Case No. D26/00

Profits tax – acquisition and sale of property – intention at time of purchase – burden of proof on purchaser to establish that property purchased for long term investment – credibility of the taxpayer before the Board – section 14 of the Inland Revenue Ordinance ('IRO').

Panel: Benjamin Yu SC (chairman), Peter R Griffiths and Dennis Law Shiu Ming.

Dates of hearing: 23, 24 and 25 May 2000.
Date of decision: 21 June 2000.

In 1978, the taxpayer had purchased various pieces of agricultural land at two Lots. In 1992, various parts of the Lots were resumed by the Government. Compensation paid to the taxpayer was vastly in excess of the purchase price. The Revenue subsequently issued profits tax assessment claiming that the profits were taxable under section 14 of the IRO.

The Revenue argued that the taxpayer knew, at the time of the acquisition of the Lots, that the Government might resume the said land for a proposed airport. The taxpayer denied such knowledge. Further, the taxpayer argued that the Lots had been purchased for long term investment (to build resort homes). However, due to extenuating circumstances, the land had never been built up.

Held by the Board, after observing the demeanour of the witnesses: -

1. The taxpayer did not merely contemplate but had a genuine intention to hold the Lots for investment. At the time of acquisition, this intention was achievable although it did become unrealised: Cunliffe v Goodman, distinguished;

2. The taxpayer had discharged its onus of having to satisfy the Board that it had no intention of carrying on trading or an adventure in the nature of a trade in relation to the lots;

3. Even though there was an absence of documentary evidence of the taxpayer's intention at the time of acquisition, at the end of the day the oral evidence of the witnesses was most important in the Board's eyes.

Appeal allowed.

Cases referred to:

Simmons v IRC [1980] 1 WLR 1196
All Best Wishes Limited v CIR 3 HKTC 750
D44/96, IRBRD, vol 11, 534
Cunliffe v Goodman [1950] 1 All ER 720

Ma Wai Fong for the Commissioner of Inland Revenue.
Lee Kang Poor, Thomas of Moores Rowland for the taxpayer.

Decision:

The background

1. The Taxpayer was incorporated in November 1977. On 10 August 1978, the Taxpayer purchased various pieces of agricultural land at two lots in District A, New Territories (' the Lots'). The Lots were never put into use by the Taxpayer. Since July 1992, various parts of the Lots were resumed by the Government. As a result, the Taxpayer received compensation money which was far in excess of the cost of these lots to the Taxpayer. The Respondent (the Revenue) issued profits tax assessments and additional profits tax assessment in respect of the surplus, claiming that these were profits taxable under section 14 of the IRO. The Taxpayer, now in members' voluntary liquidation, has challenged these assessments. Its objection to the Revenue having been overruled, it has appealed to this Board.

2. For the purpose of this appeal, the parties have agreed a ' statement of agreed facts' . We accept the facts as stated therein, and find them proved.

The Taxpayer' s case and evidence

3. The Taxpayer' s case is that the Lots were purchased for the purpose of development into resort houses for the beneficial owners of the shares of the Taxpayer company. In other words, the Lots were acquired for a long term purpose. Consequently, the profits derived from the resumption of the Lots were of a capital nature, and therefore, not subject to profits tax.

4. The Taxpayer called three witnesses to testify before us. Their proofs of evidence were, by consent of the parties, treated as their evidence in chief. Two of these witnesses, viz Mr B and Mr C, are the beneficial owners of the shares in the Taxpayer company. The third witness, Mr D,

is the real estate agent who introduced the Lots to the Taxpayer back in 1978.

5. Mr B and Mr C gave similar evidence, which was corroborated by Mr D. Their evidence is to the following effect:

(1) Mr B, Mr C and two others, namely Mr E and Mr F, became good friends in the early 1970s. They often spent their holidays together in the countryside for picnic, hiking, barbecue, fishing and swimming. After this had been going on for some time, it was suggested that they should join hands in buying a piece of land to build resort houses. Mr B said in paragraph 3 of his statement that :

> ‘ The idea was that on the one hand we could use the resort houses and the recreational facilities built by our families. The resort house that we did not use could be rented out to other holiday makers for income ...’

As Mr E was then often travelling out of Hong Kong, he did not join in the plan.

(2) To put the plan into effect, Mr B got in touch with his friend, Mr D, whom he knew was an estate agent and very experienced in land development in the New Territories and outlying islands. Mr D was asked to find a suitable site for them for the purpose of erecting resort houses.

