

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D16/91

Profits tax – resumption of agricultural land by the Government – whether lands were trading assets or long term investments.

Panel: Robert Wei QC (chairman), Edward Chow Kam Wah and Charles Wrangham.

Date of hearing: 26 March 1991.

Date of decision: 4 June 1991.

The taxpayer was a private limited company. The taxpayer's only source of profit had been trading in Letter B land entitlements. The taxpayer acquired as tenants in common with other persons a number of plots of agricultural land in the New Territories. Shortly after acquisition, part of the land was resumed by the Government for the purpose of the formation of roads and drains in the area. The remaining agricultural land which had been acquired was retained by the taxpayer. The assessor assessed to profits tax the profit which the taxpayer made on the money received from the Government for the land resumption. The taxpayer argued that the agricultural land which had not been resumed was still owned by it and was a capital asset.

Held:

It was necessary to consider the intention of the taxpayer when it acquired the agricultural land. The taxpayer had not been able to prove that the agricultural land was a long term investment as opposed to a trading asset. A number of factors were considered relevant which included inconsistency in the evidence given regarding the taxpayer's intention, no evidence of adequate financial means to develop for long term investment purposes, the fact that the taxpayer owned the land as a tenant in common and did not have the agreement of the other tenants in common for holding the land as a long term investment, etc.

Appeal dismissed.

Cases referred to:

D11/80, IRBRD, vol 1, 374

Simmons v IRC 53 TC 461

D8/88, IRBRD, vol 3, 161

K A Lancaster for the Commissioner of Inland Revenue.

Denis O'Dwyer of Ernst & Young for the taxpayer.

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### Decision:

1. The Taxpayer is appealing against the Deputy Commissioner of Inland Revenue's determination dated 15 October 1990 confirming the profits tax assessment for the year of assessment 1987/88 and the revised profits tax assessment for the year of assessment 1988/89. The profits in question were derived from the resumption by the Government of certain agricultural lands owned by the Taxpayer. The issue is whether the lands were trading assets so as to make the profits taxable, or long term investments so that the profits are not taxable.

2. Set out below are the primary facts we have found from the testimony of Mr X, the controlling shareholder and director of the Taxpayer and the only witness called, and from the documents produced by both sides.

2.1 The Taxpayer was incorporated in Hong Kong as a private company in 1982. It operated with an issued capital of \$2 until August 1986 when it increased its issued capital to \$10,000.

2.2 At all relevant times the Taxpayer has described the nature of its business carried on as 'investment and dealings in the purchase, lease, exchange and sale of land and buildings'.

2.3 From commencement through the year of assessment 1986/87 the Taxpayer's only source of income was the profit of its trade in Letter B land entitlements.

2.4 At all relevant times the Taxpayer was controlled by its holding company, A Ltd, which was controlled by Mr X.

2.5 Mr X has been in control of the Taxpayer since 1984. However, Mr Y, a director of the Taxpayer, was responsible for purchasing agricultural lands until he died in mid-1990.

2.6 As a result of negotiations commenced at least a month prior to late 1986 when a deposit was paid for the purpose, the Taxpayer acquired 23 plots of agricultural land in the New Territories with a total area of 36,252.8 square feet at the price of \$783,996, averaging \$21.62 per square foot. The relevant sale and purchase agreement is dated in late 1986.

2.7 As a result of negotiations commenced prior to late 1986 when deposits were paid for the purpose, the Taxpayer and B Ltd as tenants in common in equal shares agreed to purchase 92 plots of agricultural land in the New Territories with a total area of 174,584.4 square feet at the price of \$5,849,140 averaging \$33.5 per square foot. The relevant sale and purchase agreements, three in

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number, are all dated the same day in late 1986. On completion, the Taxpayer and C Ltd as tenants in common in equal shares took the assignment of 79 plots while the Taxpayer and A Ltd as tenants in common in equal shares took the assignment of 10 plots. For some unknown reasons the remaining 3 plots were not assigned.

