Case No. D28/12

Profits tax – whether the sale of a capital asset or trading asset – sections 14(1) and 33A(1) of the Inland Revenue Ordinance ('the IRO').

Costs – section 68(9) of the IRO.

Panel: Cissy K S Lam (chairman), Chan Yue Chow and Cheng Chung Hon Neville.

Date of hearing: 1 March 2012.
Date of decision: 4 September 2012.

The Appellant described its principal business activity as 'Property Investment' and the only business activities carried out by the Appellant were those in relation to the purchase, lease and sale of Property A. The Appellant objected to the Profits Tax Assessment raised on it in respect of the disposal of Property A, claiming that it was profits arising from the sale of a capital investment and thus not chargeable to profits tax. No one from the Appellant gave evidence before the Board even though important allegations made in the Appellant's letters to the Inland Revenue were later proved by independent evidence to be untrue.

Held:

1. The Appellant stated in its grounds of appeal that the intention was to invest. But this stated intention was not supported by oral testimony or tested by cross-examination. The Board finds that the Appellant purchased Property A with the intention of disposing of it at a profit. Further or alternatively, the Board finds that the Appellant has failed to prove its alleged intention of holding Property A as a capital investment.

2. Under section 68(9) of the IRO, this Board may order the Appellant to pay as costs of this Board a sum not exceeding $5,000. The Board thinks this is a suitable case to award costs against the Appellant in the sum of $5,000 and it so orders.

Appeal dismissed and costs order in the amount of $5,000 imposed.

Cases referred to:

Simmons v IRC [1980] 53 TC 461
Marson v Morton [1986] STC 463
Lee Yee Shing v CIR [2008] 11 HKFCAR 6
Brand Dragon Limited v CIR HCIA 2 of 2001
Real Estate Investments (NT) Limited v CIR [2008] 11 HKCFAR 433

Mr Mike Li, Messrs Li, Shiu & Co for the Taxpayer.
Chan Siu Ying Shirley and Ong Wai Man Michelle for the Commissioner of Inland Revenue.

Decision:

1. The Appellant objected to the Profits Tax Assessment for the years of assessment 2004/05 to 2006/07 raised on it in respect of the disposal of an office ('Property A') in a commercial building ('Building A'). The Appellant claimed that it was profits arising from the sale of a capital investment and thus not chargeable to tax under section 14(1) of the Inland Revenue Ordinance, Chapter 112 ('the IRO'). On the same basis the Appellant claimed it was entitled to commercial building allowance under section 33A(1) of the IRO. By determination dated 21 June 2011 ('the Determination') the Deputy Commissioner of Inland Revenue ('Deputy Commissioner') rejected its claim. The Appellant now appeals to us.

The undisputed facts

2. The Appellant was a company incorporated in Country B. It was incorporated in August 2004 and registered as an overseas company in Hong Kong under Part XI of the Companies Ordinance on 12 July 2005. At all material times the issued capital of the Appellant was one ordinary share of US$1.

3. Mr C was appointed its sole director on 14 September 2004, same day as Property A was purchased. Mr C remained the Appellant's sole director until the Appellant agreed to sell Property A in May 2006. Mr C's wife was added as a director of the Appellant on 6 June 2006.

4. Mr C was and is also the chairman and managing director of Company C which is the parent company of Estate Agent C, a prominent estate agent company in Hong Kong. Estate Agent C was the estate agent through which the Appellant purchased and sold Property A.

5. In the 2004/05 to 2006/07 Profits Tax returns, the Appellant described its

principal business activity as 'Property Investment'.

6. The only business activities carried out by the Appellant were those in relation to the purchase, lease and sale of Property A.

7. By a provisional agreement for sale and purchase dated 14 September 2004 ('Provisional Purchase Agreement'), the Appellant agreed to purchase Property A at $17,782,000. The formal agreement for sale and purchase was executed on 5 October 2004. The purchase was completed on 28 October 2004.

8. To finance the purchase, the Appellant obtained a loan of $8,891,000 ('the Bank D Loan') from Bank D on 28 October 2004. The Bank D Loan was for a term of 28 years secured by a mortgage against Property A in favour of Bank D.

