the cemetery view and flatly refused to live there. That was the only occasion that Madam B had been at the Subject Property. One week thereafter, Mr A asked an estate agent to sell the Subject Property.

INLAND REVENUE BOARD OF REVIEW DECISIONS

12. The Representative referred us to a Board decision D65/95 which decided that a company which had purchased and, within one month, sold a property was held to have acquired the property as investment and no tax was assessed on the sale proceeds.

Revenue's case

13. The Revenue argued that Private Housing Estate E in which Mr A and Madam B had lived at all relevant times was closer to the office in District F of their business undertaken by Company G of which Mr A and Madam B were directors and shareholders together with other parties. The Subject Property was left vacant during the whole of the time that the Taxpayer was its owner. The quick resale (4 months) was a pointer towards trade. There were no attempts to purchase a replacement property. These above facts, according to the Revenue does not support the Taxpayer's stated investment intention.

14. On the reason for resale, the Revenue argued that:

- a. There was no documentary evidence that there was a cemetery facing the Subject Property.
- b. If Madam B believed in fung shui so much, it would not be realistic for the Taxpayer to commit to purchase the Subject Property without Madam B having inspected it.

15. On the absence of bank loan to finance the purchase, the Revenue pointed out that this was a neutral point and did not assist the Taxpayer's case. As a contrast, the Revenue pointed out that there was a legal charge on the unit in Private Housing Estate E in which Mr A and Madam B were residing and yet it could be considered as a long term investment.

16. Lastly, the Revenue pointed to the speed in which the Taxpayer distributed the profits earned on the resale and the application to the Companies Registry strike itself off from the register to companies indicated an adventure in trade and intention to realize a quick profit.

The law

17. The law is clear on the issue before us. The intention of the Taxpayer at the time of acquisition determines whether an asset was acquired as a capital or trading asset. The intention must be genuinely held, realistic and realisable. No single test provides the answer. The Taxpayer's stated intention is not decisive. The whole of the evidence, surrounding circumstances, things said and done at the time, before and after the acquisition must be considered. *All Best Wishes Ltd v CIR [1992] 3 HKTC 750* is the leading authority on the above propositions of law which this Board adopts.

INLAND REVENUE BOARD OF REVIEW DECISIONS

18. Section 68(4) of the Inland Revenue Ordinance puts the onus of proving that a tax assessment is excessive or incorrect on the taxpayer. We must consider whether this onus has been discharged.

Reasons for decision

19. We have considered all the evidence placed before the Board, the oral testimonies of Mr A and Madam B, the correspondence between the Representative and the Revenue prior to this appeal and the cases cited by the Representative and the Revenue. Both the Taxpayer's and the Revenue's cases centre around the central issue of intention. Each of the Taxpayer's grounds revolves around this issue. Having considered all such evidence, we find that the intention of Taxpayer or its directors was to acquire the Subject Property for trading purpose and the Taxpayer has failed to discharge its onus of proof.

20. There is contradiction in the oral testimony of Mr A and the Representative's written reply to the Revenue dated 30 June 1998. The written reply stated that the Subject Property was for the use of Madam B but the oral testimony was that both Mr A and Madam B would use Subject Property. This contradiction was not satisfactorily explained by Mr A when cross examined by the Revenue.

21. It was odd that Madam B had never even inspected the Subject Property nor seen the environment in which the Subject Property was purchased prior to the date of purchase in October 1996 or in the period from that time until after completion in early December 1996. It appears to be available for inspection as Mr A testified that he had been at Private Housing Estate C before he committed the Taxpayer to the purchase. Mr A's friend, Mr H, had even reserved the Subject Property for a few days for Mr A to consider whether to purchase the Subject Property. An inspection of the Subject Property or its surroundings prior to purchase would have been a good indicator that Madam B would move in the Subject Property with her husband. This was not done.