(3) In his evidence, Mr B explained that the three of them, that is, Mr B, Mr C and Mr F, decided to look for a site, rather than completed resort houses because the three of them wanted to have their resort houses in a row. They also wanted to have space for recreational area. Mr D came up with the Lots in District A. Although the various pieces were scattered, some with areas as large as 6,000 square feet and some with little more than 400 square feet, Mr B, Mr C and Mr F decided, upon Mr D’ s advice, to purchase them. The Lots were on offer by the vendor as a package, and it was not open to the three of them to buy some and reject the others.

(4) Mr B did not himself visit the Lots before the purchase. He relied on Mr C and Mr D. Mr C’ s evidence is that he did go to the vicinity of the Lots and took a look at the surrounding. He was aware that the Lots were scattered, and did take in Mr D’ s advice that the scattered lots would not be ideal for building resort houses. He nevertheless took comfort in Mr D’ s advice that since some of the Lots were located near a village, it was possible either to obtain permission to build small houses or to combine the lots with other adjacent lots through exchange with adjoining land owners.

(5) Mr B, Mr C and Mr F decided to use the Taxpayer company to hold the Lots and appointed nominees as directors and shareholders. They were aware that these were agricultural lots, and that permission had to be obtained from the relevant authority before they could be built on. They believed, however, at the time that Mr D, who was experienced in these matters, would be able to assist them in effecting exchange of some of the lots with adjoining land owners to form a single united site for building resort houses, or in making application to the relevant authority for approval in building resort houses. Mr C said in evidence that in his work as a bank officer, he had come across many such cases.

(6) Mr D explained that in those days it was not difficult to obtain permission to build village houses provided one could secure the assistance of an indigenous villager. The procedure was that once he could locate a willing villager, the lot would be assigned to him, whilst the villager would execute a power of attorney to authorise someone (who would be the beneficial owner of the lot) to handle the matter on his behalf. Application could then be made by the attorney to the District Office for approval of erecting a village house on the lot. Mr D had good connection with the chairman of the Rural Committee of District A and he thought that he would have little difficulty in finding an indigenous villager willing to help.

(7) Mr D explained that the project came to a hitch when Government changed its policy and would only accept powers of attorney from indigenous villagers who had left Hong Kong. As a result, Mr D had a much more difficult task, for he had to secure the assistance of not just any villager, but one who has already emigrated.

(8) In 1981, Mr F withdrew from the project and his share was taken up by Mr E. From then on until resumption of the Lots, Mr B, Mr C and Mr E were the partners in this potential development.

(9) Mr B explained that during the 1980s and 1990s, the partners were too busy handling their own personal affairs and could not afford the time to follow up on the proposed development. In Mr B’ s case, he needed to travel extensively in Asia Pacific countries in the 1980s and he was seconded to these countries during the period from 1991 to 1999. Mr E and his family emigrated to Country G in 1986. Mr C and his wife also planned to emigrate to Country H or Country I. They could but rely on Mr D to take the development further. In the event, Mr D was not able to secure the assistance of an indigenous villager, and although he had had one offer for exchange, Mr D decided to turn it down for the site offered was considered unsuitable.

(10) There had been offers to purchase the Lots. These were all communicated through Mr D. The first offer was made in about 1980. This was shortly after the Government announced its proposal of building a new airport, and prices of land in or around District A had shot up to about $16 to $17 per square foot, compared to $7 per square foot at the time when the Taxpayer acquired the Lots. The second offer was in 1990, when someone offered $80 per square foot. It would be remembered that the Government had shelved its plan to build a new airport some time in 1983 and the plan was revived in the Policy Address of the Governor in October 1989. The third offer was made in 1992 when the Taxpayer was offered $160 per square foot. None of these offers was accepted, it being the Taxpayer's case that the partners rejected the offer because they had not given up their original plan of building resort houses.

(11) The decision to wind up the Taxpayer company voluntarily was wholly due to the decision of Mr C to emigrate and his wish to recover his investment in the company. As the value of the Lots had substantially increased by then, the remaining partner did not want to buy up Mr C's shares, and hence the decision to liquidate the company.

The Revenue's argument

6. Mr B and Mr C were subjected to detailed cross examination. Ms Ma sought to explore inconsistencies in Mr B and Mr C's evidence. She also pointed to a letter from the Taxpayer's representative dated 25 October 1996 which merely stated that the land was purchased for long term investment, without stating that the Taxpayer intended to build resort houses for the use of its beneficial shareholders. We have considered all the points raised on the veracity of the Taxpayer's case and suffice it to say that we do not find them to be of substance. The fact that the 25 October letter was silent as to the intention to build resort houses is neither here nor there. There had been earlier correspondence between the Taxpayer and the Government which recorded the Taxpayer's intention to build houses on the Lots. True it is that some of the correspondence referred to the prospect of building houses for rental, but building houses for rental is not inconsistent with the original intention as Mr B stated in paragraph 4 of his statement.