9. By a provisional agreement for sale and purchase dated 6 May 2006 ('Provisional Sale Agreement'), the Appellant agreed to sell Property A to Company E, the purchaser, at $25,365,500. The formal agreement for sale and purchase was executed on 22 May 2006 and the sale was completed on 15 June 2006.

10. Property A was purchased with a sitting tenant, Company F. The term of the tenancy ('the Existing Tenancy') was from 15 March 2004 to 31 March 2006. Company F left upon the expiration of the existing tenancy. Property A was sold with vacant possession.

Intention to Trade

11. Both parties agree that whether under section 14(1) or section 33A(1) of the IRO this appeal turns on one issue, namely, whether the sale of Property A was the sale of a capital asset or whether it was a sale in the nature of trade within the meaning of the IRO. The answer to this issue turns on the Appellant's intention at the time of purchase. The question to ask is: 'Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment?' [see the oft-quoted dictum of Lord Wilberforce in Simmons v IRC [1980] 53 TC 461 at page 491].

12. The intention to dispose of at a profit was contrasted with the intention to buy as a 'permanent investment'. Likewise in Marson v Morton [1986] STC 463, Sir Nicolas Browne-Wilkinson V-C, when discussing the nine badges of trade had this to say: '(8) What were the purchasers' intentions as to resale at the time of purchase? If there was an intention to hold the object indefinitely, albeit with an intention to make a capital profit at the end of the day, that is a pointer towards a pure investment as opposed to a trading deal. On the other hand, if before the contract of purchase is made a contract for resale is already in place, that is a very strong pointer towards a trading deal rather than an investment. Similarly, an intention to resell in the short term rather than the long term is some indication against concluding that the transaction was by way of investment rather than by way of a deal. However, as far as I can see, this is in no sense decisive by itself.'

13. Of course the ultimate question is whether there was an intention to trade and no single factor is decisive by itself. But the words 'permanent' and 'indefinitely' clearly emphasize the absence of any intention to sell. If a person purchases a property with an intention to sell it, whether in the immediate future or in the distant future waiting for the opportune moment for sale at a profit to come, that is an intention to trade the property. Holding long-term may be a factor in support of an intention to hold as a permanent investment (see the badges of trade summarized by McHugh NPJ in Lee Yee Shing v CIR [2008] 11 HKFCAR 6, at page 28). But holding long term or using the property in the meantime to earn income does not per se turn the property into a capital investment.

14. The chronology of the purchase and sale of Property A may be summarized as follows:

14 September 2004	The Appellant agreed to purchase Property A at $17,782,000.
28 October 2004	Assignment of Property A to the Appellant.
31 March 2006	The Existing Tenancy expired.
6 May 2006	The Appellant agreed to sell Property A to Company E at $25,365,500.

15. Stripped down to its essential facts, this chronology of events demonstrate a typical case of trading and a plain intention to trade. It is for the Appellant to prove otherwise.

Absence of oral testimony

16. Given that the Appellant is not a person, when one speaks of the Appellant's intention, one is really looking at the intention of its controlling mind who was clearly Mr C, its sole director at all material times [Brand Dragon Limited v CIR HCIA 2 of 2001, paragraph 18]. Nonetheless, Mr C did not give evidence before this Board. We made it clear to Mr Li representing the Appellant that his submission before this Board could not stand as evidence and could not displace oral testimony given by a witness under oath. Fully understanding this Mr Li was happy to rest the Appellant's case solely on the Statement of Agreed Facts and the documents produced before this Board. He asked us not to infer that Mr C was trying to hide anything from this Board by not giving evidence.

17. It is not for this Board to advise the Appellant what evidence it should or should not produce. The decision is entirely the Appellant's. We will not draw adverse inference against the Appellant from the absence of witness. But the lack of oral testimony means that we will not look beyond the undisputed facts. In particular we are not prepared

to accept assertions or allegations made by the Appellant in its letters to the Inland Revenue Department ('the IRD') as evidence unless such assertions or allegations are supported by undisputed documents. This is particularly relevant in the present case when important allegations made in the Appellant's letters, namely those relating to the circumstances surrounding the sale of Property A (see below), were later proved by independent evidence to be untrue.

