

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D17/95

Profits tax – purchase and sale of property – whether trading transaction.

Panel: Ronny Tong Ka Wah QC (chairman), Charles Graeme Large and Rowdget W Young.

Date of hearing: 16 March 1995.

Date of decision: 16 May 1995.

The taxpayers were husband and wife who purchased a flat in their joint names. The flat was under construction. Some three months before the issue of the occupation permit the taxpayers sold the flat at a substantially higher price than the purchase price. The assessor assessed the surplus to profits tax. The taxpayers appealed and submitted that it was a capital gain. At the hearing one of the taxpayers and his daughter gave evidence. The evidence was accepted by the Board of Review. The taxpayers explained the circumstances of the purchase and subsequent sale of the property.

Held:

The taxpayer had discharged the burden of proof and had shown that when acquiring the property they did not have the intention to trade but had an intention to invest on a long term basis.

Appeal allowed

Case referred to:

Simmons v CIR 53 TC 461

Amy Wong for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

BACKGROUND FACTS

1. The taxpayers are husband and wife. On 1 March 1991, they purchased a flat ('the Flat') in District A in their joint names. The purchase price was \$924,300. The Flat was still under construction at the time.

INLAND REVENUE BOARD OF REVIEW DECISIONS

2. On 29 September 1991, some 3 months before the issue of occupation permit, the Taxpayers sold the Flat for \$1,748,000. The assessor raised on the Taxpayers profits tax assessment which was affirmed upon objection on 30 September 1994. The Taxpayers appealed to this Board.

THE ISSUE

3. It is not in dispute that the sole issue we are concerned with is: what was the intention of the Taxpayers at the time of acquisition of the Flat? To be liable for profits tax under section 14 of the Inland Revenue Ordinance (the IRO) Chapter 112, the Taxpayers must have carried on trade in Hong Kong. In Simmons v CIR 53 TC 461, the necessary intention is said to be this (at page 491):

‘Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the 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?’

THE EVIDENCE

4. The Taxpayers attended the hearing of this appeal in person. Mr X gave evidence relating to the circumstances surrounding the purchase and the events which led to the sale of the Flat. His evidence was largely supported by his daughter who also gave evidence.

5. The gist of the evidence given before us is this. Mr X’s family had lived in District B since 1984. In 1989, Mr X sold the flat the family had been residing in for \$575,000. He used part of that money, \$220,000 to be exact, to purchase a laundry business which he hoped the family as a whole could run. The premises of this business were rented and were also in District B. These premises consisted of a shop front and a small cockloft of some 200 to 300 square feet which was used for accommodation purposes. This was, of course, wholly inadequate since at the time, their teenage son (now studying in Country C) was living with the Taxpayers (the daughter was studying at all material times in Country D). Nevertheless, Mr X preferred to wait until the business had improved before committing to another property. This was a wise decision in that the business later on proved to be a failure.

6. Mr X sold the laundry business just a little over a year later for the same consideration which he paid for, namely, \$220,000. From 10 January 1991, Mr X began his employment with Company P as a draughtsman at an initial salary of about \$8,000.

7. It was obvious that upon disposal of the laundry business Mr X’s family needed to find a permanent place of residence. As a temporary measure, Mr X rented a room. The room was small; the area was about 100 square feet. Meanwhile, the Taxpayers searched for a suitable home. That was how the Flat was found. Mr X gave very positive evidence here. He said he, his wife and his daughter went to the site of the building. They went to look at the sample flat. The whole family agreed on the Flat. It was the best compromise in terms of area, price and location.

INLAND REVENUE BOARD OF REVIEW DECISIONS

8. Mr X went to the Central office of the developers to pay a deposit. He said there was no queue of buyers. In fact, there were very few buyers. The development was not a popular choice for speculators. Although there were many flats for him to choose from the family agreed on a west facing flat. Again, not a popular choice for speculators.