7. One principal point that Ms Ma made in her submissions was that at the time of the acquisition of the Lots by the Taxpayer, the Government was studying the possibility of building a replacement airport. As to that she relied on the Annual Review by the Director of Civil Aviation for the financial year 1977/78 which contained the following paragraph :

> 'In September, the Aviation Advisory Board recommended that the government should proceed with a feasibility study of a proposed site ... for a replacement airport.'

8. We were not told whether this is a public document, and if so, the date of its publication. Nor has the Respondent (the Revenue) introduced any evidence that the Government's intention to build a replacement airport near District A was public knowledge around the time of the purchase by the Taxpayer. Further, there is simply no evidence that those behind the Taxpayer were aware of Government's intention. Ms Ma went on to submit that :

> ' the possibility of the resumption of the land by the Government was always there when the (Taxpayer) purchased the land. This could in fact be an opportunity for a handsome gain.'

9. In our view, there is just no evidential basis for that submission. Mr B and Mr C denied that they had knowledge of any proposal to build a new airport at the time of the purchase. The substantial increase in price per square foot of the Lots in District A between the time of the purchase in 1978 and the first offer received by the Taxpayer in 1980 speaks eloquently of the fact that Government's intention was not public knowledge at the time of the acquisition.

10. Another line of challenge by Ms Ma was that there was no documentary evidence in support of the Taxpayer's case. It is true that the minutes of the board meeting in August 1978 were silent as to the Taxpayer's intention of acquisition, but the report of directors that we have seen described the Taxpayer's principal activity as 'land investment'. At the end of the day, it is the evidence of the witnesses that matters.

11. Ms Ma also queried the declared intention of the Taxpayer on the ground that nothing had really been done by the partners for a very long term to implement their proposed development. As to this, we have already recorded Mr B, Mr C and Mr D's explanation for the Taxpayer's inability to make headway on the project prior to the resumption process in 1992. Again, the question here is whether we accept their evidence.

Our findings and conclusion

12. In considering whether the Taxpayer has discharged its burden in this appeal, we have to look at evidence of the intention of the Taxpayer at the time of the acquisition. We bear in mind that the Taxpayer's assertion of his intention cannot be decisive and his actual intention must be determined upon the whole of the evidence [Simmons v IRC [1980] 1 WLR 1196 and All Best Wishes Limited v Commissioner of Inland Revenue 3 HKTC 750]. Having considered the evidence adduced on behalf of the Taxpayer, we are in no doubt that the Taxpayer acquired the Lots for a long term purpose, and not with the intention to trade. We accept the evidence given by Mr B and Mr C on this, which, as we say, was corroborated by Mr D's evidence, which we also accept. We accept their explanation for the Taxpayer's inability to implement the original intention. We quite understand that the initial partners may have lost some of the original enthusiasm in the

pursuit of their original plan as each of them became more advanced in his respective profession or occupation and became diverted from the project because of work or the desire to emigrate. We also bear in mind that there is no evidence that any one of the partners had been speculating on agricultural land either in District A or in any other area and the fact that the Taxpayer had kept the Lots for some 14 years and had never voluntarily disposed of any of the Lots. In the course of our deliberation, we have considered the decision of the Board in D44/96, IRBRD, vol 11, 534. There the Board held that profits arising on a resumption of land could be assessable. However, the Board in that case came to the conclusion that the company acquired the land lots not as long-term investments, but as trading stock. The facts of the present case are different, and we have come to the opposite finding.

13. Finally, Ms Ma submitted that the proposed development was fraught with difficulties, and that many matters, such as the prospect of obtaining an exchange or obtaining permission to build village houses, were outside the Taxpayer' s control. She argued that the Taxpayer had at best a ' mere contemplation' . She relied on Cunliffe v Goodman [1950] 1 All ER 720, where (at page 724) Asquith LJ said:

> ' *Not merely is the term "intention" unsatisfied if the person professing it has too many hurdles to overcome, or too little control of events; it is equally inappropriate if at the material date that person is in effect not deciding to proceed but feeling his way and reserving his decision until he shall be in possession of financial data sufficient to enable him to determine whether the project will be commercially worth while. A purpose so qualified and suspended does not, in my view, amount to an "intention" or "decision" within the principle. It is mere contemplation until the materials necessary to a decision on the commercial merits are available and have resulted in such a decision. In the present case it seems to me that ... she never got, in respect of the first scheme, a stage at which she could decide on its commercial merits, nor, in respect of the second scheme, the stage of actually deciding that the scheme was commercially eligible unless, indeed, she must be taken, not merely to have repudiated her architect' s authority, but to have decided that it was commercially ineligible. In the case of neither scheme did she form a settled intention to proceed. Neither project moved out of the zone of contemplation – out of the sphere of the tentative, the provisional and the exploratory – into the valley of decision.'*

14. In Cunliffe v Goodman, the tenant was being sued for breaches of repairing covenant. The tenant sought to rely on section 18(1) of the Landlord and Tenant Act 1927 which provided that :

> ' *no damage shall be recovered for a breach of any such covenant or agreement to leave or put premises in repair at the termination of a lease, if it is*

shown that the premises, in whatever state of repair they might be, would at or shortly after the termination of the tenancy have been or be pulled down.'

