Case No. D25/88

Profits tax – sale of letters of entitlement to land – whether profits were trading gains or realization of capital – evidential factors: prior history of dealing and accounting treatment – s 14 of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Della P H Chan and Robert Gaff.

Date of hearing: 2 June 1988.
Date of decision: 15 July 1988.

The taxpayer company purchased letter B land entitlements which it intended to exchange for land in the New Territories. It sold them at a profit. The IRD assessed the taxpayer to profits tax with respect to such profits.

Previously, the taxpayer had sold one batch of letters B at a profit, and did not object when the gains were assessed to profits tax. Another batch was contributed to a joint venture which developed land for resale. In addition, the taxpayer had previously redeveloped some land: although that land was classified as a fixed asset in the taxpayer's accounts, the taxpayer had claimed a trading loss with respect to the redevelopment for profits tax purposes.

Held:

The profits were assessable.

(a) Letters B are trading stock if they are acquired either for resale or for the purpose of exchanging them for land to be developed for resale. On the other hand, they are investment assets if they are acquired for the purpose of exchanging them for land to be developed and held as a long-term investment.

(b) The taxpayer's intention to acquire letters B for the purpose of acquiring land was a neutral factor, because such expansion could take the form of either trading or investment. The taxpayer's prior transactions involving letters B pointed to trading. There was no evidence of an intention to hold land for rental purposes.

(c) The designation of the developed property as a fixed asset in the taxpayer's accounts carried little weight, particularly since the taxpayer had claimed a deduction for trading losses with respect to that development.

Appeal dismissed.

Wong Chi Wah for the Commissioner of Inland Revenue.
Robert Lew of James Lew & Co for the taxpayer.

Decision:

This appeal is by the taxpayer company against two assessments, namely an additional profits tax assessment for the year 1981/82 and a profits tax assessment for the year 1983/84, both of which brought into account for taxation profits or gains which the Taxpayer had made on the sale of certain letter B land entitlements.

The facts of the case are set out in the Commissioner's determination, the Taxpayer's audited accounts for the years ended 31 March 1978, 31 March 1979 and 31 March 1985, the appendices to the Commissioner's determination, the audited accounts for the year ended 30 June 1986 for a company, X Ltd, and an undated letter from the company to the acting senior assessor (appeals) of the Inland Revenue Department.

Apart from the accounts and letter referred to above, no further evidence was produced before the Board of Review and no witnesses were called to give evidence either by the Taxpayer or the Commissioner.

The question to be decided by the Board of Review is whether or not the decision of the Commissioner in deciding that the profits or gains from the sale of the letter B land entitlements were assessable to profits tax or whether the same were capital gains and should not be taxable.

The representative for the Taxpayer submitted that the accounts of the Taxpayer showed that at all material times the Taxpayer derived its income principally from the letting and managing of properties. It was submitted that during the years in question the Taxpayer did not carry on any business of trading in properties. It was said that in 1978 the Taxpayer looked to the New Territories for expansion and decided that the appropriate method for expansion was to acquire letter B land entitlements which could be exchanged for land to be developed. It was submitted that pursuant to this policy the Taxpayer acquired six letter B land entitlements.

It was stated by the Taxpayer's representative that numerous applications were made by the Taxpayer to the District Land Office to exchange the various letter B land entitlements for land which could be developed. It was alleged that this could not be done

because land prices from 1978 to 1984 were strong and many people were rushing to acquire land using letter B land entitlements. The letter B land entitlements which the Taxpayer had acquired were relatively new and did not take priority so that the Taxpayer's applications were unsuccessful.

The Taxpayer's representative said that the intention of the Taxpayer was manifested in a minute of a directors' meeting of the Taxpayer held in 1978, a copy of which was attached to the Commissioner's determination and which read as follows:

> 'The Chairman pointed out that the cost of purchasing land exchange entitlements for exchange of land in the New Territories is lower than that of direct purchase of land through Government land auction or private sources.
> IT WAS RESOLVED:
> THAT the Company will acquire land exchange entitlements from time to time for the purpose of surrendering them in exchange for land in the New Territories.'

It was submitted that there was a clear intention that the Taxpayer intended to exchange the letter B land entitlements for land to be developed for the construction of buildings to earn rental income. It was submitted that this was clear from the resolution quoted above, from the alleged fact that the Taxpayer on numerous occasions attempted to exchange the letter B land entitlements, from the alleged fact that the Taxpayer had historically had the habit of managing buildings, and from the alleged fact that the Taxpayer would not have known what to do with the land if it had won it through a tender procedure when offering to exchange letter B land entitlements.