22. Madam B mentioned that she did not inspect the building site because she was a diabetic and had pain in her feet. Mr A, however, had testified that Madam B didn't go to inspect the Subject Property because she didn't have the time. Even if the Board accepted Madam B's medical condition, there was no evidence that she was bedridden or incapacitated to the extent that going outdoors was a physical impossibility. If Madam B was also to live at the Subject Property, one would have thought that even a cursory inspection would have been arranged before the purchase. Further, one would have thought that living in a duplex apartment with staircases between the sitting area and bedroom would have aggravated her feet problem and medical condition. Neither Mr A nor Madam B appeared to have considered this problem.

23. Mr A's evidence was unclear, unsatisfactory and evasive in several ways. It was not clear why a decorator had looked at the unit when Madam B had already refused to move

INLAND REVENUE BOARD OF REVIEW DECISIONS

into the unit. Further, while he stressed that in his inspection prior to the purchase, he was looking only at the building structure and fixtures and fittings and did not pay attention to the view, he stated on re-examination that the cemetery could be seen very clearly from the Subject Property. On cross examination, he mentioned that the cemetery was visible from the ground floor but then on re-examination denied that the cemetery was visible at street level. Mr A testified that he, too, disliked the cemetery view but to defend himself from his wife for his mistake in purchasing the Subject Property, he said that he did not mind the cemetery view. If he did mind the cemetery view, then surely he would have noticed the clearly visible cemetery and refused to purchase the Subject Property.

24. In addition to the Board's finding that the testimonies of the witnesses were not credible, the Board has also considered the following factors which pointed to a trading intention. Mr A testified that he did think about a replacement property and no suitable unit was identified. The search for a replacement was at best very passive. Madam B testified that she did not even get involved. The speed with which the Taxpayer applied to be struck off the Companies Registry and the distribution of dividends was very quick. The application to be struck off was made on 6 September 1997 before the preparation of the Taxpayer's annual accounts and profits tax return. The holding period of 4 or 5 months was short and the resale was quick. No evidence was offered on how close the factory in China was from the Subject Property and how much time the Taxpayer's directors spent in the factory which was held by a separate entity. None of the above mentioned factors on their own would have pointed to a trading intention. However, taking in their totality and given the Board's view of the unsatisfactory oral evidence given at the hearing, we find that the intention to purchase the Subject Property for the residence of the directors, while realistic and realisable, was not genuinely held by the directing minds of the Taxpayer.

25. The only factors which pointed to a capital intention were the early completion of the purchase and the absence of bank or outside party (other than directors or shareholders) financing. These two indicators are overwhelmed by the opposite indicators described above. The minutes of the Taxpayer dated 18 October 1996 exhibited at the hearing described the Subject Property as 'investment property'. But the minutes are meaningless to Mr A or Madam B as they merely sign whatever minutes given to them. In their testimonies, they could not identify either the minutes authorizing the purchase of the Subject Property or the distribution of dividends other than their signatures. Nor was Mr A very particular about the accuracy of the minutes. The minutes authorizing the distribution of dividends was dated 31 October 1997 but Mr A said that the distribution took place long before the date of the minutes.

26. The Revenue raised the issue of there being no documentary evidence of the existence of the cemetery which can be viewed from the Subject Property. The Representative mentioned that photographs were taken but they were not produced at the hearing because the negatives had not been developed. The photographs, if produced, would not have made any difference in our decision. We would have been prepared to accept that there were graves which could be seen from the Subject Property.

INLAND REVENUE BOARD OF REVIEW DECISIONS

27. We have also considered Decision D65/95 cited by the Representative. It was also a company who purchased and sold a property very quickly (less than one month) with the intent that the family of one of the directors and the brother of that director would reside in the property. Certain facts in D65/95 were more indicative to a trading intention than the present case and other facts therein had the opposite effect. We do not wish to compare the facts in D65/95 and the present case. Suffice to say that the Board in D65/95 applied the same principles of law mentioned in this decision. That Board was satisfied with the evidence given by the witnesses which were found to be reliable and worthy of credence. The witnesses' testimonies in that case were considered in light of the whole of evidence and that Board found that, on balance, the intention of the appellant was to hold the property as capital asset.

28. Having undertaken the same exercise in evaluation of the whole of evidence and testimonies in this present case, we came to the opposite view in respect of the Taxpayer's alleged intention with regard to the Subject Property. Accordingly, the appeal is dismissed.