The Audited Accounts 2004/05

18. Ground 1 of the grounds of appeal relies on the Appellant's audited accounts for the year 2004/05 which described Property A as an 'investment property'. The Appellant argues that this is evidence of its intention at the time of purchase to hold Property A for long-term capital investment.

19. We note, however, that the audited accounts 2004/05 was signed by Mr C as sole director on 5 June 2006, that is after the Appellant had agreed to sell Property A. It was hardly a contemporaneous document to show Mr C's intention at the time of purchase.

20. Moreover, in the absence of oral testimony the accounts were not tested by cross-examination. We do not know how the auditors arrive at the view that Property A was an investment property. We do not know whether the auditor formed an independent view of the nature of Property A, and if so on what basis, or merely followed the opinion of Mr C.

21. In note 7 of the Notes to the accounts it was stated that 'At 31 March 2005, the investment property was held under a long-term lease in Hong Kong'. If the auditors considered a two-year tenancy as 'long term' and if that was the basis on which they arrived at their conclusion that Property A was an 'investment property', then their conclusion was clearly fallible.

22. The way a property is classified and treated in a taxpayer's audited accounts is relevant but not conclusive [Real Estate Investments (NT) Limited v CIR [2008] 11 HKCFAR 433 at paragraphs 33 to 35]. The audited accounts 2004/05 were non-contemporaneous and self-serving. They carry little weight in our consideration.

Use of Property A for earning rental income

23. Grounds 2 and 7 of the grounds of appeal rely on the fact that Property A was held from September 2004 to May 2006, that is for almost 20 months. It was rented out and was income producing during most of that period. The Appellant argued that 20 months was not a short period.

24. We do not agree. Unlike shares and commodities, with real property, even with a market as vibrant as the one in Hong Kong, prices do not rise and fall overnight. It is often necessary to hold the property for a period of time before one can sell to make a real profit. In the meantime, the property can be and very often are rented out to earn income.

Property A was purchased with an existing tenancy. What could be more convenient than to hold the property with the existing tenancy, earn rental income in the meantime and wait for the property market to pick up and sell? Contrary to the Appellant's argument, we do not consider 20 months in the context of the sale and purchase of real property as any notable length of time.

25. In the same light, we do not consider the search for new tenants (which evidence is in any event disputed) assist the Appellant. Property A was purchased with a sitting tenant and could be sold with a sitting tenant. For a commercial property, an existing tenancy at market rent may have little impact on its resale value.

Expiry of the Existing Tenancy

26. The Existing Tenancy was for a term of 2 years expiring on 31 March 2006. We asked Mr Li representing the Appellant whether Company F gave notice of termination or whether there was any negotiation for the renewal of the tenancy. Pursuant to this request, the Appellant produced to this Board a letter dated 22 February 2006 from Company F's property agent to Mr C's secretary, Ms G, which asked to 'contact with you about the lease of the premises which will expire on 31/Mar/2005 [sic].' This letter leaves open the question whether Company F left of its own accord or whether there was any discussion about the renewal of the tenancy. The Appellant could have called Ms G to clarify the point but did not. This lack of evidence adds to our doubt whether the Appellant genuinely sought to continue to rent out Property A after March 2006.

The search for new tenants

27. The Appellant alleges that it had actively sought for new tenant before and after the Existing Tenancy expired. In support of this allegation the Appellant rely on copies of advertisements of Estate Agent C published in Newspaper H. These advertisements cover the periods from 27 February 2006 to 24 April 2006. They were in Chinese. Each of them contained advertisements for lease of a number of different office units. At a prominent position on the left hand side under the heading 'sole agency' one finds an advertisement for lease of a unit at Building A, approximately 2,615 square feet, with full sea view, decorated and vacant at @30 approximately. The advertisement did not identify Property A. For this reason the Deputy Commissioner did not accept the copy advertisements as evidence of the Appellant's intention to continue to rent out Property A.

28. The Appellant in ground 8 of the grounds of appeal alleged that: 'this is practice of property market that the exact addresses of the letting properties are not shown in the advertisements (see other properties in the same advertisements). The Company confirmed that those property features (that is 2,615 square feet A\and sea view etc) are referring to the subject Property for lease.'