It was held that the tenant could not rely on section 18 to escape liability for breach of the covenant to repair unless he can prove that on the relevant date the landlord had a definite intention to pull down the premises. Now, we quite agree that when one considers whether the taxpayer has shown on the evidence that it has a certain intention, it has to be realistic, so that if objective facts were to indicate that it would be unlikely for the taxpayer to achieve such a result, those facts must be borne in mind in deciding whether the taxpayer did have the declared intention: see per Mortimer J in All Best Wishes Ltd v Commissioner of Inland Revenue 3 HKTC 750 at 771:

> ' *The intention of the taxpayer, at the time of acquisition, and at the time when he is holding the asset is undoubtedly of very great weight. And if the intention is on the evidence, genuinely held, realistic and realisable, and if all the circumstances show that at the time of the acquisition of the asset, the taxpayer was investing in it, then I agree. But as it is a question of fact, no single test can produce the answer. In particular, the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of the evidence. Indeed, decisions upon a person's intention are common place in the law. It is probably the most litigated issue of all. It is trite to say that intention can only be judged by considering the whole of the surrounding circumstances, including things said and things done. Things said at the time, before and after, and things done at the time, before and after. Often it is rightly said that actions speak louder than words.'*

15. In the present case, we are in any event satisfied on the evidence that *at the time of acquisition of the Lots,* those behind the Taxpayer did not merely have a contemplation. They did, at that time, have a genuine intention to hold the Lots for the purpose of building resort houses for themselves and for rental. That intention was, at the time, achievable, and believed to have been achievable. But circumstances have changed and as events turned out, became unrealised.

16. That said, we doubt whether it is right to apply wholesale Asquith LJ's dictum in Cunliffe v Goodman to the question of intention in a tax appeal of this nature. One must not forget that in this appeal, although the burden is on the Taxpayer to show that the assessment appealed against is wrong or excessive, the ultimate question is whether the Taxpayer had shown that it had no intention to carry on trading or an adventure in the nature of trade. If the Board is satisfied to the requisite standard of proof that the Taxpayer had no such intention, the Board should allow the appeal and set aside the assessment. In a sense, the Taxpayer assumes a burden of proving the negative. True it is that in practically all cases as in the present one, the Taxpayer seeks to prove the positive: namely an intention of acquiring a property for a long term purpose. That is presumably because in Simmons v IRC [1980] 1 WLR 1196, Lord Wilberforce said:

> ' *What I think is not possible is for an asset to be both trading stock and permanent investment at the same time, nor to possess an indeterminate status – neither trading stock nor permanent asset.'*

But it seems to us that perceived difficulties in the realization of an intention of a long term nature do not necessarily relegate an intention to a mere contemplation. That is a question of fact. Moreover, we venture to suggest that one must be careful in seeking to equate perceived difficulties in the realization of a long-term goal with a finding that the Taxpayer had not disproved an intention to trade or embark upon an adventure in the nature of a trade. We have said that in the present case, we are satisfied that the Taxpayer did not have a mere contemplation, but did form the necessary intention. Even if we were wrong, and it is said that because the success of the development depended on matters outside the Taxpayer' s control, so that it could not objectively be termed an intention to build resort houses, we would still hold that in acquiring the Lots, the Taxpayer did not do so with an intention to trade or to embark upon an adventure in the nature of trade.

17. In the circumstances, we find that the Taxpayer has discharged the onus on it of showing that the assessments appealed against were wrong. We hereby allow the appeal and set aside the assessments and additional assessments. These are :

(1) the profits tax assessment for the year of assessment 1994/95, showing assessable profits of $3,681,993;

(2) the additional tax assessment for the year of assessment 1995/96 showing additional assessable profits of $9,230,518;

(3) the profits tax assessment for the year of assessment 1996/97, showing assessable profits of $985,345;

(4) the first additional profits tax assessment for the year of assessment 1996/97 showing additional assessable profits of $2,189,271, which has been reduced to $1,464,252 as per the Commissioner' s determination dated 10 May 1999; and

(5) the second additional profits tax assessment for the year of assessment 1996/97 showing additional assessable profits of $2,756,532, which has been reduced to $1,256,532 as per the Commissioner' s determination.