There was also a suggestion by the Taxpayer's representative that, when acquiring the first of the letter B land entitlements in 1978, the company had intended to retain the entitlement but changed its intention in 1979. It was further suggested that similar considerations should apply to the two letter B land entitlements now the subject matter of this appeal, that is, that there was a subsequent change of intention.

The Commissioner's representative summarised the question to be decided as follows:

> 'If a company acquires letters B for the purpose of resale at a profit, the letters B are nonetheless the trading stock of the company. On the other hand, a company can acquire letters B for the purpose of exchange of land with the Government. In that case, the exchange of the letters B can be regarded as part (the first part) of a single process of an acquisition of a particular piece of land. Whether such letters B can be the trading stock of the company will depend on whether it is the company's intention to redevelop the land for long-term investment or for resale at a profit. If the latter, the letters B should be considered as the company's trading stock.'

With this statement we are in total agreement.

The Commissioner's representative then submitted that the resolution passed by the directors in 1978 was neutral and did not indicate why the company wished to acquire land in New Territories. He drew our attention to the fact that the one letter B land entitlement which was exchanged in 1979 was not exchanged by the company for land which it could develop for rental purposes but was in fact given to a joint venture company (of which the Taxpayer was a small minority shareholder) to enable the joint venture company to acquire a large land entitlement in the New Territories which was developed for the purposes of sale and not rental. He also drew our attention to the fact that, in the year of assessment 1983/84, the Taxpayer had commenced the redevelopment of property A which was redeveloped for the purpose of sale and not to acquire rental income.

The Board enquired of the Taxpayer's representative how the property A redevelopment had been handled by the Taxpayer in its accounts and the Board was informed that a trading loss of $500,000 had been claimed for tax purposes on the allegation that the property was a trading asset. The Taxpayer's representative submitted that this was probably incorrect and that, because the item was described as a fixed asset in the Taxpayer's accounts, it should not have been considered to be a trading loss. Apparently and nevertheless the Taxpayer had claimed and accepted for profits tax purposes a loss of $500,000.

On the facts before us, we have no hesitation in dismissing this appeal and confirming the two assessments appealed against. The onus of proof is on the Taxpayer to prove that the Commissioner's determination is incorrect. In the present case, there are few facts before the Board of Review and those facts which we have are either neutral as to the intention of the Taxpayer or point in the direction of the Taxpayer being a property trading company. There is no evidence before us that the Taxpayer had any intention of exchanging the letter B land entitlements which are the subject matter of this appeal for land to be developed for rental purposes.

The case starts when the directors of the Taxpayer passed the resolution in 1978. That resolution was no more than that the Taxpayer would acquire letter B land entitlements with a view to exchanging them for land in the New Territories. Based on that decision, the Taxpayer proceeded to acquire letter B land entitlements. The first of these entitlements was purchased in 1978 and sold less than 12 months later for a substantial profit which was assessed to tax. The Taxpayer did not then argue that the first letter B land entitlement was a long-term capital investment but accepted that it was a trading transaction. The third lot of letter B land entitlements was exchanged for land in 1979 and was clearly not exchanged pursuant to the alleged policy to acquire land for development for rental purposes. This was a clear exchange of land for development for sale. The fact that the Taxpayer was a minority shareholder in a large joint venture company is immaterial. The fact is that the Taxpayer was prepared and willing to use its third lot of letter B land entitlements for the purpose of exchange for land for redevelopment for sale and not in pursuance of the alleged policy of acquiring land for rental.

We attach no importance to the classification of the assets in the audited accounts of the Taxpayer. It is quite clear from the way in which the Taxpayer treated the redevelopment of property A that the designation of 'fixed assets' did not inhibit the Taxpayer in claiming that the asset was a trading asset to enable it to claim a loss of $500,000.

Though the Taxpayer's representative said in his submission that the Taxpayer had repeatedly attempted to exchange its letter B land entitlements for land for development for rental purposes, there is no evidence of this. He said that all documentary evidence had been lost or was otherwise not available. As no evidence was given before us, we are unable to accept statements made by the Taxpayer's representative as having any evidential value. The facts before us are that there were two known attempts by the company to exchange letter B land entitlements. One we have already referred to and it was clearly an exchange other than for rental purposes. The other occasion when there is evidence that the company attempted to exchange its letter B land entitlements was a resolution in 1980 when apparently the company resolved that it would take part in the bidding for a land lot in the New Territories in conjunction with other companies. We have no further evidence regarding this and it is reasonable to assume that the intention was similar to the joint venture operation which was successful and which was for sale and not rental purposes.

As stated on the evidence before us, we have no hesitation in upholding the Commissioner's determination and dismissing the appeal.