29. If the Appellant wanted to rely on market practice, it should have called evidence to substantiate such practice. Besides if instructions were given to Estate Agent C

to relet Property A, one would expect the estate agent to have records of such instructions, whether in the form of a proper written instruction or in the form of computer records. Estate Agent C is a prominent estate agent in Hong Kong. It must have a system for keeping records. Given Mr C's position in relation to Estate Agent C, he should have no difficulty in procuring the necessary records or in procuring the agent responsible for letting out the property to give evidence before us. The copy newspaper advertisements are clearly unsatisfactory. We are not persuaded that the Appellant had made any genuine effort to relet Property A.

The circumstances in relation to the sale of Property A

30. In paragraphs (8) and (9) of the Appellant's letter of 15 November 2007, the Appellant alleged the followings:

> ' The Company has no intention for selling the Property, as evidenced by the continuous and proactive efforts in seeking new tenant (see point (7)(v) above). On 3 May 2006, [Company E] which was situated at ... Building A and next to the subject Property (see floor plan at Appendix 7) enquired and inspected the Property seeking for investment opportunity. Instead of renting the Property, [Company E] offered a very high price of around $25M for buying the Property (i.e. $9,500 per square feet).
>
> The Company considered that this was a very high price too good to refuse, as it represented a capital return of 40% of the original investment (purchase price of $6,800 per square feet as compared to $9,500). In view of the circumstances, the Company decided to sell the Property, and signed the provisional sale agreement on 6 May2006 (See Appendix 2). The buyer, [Company E], did let out the property for rental income after the acquisition.'

31. In paragraph (10) of the same letter, the Appellant continued as follows:

> ' (a) The sale was triggered by an unsolicited offer received from a neighbor next to the subject Property, i.e. [Company E]. ...
>
> (b) There is no appointment for sale, which was triggered by an attractive and unsolicited offer from [Company E]. ….'

32. In reply to the IRD's request for further information, the Appellant in a subsequent letter of 20 January 2009 stated as follows:

> ' <u>Any action for the sale of the Property</u>
>
> (8) Except for reviewing the offer made by [Company E] (see below), our client confirms that the Company had not taken action to sell the Property during the period from 14 September 2004 to 8 May 2006.

[Company E]

(9) [Company E] *first* approached the Property Agent for the sale of the Property on 3 May 2006.

(10) & (11) [Company E], which was situate next to the Property and, represented by [Mr E], Director and Alternate Chief Executive of [Company E], contacted the Property Agent and inspected the Property on 3 May 2006. [Mr E]'s contact details are as follows: …..

(12) Our client advises that there is no record of document signed for viewing the Property. [Company E] immediately decided to buy the Property after the above inspection and signed [the Provisional Sale Agreement] on 6 May 2006.

(13) The price offered by [Company E] on 3 May 2006 was HK$24,642,500 (i.e. HK$9,500 per sq. ft* 2,615 - *see* point (8) of our letter dated 15 Nov 2007) and the final price was HK$25,365,500 (i.e. HK$9,700 per sq. ft * 2,615). ...'

33. The allegations in these letters quoted above were clearly made to give the impression that the offer to sell Property A was a totally unsolicited offer. It was Company E who took the initiative to approach the Appellant and the price of $9,500 per square feet was set by Company E and not by the Appellant.

34. These allegations were subsequently proved to be far from true. The Tax Assessor took the step of writing to Company E for information and obtained the following answer (as per Company E's letter of 18 July 2008):

' 1. It was through advertisement leaflets (as attached) placed with our reception area that we were aware that the property next to our office was for sale in May 2006.

2. Through the information provided in the leaflet, we approached the contact person therein.

3. We initially offered HKD23,800,000.00 and HKD24,842,500.00. The final completion price was HKD25,365,500.00 which was agreed upon the revised upwards to on 6 May 2006.'