- 2.8 The purchases mentioned in paragraphs 2.6 and 2.7 above, comprising 112 plots in all, are mostly separate pieces of varying sizes scattered over a wide area.
- 2.9 By three resumption notices in late 1986 and early 1987 respectively, the Government resumed a total of 22 plots out of the 112 plots, 5 being solely owned by the Taxpayer and the other 17 owned with the co-owners. The total area resumed was 15.3% of the total area of the 112 plots.
- 2.10 The resumption was in connection with the formation of roads and drains in the area. About a year after the resumption, a road was built along some of the plots resumed.
- 2.11 The plots remaining after the resumption have all been retained.
- 2.12 Paragraphs 2.13 to 2.16 below inclusive contain findings mainly based on the audited accounts of the Taxpayer and an associated company.
- 2.13 In the year ended 31 December 1986 the Taxpayer's sales of Letter B land entitlements grossed \$20,000,000, resulting in a net profit of \$2,300,000.
- 2.14 In the year ended 31 December 1987 sales of Letter B land entitlements grossed \$72,000,000 which was mainly responsible for producing a net profit of \$14,000,000 and net assets of \$16,000,000. Its assets included a property under development which has since been sold after development; the profits made were declared for assessment to profits tax.
- 2.15 The year ended 31 December 1988 saw the introduction of a new item 'investment properties' which was defined in the 'notes to the accounts' as 'interests in land and buildings in respect of which construction work and development have been completed and are held for their investment potential'. That item was \$15,000,000 at the year end of 1988 and \$22,000,000 at the year end of 1989. Loans within the group, to associated companies, from directors and banks – all had marked increases as compared with 1987. Total assets were \$188,000,000 at both the 1988 and 1989 year ends with net assets at \$20,000,000 and \$29,000,000 respectively. There were ten subsidiaries, a majority of which owned properties from which they derived rental income.
- 2.16 D Ltd, an associated company controlled by Mr X, owns a property valued at \$100,000,000 and has mortgaged it for a bank loan of \$50,000,000. The book

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cost of the property as at 31 March 1990 was \$7,000,000 while its annual rental income was \$9,800,000.

- 2.17 The consideration or compensation paid by the Government for the resumption exceeded the cost of the plots resumed, resulting in profits being made by the Taxpayer:

<u>Year</u>	<u>Square Footage Resumed</u>	<u>Compensation per Square Foot</u>	<u>Profits</u>
1987/88	9,302	\$ 52.23	\$ 284,569
1987/88	19,205	51.6	173,774
	(50% owned)		
1988/89	2,718	118.47	115,477
	(50% owned)		

- 2.18 The assessor was of the opinion that the profits were subject to profits tax while the Taxpayer maintained that they were capital gains and therefore not taxable. The profits made in 1987/88 totalling \$458,343 are included in the year of assessment 1987/88 while the profit of \$115,477 made in 1988/89 is included in the year of assessment 1988/89.

- 2.19 On 30 June 1989 the tax representatives of the Taxpayer wrote to the assessor concerning the profits of \$458,343:

‘Our client did not have knowledge of the Government’s intention to resume the lands at the time of purchase ...’

‘The lands are purchased for investment purpose as our client considered land investment as a best way of investment because their value will be appreciated in long term. Our client still has no definite plan of redevelopment of the lands.’

- 2.20 On 2 April 1990 the tax representatives of the Taxpayer wrote to the assessor concerning the profit of \$115,477:

‘(H) Gain on resumption of agricultural land by the Government  
\$115,477

- (i) Please be informed that only half of the agricultural land was owned by our client.
- (ii) Due to different point of view on the usage of the land between our client and the other partner there is still no definite planning on the land held.’

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2.21 On 13 July 1990 the tax representatives of the Taxpayer wrote to the assessor concerning the profit of \$115,477:

‘It would appear from the gazette notification that the Government’s intention of resuming land was published before our client acquired the agricultural land for long term investment. Our client maintains that it was not aware of this notification and claims that negotiation for the purchase commenced much earlier than the notification date. We also assume that had the vendors received prior knowledge of the resumption they would not have proceeded with the sale. The point we want to stress is that the acquisition was made in normal circumstances unaware of the impending resumption programme by the Government.’

2.22 On 15 October 1990 the Deputy Commissioner made his determination confirming the year of assessment 1987/88 and the revised 1988/89 assessment.

2.23 On 14 November 1990 the tax representatives of the Taxpayer gave a notice of appeal against the Deputy Commissioner’s determination which contains the following grounds of appeal:

‘The grounds of our appeal are that:

- (i) The Deputy Commissioner has made wholly unjustified assumptions in reaching his decision.
- (ii) The agricultural land was distinct from the trading stock of our client and was held as a long term investment.
- (iii) That there is no such trading activity as holding assets in “an expected appreciation in their value”.
- (iv) Such other grounds as may with the permission of the Board of Review be presented.’

3. Mr X’s testimony, except as to matters relating to the facts stated in paragraphs 2.1 to 2.23 above, may be summarised as follows:

### In Chief

3.1 The directors considered that the village in which the agricultural land was acquired was a good place for development. Their aim was to buy sufficient land to form a large site which could be used for rental or development. One idea was to use it as a car and lorry park since at the time there were no controls on such usage. Other possibilities were to turn it into a resort or a camp site or to develop a housing estate or separate houses. No definite plan could be made

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until a sufficiently large site was established. Efforts are continuing to buy more sites and it is hoped to exchange isolated sites so as to obtain a large site.