9. The Flat was a 3 bedroom flat. Although there was no immediate need for a 3 bedroom flat the Taxpayers obviously considered it only right that they should have a 3 bedroom flat to cater for the return of the daughter after her studies. It was a long term consideration.

10. The Taxpayers purchased the Flat in their joint names. There was, of course, no need to join in the wife if the Flat was purchased with a view to sell for profit. It would be marginally more convenient to effect a quick resale if the Flat was purchased in the sole name of either the husband or the wife.

11. The purchase price could be paid by 3 different methods. The Taxpayers opted for immediate mortgage although they could go for stage payments (again, a popular choice for speculators) which would avoid the need for an immediate mortgage and the associated costs. The mortgage placed an immediate strain on the family's resources in that the monthly payment came to some \$8,000 odd which ate up most if not all of Mr X's salary. But Mr X thought he could pull through since he still had some savings including the balance of the proceeds of their original flat in District B. Mrs X was looking for a job and the Taxpayers thought things would look better in due course after they agreed with the bank to fix the monthly repayments. After all, Mr X's salary would only increase. It may not be a very wise decision; it may not even be a prudent decision, but there is nothing to cause us to doubt this testimony.

12. There was then a significant change in the summer of 1991. The son obtained very good results from his school examinations so much so he was offered a scholarship to study in Country C. Mr X claimed he did not know of his son's intentions until the summer. The Revenue questioned Mr X extensively on this point. It was said that the son's school was a school specially catered for students intending to go to Country C. That Mr X therefore knew very early on that his son would go to Country C. Therefore there was no need to buy a flat with 3 bedrooms. Therefore Mr X must have intended to sell the Flat in due course for profit.

13. With respect, the whole argument has a certain ring of artificiality. Even if the Taxpayers had always harboured a desire that their son should go to Country C to study there could be no certainty he could go unless his grades were good enough to be admitted by a university not to mention the getting of a scholarship. The purchase of a flat was a major financial decision for this family whose resources were strained to the limit. Is it realistic to suppose that they should get a 2 bedroom flat? What if the son could not find a university in Country C to accept him? What if the daughter were to come back from Country D after her studies? Should they then sleep in the same room?

14. Nor can we overlook the evidence of the daughter which we find to be inherently truthful. She said although she was not familiar with the system in Hong Kong

INLAND REVENUE BOARD OF REVIEW DECISIONS

she knew that the son was in fact accepted by a local University. She said the son had intended to go to Country C but never told his parents his intentions. There was in fact an argument between the father and the son; but in the end, as it would be expected, it was the father who relented. Should the family then sell the Flat and move to a smaller and cheaper place to enable the son to pursue his studies overseas? The answer was obvious. The daughter persuaded her parents to sell the Flat. To try to retain the Flat would be too harsh for them. Besides, they began to realise the traffic condition in District A was not ideal. Mr X had to travel to District E to work. It would be too much of a sacrifice.

15. There were other difficulties. They were asked to leave the rented flat. The Flat was not yet ready. It was said that it would be completed by the end of the year but by September there was still no indication as to when the Flat would be ready. The Taxpayers would have to prepare for the son's impending trip to Country C. Decorating a brand new flat would be costly.

16. The Taxpayers then looked around for a smaller flat. They found one in District B. It was a 20 odd year old flat but it was cheap. It only sold for \$980,000. No doubt the Taxpayers' decision was made easier by the fact that meanwhile the market had risen substantially. They could now make a handsome profit by selling the Flat: some \$700,000 to be exact. In our view, there is nothing wrong with a taxpayer seeking to take advantage of the market in this way provided when he acquired the asset he did so not with the intention to dispose of it at a profit but with the intention to make a long term investment.

THE CASE FOR THE REVENUE

17. The Revenue attacked the Taxpayers' case by suggesting that:

- (a) the Taxpayers did not have the financial means to sustain the mortgage of the Flat; and,
- (b) the Taxpayers had put forward a 'new reason' for the sale of the Flat which was not credible.