35. The advertisement leaflet enclosed with Company E's letter ('the Advertisement for Sale') was in English and Chinese. We quote the part in English below:

Date: 3-5-2006		
	Office for Sale	
		Subject to contract & Availability
Property	:	[Property A]
Area		Approx. 2,615 sq. ft. (Gross)
Building Completion		1980
Price		HK$25,627,000 (i.e. HK$9,800)
Mgt. Fee		HK$5.10 per sq. ft. (Include AC Charge)
View		Full Sea View
Decoration		Fully Fitted
Payment Terms		To be mutually agreed
Agency Fee		1% of purchase price shall be paid by the purchase to [Estate Agent C]
Remarks		Rent @29
For details, please contact [Estate Agent C] Ms J [mobile number]		

36. So quite contrary to the Appellant's allegations, the information obtained from Company E revealed that:

(1) The Appellant took active step to sell Property A by issuing and distributing the Advertisement for Sale.

(2) The Advertisement for Sale advertised for sale only, not for sale or lease.

(3) The price of HK$25,627,000 (that is HK$9,800 per square feet) was set by the Appellant, not by the purchaser.

(4) Company E did not immediately offer to buy. There was a negotiation of the price but the Appellant maintained their asking price.

37. Armed with the information from Company E, the Tax Assessor wrote to the Appellant by letter of 10 February 2009 to ask for clarifications. The Assessor informed the Appellant that she had information which indicated that Estate Agent C had printed a leaflet

dated 3 May 2006 for the sale of Property A at an asking price of HK$25,627,000. The Advertisement for Sale was not supplied to the Appellant.

38. The Appellant replied by letter of 14 March 2009 and elaborated on its allegations as follows:

> ' As explained in our letter dated 20 January 2009, [Company E] (through its representative [Mr E]) situated next to the subject Property contacted the Property Agent and inspected the Property on 3 May 2006. Our client clarifies that [Company E]'s representative enquired about purchasing the Property in person on that date.
>
> According to our client's understanding, the Property Agent arranged an open day for property inspection on 3 May 2006. [Company E] staff passed by and viewed the subject Property on 3 May 2006 and thereafter on the same date, [Mr E] ([Company E]'s Director at that time) inspected the Property. [Company E] decided to buy the Property and signed the provisional sale agreement on 6 May 2008.
>
> …....
>
> (a) Regarding action to sell, our client has no records of the leaflet dated 3 May 2006 you mentioned in your above letter. Our client requests that a copy of the leaflet be sent to our client for reference.
>
> (b) It is not uncommon for property agent to invite offer from buyer to purchase property though the property is offered for lease. Without prejudice, this might be the situation such that the Company's Property Agent had arranged open day on 3 May 2006 as mentioned above that it also invited offer from potential buyer while the Property is offered for lease.'

39. So the Appellant maintained its stance that it was an unsolicited offer by Company E to buy. In addition the Appellant seemed to suggest that if there was any offer to sell, it was made by the estate agent without instruction. We cannot accept any of these allegations. The Advertisement for Sale did not mention any open day. Nor did Company E mention any open day in their letter of 18 July 2008. The Advertisement for Sale was not an advertisement for sale and lease. It was an advertisement for sale alone. And we see no reason why the agent Ms J should choose to offer Property A for sale contrary to her client's instruction, especially when the client was 'the big boss'.

40. We take a very dim view of these repeated false allegations made by the Appellant. It was the duty of the Appellant to supply the IRD with true and accurate

information. The Appellant carried on no other business activities except those relating to the purchase, lease and sale of Property A. If Company E could produce the Advertisement for Sale, we see no reason why the Appellant could not. If Company E could provide information about the sale including negotiation of the price, we see no reason why the Appellant could not. Estate Agent C is a substantial organisation. Mr C was the chairman and managing director of Company C, the parent company of Estate Agent C. Ms J was not working for an ordinary client. She must have records of the sale. We fail to see how the Appellant could allege facts so removed from the truth. Ms J was not called to explain.

41. Not only was there no attempt to explain how the Appellant came to make the false allegation, the Appellant tried to argue in ground 15 of the grounds of appeal that the Advertisement for Sale merely proved a change of intention from investment to trade on 3 May 2006. It maintained that the intention prior to that was only to rent out. We cannot accept this argument. This is another attempt by the Appellant to change its stance to suit the evidence. We are not persuaded that the Appellant had made any genuine effort to relet Property A. We are not persuaded that the intention to sell only arose on 3 May 2006. We find that from the day of purchase the intention was to resell Property A for profit.