- 3.2 As the plots purchased are widely scattered, the Taxpayer has not been able to use them at all, but they are intended for long term investment. Mr X or his group of companies have now \$50,000,000 available for development purposes; another \$40,000,000 to \$50,000,000 can be raised on mortgage of properties.
- 3.3 Mr X was not aware that the Government intended to resume part of the land the Taxpayer bought.

### In Cross-examination

- 3.4 As to whether it was the common intention of the Taxpayer and the co-owners to develop the plots for long term investment, there were negotiations between Mr Y and the co-owners, and Mr X believed that the plots were aimed for future development. There is no written agreement with the co-owners on future development. It is a matter of trust. Although Mr Y dealt with all matters relating to the land, he would consult Mr X before he did anything.
- 3.5 As to whether there was any disagreement as to the use of the land as suggested in the letter referred to in paragraph 2.20 above, there was in fact no such disagreement. Prices were going up as the road was built; Mr Y thought care should be exercised in buying more land so as not to waste money. The letter was meant to be an explanation to the Inland Revenue Department. It was a convenient way of writing the letter instead of telling everything about people in the New Territories asking higher prices for their land. Mr X instructed the tax representatives as to the content of the letter. There was disagreement as to prices to be paid in buying more land, but not as to the use. The co-owners trusted Mr X as to the use of the land.
- 3.6 No approach has been made to the district land office for a change of use. If one holds a large enough piece of land, one can apply for a change of use. Through its consultant, the Taxpayer has found out from the town planning authorities that the new town plan still provides no development for the area where the plots are situated. It is for the owner to apply for the use desired. (When asked by the Board whether by a long term investment he meant a long term investment as agricultural land, Mr X said no.) The town planning authorities have so far no plans for developing the area. No feasibility study has been undertaken.

### In Re-examination

- 3.7 Mr X is confident that he will obtain the co-owners' consent to development when the time arrives.

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4. The assessments under appeal were raised on the basis that the resumed plots were trading assets. It is for the taxpayer to prove that the assessments are incorrect (section 68(4)). It seeks to do this on the ground that the plots were long term investments. Whether an asset is a trading asset or long term investment turns on the intention which existed at the time of acquisition; the onus is on the Taxpayer to establish that it acquired the plots with the intention of holding them for long term investment.

5. The Taxpayer's case is put succinctly in Mr X's testimony in chief in paragraph 3.1 above. The effect of that testimony is that the plots were intended to be consolidated with other plots that might be acquired in the future into a large site for development for long term investment. The Taxpayer is still a long way from getting a site; until that happens, no definite plan for development nor any application for a change of use can be made.

6. The Taxpayer's case of an intention to piece together a site for development for long term investment was raised for the first time at the hearing of this appeal; it is not mentioned in the notice of appeal (refers to paragraph 2.23 above), nor in the two letters to the assessor dated 30 June 1989 and 2 April 1990 respectively (refers to paragraphs 2.19 and 2.20 above). No explanation has been given for these conspicuous omissions. Both letters refer to the absence of a definite plan of development. The letter dated 30 June 1989, instead of giving the lack of a site as a reason for not having a definite plan, suggests an intention of holding the plots as a long term investment for appreciation in value, that is, capital growth, while the letter dated 2 April 1990 puts the blame for the lack of definite planning 'on the land held' on a disagreement between the owners as to the use of the land, the implication being that had the owners agreed as to the use, there would have been definite planning for 'the land held', that is, the plots in question. Thus the Taxpayer has put forward three different intentions, one at a time, with regard to its case of a long term investment: (1) an intention of holding the plots for capital growth, (2) an intention of developing the plots, provided that the owners resolved their disagreement as to the use and (3) an intention of consolidating the plots and other plots that might be acquired in the future into a large site for development; and it is not part of the Taxpayer's case that from time to time it changed its mind as to what to do with the plots. These inconsistencies impact the Taxpayer's credibility and rock the foundation of its whole case.

7. It has been said that intention connotes an ability to carry it into effect (D11/80, IRBRD, vol 1, 374). Without an agreement as to intention and purpose among the owners, no single owner is in a position to carry out its intention. Here the Taxpayer's case faces another insurmountable difficulty: the lack of proof that the Taxpayer and the co-owners shared a common intention and purpose in acquiring the plots. In his testimony Mr X stated that the co-owners had complete faith in Mr Y and that Mr X was confident that he would be able to obtain their consent to development. We do not think that is sufficient. No written agreement between the owners or documentary proof of any such agreement was produced, nor was any witness representing the co-owners called to corroborate Mr X's testimony. On the other hand there is the letter dated 2 April 1990, already mentioned, disclosing a disagreement as to the use. Mr X's unsatisfactory explanation (see paragraph

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3.5 above) only serves to enhance the evidential value of the letter. We should mention also that generally we do not find Mr X a satisfactory witness.