18. The Revenue pointed out that the Taxpayers could not possibly hope to sustain the monthly mortgage payments of \$8,028 (increased to \$8,552 in July when at the Taxpayers' request the monthly repayment was fixed) at Mr X's meagre monthly salary of about \$8,000.

19. Mr X explained, on the other hand, that at the time they had just sold their laundry business and they were hopeful that Mrs X would be able to find a job. After all, Mrs X had worked prior to purchasing the laundry business and thereafter she, together with Mr X, worked full time looking after the laundry business. Further, we should not overlook the fact that they had some \$500,000 as savings. Mr X was not asked in detail as to how this sum was arrived at but we could see that he had the balance of the sale proceeds from the original flat which came to some \$300,000. The Taxpayers also drew a total of some \$115,000 from the laundry business despite the fact they lived at the shop premises rent free. Last but not least, the Taxpayers, of course, received \$220,000 upon the sale of the

INLAND REVENUE BOARD OF REVIEW DECISIONS

laundry business. We think the Taxpayers had some justification in being a little optimistic at that time.

20. It is also important to bear in mind that despite being painted as financially precarious the Taxpayers were accepted by Company Q, the mortgagee, as suitable mortgagors. In other words, they were not considered to be so financially precarious as to not qualify for a 90% mortgage of the Flat.

21. At the heart of this argument is the necessary implication that if a taxpayer overstretched his financial resources he must be looking for a quick profit upon resale. We do not agree. The fact that a taxpayer has overstretched his financial resources is obviously a factor to bear in mind in assessing his credibility but it is no more than one of the many factors to consider. We do not accept that all laymen are financial wizards. The ordinary men in the street do make mistakes. They do sometimes take risks, even unnecessary or unreasonable risks in the eyes of the independent observer. It is easy to be wise after the event, especially when one is assessing not his own affairs but others.

22. In the present case, we have considered the evidence of Mr X and his daughter very carefully and we do not see any glaring inconsistencies. We consider both witnesses to be essentially truthful and we have no hesitation in accepting their evidence.

23. The other argument of the Revenue is perhaps easier to deal with. It was said that the eviction of the Taxpayers from their rented flat in District B was a recent invention and was not credible. We have difficulty in seeing how this conclusion was arrived at by the Revenue. The appeal of the Taxpayers was launched on 23 October 1994 and in a letter of the same date a copy of a letter from the landlady was enclosed supporting the Taxpayers' case. In that letter, the landlady even offered to provide the necessary documentation to prove the asserted facts. This letter was agreed by the Revenue and no attempt was made to require the Taxpayers to call the landlady.

24. It was then said the fact that the Taxpayers were prepared to complete the purchase of the District B flat in February 1992 suggested that Mr X's explanation was incredible in that the Flat was ready for occupation in January 1992 and the Taxpayers could or should have moved into the Flat if there was an urgent need to move out of the rented premises. This argument of course ignores the Taxpayers' case that it was a combination of factors which led to the family's decision to sell the Flat and the timing of that decision. In September, there was still no word as to when the Flat would be available for occupation. Both the flat in District B and the Flat were purchased and sold respectively in early October 1991. Furthermore, there was nothing unusual or unreasonable for the vendor of the District B flat to ask for the completion to take place in a few months time. In this respect, Mr X had very little say in the timing of the availability of both the District B flat and the Flat.

25. Finally, what happened after the purchase of the Flat has only limited relevance as to the intention of the Taxpayers at the time of purchase of the Flat. We should, of course, test the declared intention of the Taxpayers against the background of subsequent facts but at the end of the day, it is the intention of the Taxpayers at the time of purchase of the Flat which counts.

INLAND REVENUE BOARD OF REVIEW DECISIONS

OUR DECISION

26. In the premises, we find that the Taxpayers have discharged their burden in showing that the Flat was acquired not with the intention to trade but with the intention to invest on a long term basis. We allow the appeal and direct that the assessment by the Revenue be set aside.