The Appellant's financial capability to hold Property A on a long term basis

42. Grounds 3, 4, 5, 6 and 8 of the grounds of appeal were devoted to the Appellant's financial capability of holding Property A on a long term basis.

43. The purchase price of Property A was financed 50% by the Bank D Loan and 50% by a loan from Mr C in the form of an interest free director's loan. The rental income was sufficient to cover the mortgage payment under the Bank D Loan until there was an increase in interest rate. After that there was a small shortfall which was covered by further interest free loans from Mr C. The Appellant argued that Mr C was of sound financial means and would have no difficulty in continuing to provide funding to the Appellant if necessary. Further if Property A was relet at $30 per square feet the more than two-fold increase in rental income would have well covered the whole mortgage payment without any injection of fund from Mr C.

44. We accept the Appellant's arguments. But this does not affect our finding above of an intention to trade. Mr C might have sufficient means to hold Property A for a long term if necessary, but we do not accept that his intention was to hold Property A long term.

Hong Kong Property Reviews

45. Miss Chan representing the IRD referred us to various parts of the Hong Kong Property Reviews 2005 to 2007 published by the Rating and Valuation Department. She argued that they showed a strong uptrend in the property prices of offices in Grade A commercial buildings starting from the latter half of 2003 and continuing into 2005 whilst the rental yield experienced a drop in comparison. Mr C with his experience in the estate

agent business would certainly look to the surge in price as opposed to the moderate increase in rental income for profit.

46. While there is some force in Miss Chan's argument, we do not wish to rely on market trends to come to our findings.

Chairman's Statements and Newspaper Report

47. Miss Chan further referred us to various parts of the Chairman's Statement contained in the Annual Reports of Company C from 2004 to 2006. There is also a newspaper report of an interview given by Mr C to Newspaper H in January 2004.

48. We accept that Mr C's view of the property market in general may throw light on his intention regarding Property A. But Chairman Statements and newspaper interviews may not reflect his true personal view. These might be useful materials for cross-examination had Mr C chosen to give evidence. As they are, we do not think much weight can be placed on them.

Mr C's other property dealings

49. There is before us evidence of other property dealings by Mr C. Whether and how Mr C has traded in other properties is a relevant consideration. But these other property dealings involved companies not solely owned by Mr C. We do not know if and how far Mr C was the directing mind behind these other property dealings. We do not find evidence of these other property dealings assists our present considerations.

Conclusion

50. In summary we rely on the followings:

(1) The Appellant stated in its grounds of appeal that the intention was to invest. But this stated intention was not supported by oral testimony or tested by cross-examination.

(2) We have no contemporaneous record of this stated intention.

(3) The audited accounts 2004/05 were non-contemporaneous and self-serving.

(4) Property A was rented out and was income producing during most of the holding period. But this was not inconsistent with an intention to sell. Property A was sold soon after the Existing Tenancy expired. The holding period was 20 months. It was a relatively short period in the circumstances.

(5) We are not persuaded that the Appellant had made any genuine effort to let or relet Property A.

(6) We do not accept the Appellant's allegations surrounding the circumstances of the sale. We do not accept that the offer to sell was an unsolicited offer from the purchaser. We find that the Appellant took positive step to sell Property A. We are not persuaded that the intention to sell only arose on 3 May 2006.

51. On the facts and circumstances examined above, we find that the Appellant purchased Property A with the intention of disposing of it at a profit. The Appellant did not intend to hold Property A as a permanent investment. The sale and purchase of Property A amounted to the carrying on of a trade and Property A was not a capital investment. Further or alternatively, we find that the Appellant has failed to prove its alleged intention of holding Property A as a capital investment. The Appellant has not discharged its onus of proving that the assessment appealed against is excessive or incorrect. The Profits Tax Assessment for the years of assessment 2004/05, 2005/06 and 2006/2007 are hereby confirmed.

52. Under section 68(9) of the IRO this Board may order the Appellant to pay as costs of this Board a sum not exceeding $5,000. We think this is a suitable case to award costs against the Appellant in the sum of $5,000 and we so order.