8. As a considerable body of evidence concerns the Taxpayer's financial position as disclosed in its annual accounts, we shall state our views on this aspect, even though, in view of what has been said in paragraphs 6 and 7 above, it is not necessary to do so. Here again the proposition that intention connotes an ability to carry it into effect comes into play. To prove one's intention of holding an asset as a long term investment, one must prove that one is financially able to do so. Where the claimed intention involves development which is carried out immediately or within a short period of time after the acquisition of the asset in question, ability to carry out the development is readily inferred and the only thing to prove is the ability to retain the development for long term investment. This ability need not be proved in absolute terms; allowances can be made, for instance, for a need to sell the development to finance another development with better prospects and for possible frustration by events beyond one's control, such as less favourable economic climate, changes in the law, declining property market, difficulties in obtaining long term credit, etc (see Simmons v IRC 53 TC 461, at 472 and 494).

9. Where, as in the present case, the claimed intention involves development which is a matter of the rather distant future, it is our view that subject to allowances being made and everything else being equal, one must prove that at the time of acquisition of the asset in question, one was so placed that one could reasonably expect that one would be able to carry out the development when the time arrived and to retain the development for long term investment. In our view, this element of reasonable expectation of an ability to carry out one's intention is an essential ingredient of the intention; without it one can have no true intention, but only a wish, a hope; in any event, such a bare assertion of intention normally lacks credibility. In the present case, the avowed intention is to create a large site for development by consolidating and, where necessary, exchanging a number of smaller pieces of land (including the plots in question which are the only ones acquired so far), to develop that site and to retain the development for long term investment. That being its intention, we think that there should be added to the list of allowances a possible need to exchange the plots in question or some of them for other plots with better prospects of consolidation, and two possible causes of frustration: unavailability of a suitable site for development and unobtainability of a change of use from the authorities. Subject to allowances being made, and everything else being equal, the Taxpayer has to prove, in our view, that at the time of acquisition, that is, in late 1986, it was so placed that it could reasonably expect to have sufficient funds to carry out the development and to retain it for long term investment. The Taxpayer could not even begin to prove that because it did not and could not know what site it was going to have or what development it was going to carry out. Mr O'Dwyer, the Taxpayer's representative, contended that the fact that the Taxpayer did not sell any of the plots but kept them (except the resumed ones) was enough proof and that it was irrelevant to inquire any further into the question of availability of funds for the development. We disagree. The fact that the Taxpayer has retained the plots does not necessarily mean that at the time of acquisition it could reasonably expect to have sufficient funds for the eventual development. The annual accounts (paragraphs 2.13 to 2.16 above) show that the sales of Letter B land entitlements in 1986 netted a profit of



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\$2,300,000 and the sales in 1987 were mainly responsible for a net profit of \$14,000,000. 1988 saw the introduction of a new item 'investment properties' which was \$15,000,000 at the end of 1988 and \$22,000,000 at the end of 1989. The group was expanding and by 1989 the Taxpayer had ten subsidiaries, most of which were holding properties. Loans within the group, by shareholders and directors and from banks, all increased significantly. 1988 and 1989 saw brisk expansion and significant increase in scale of operations. Mr X claimed that some \$100,000,000 could be raised now for development purposes (refers paragraph 3.2 above). However, we are concerned with its position as of late 1986, when the Taxpayer still had its relatively humble beginnings. The facts disclosed by the annual accounts do not answer the question we have to ask. Mr Lancaster, the Commissioner's representative, submitted that without a cash flow budget it was impossible to evaluate whether sufficient finance would be available and that without a feasibility study there could be no fair estimation of the cost. We agree.

10. There was some question as to whether the Taxpayer was aware of the impending resumption when it was purchasing the plots. On the views we take of this case, it is not necessary to deal with that matter. Suffice it to say that there is no evidence to show that the Taxpayer was aware of the resumption.

11. For all those reasons, the Taxpayer has failed to discharge its onus of proof that the plots were acquired as long term investments. It follows that the plots fall to be treated as trading assets and that the profits the Taxpayer made out of the resumption are taxable under section 14 notwithstanding the compulsory nature of the disposition (see D8/88, IRBRD, vol 3, 161). This appeal is therefore dismissed and the assessments in question are hereby confirmed.