

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D30/95

Profits tax – sale of residential flat – whether profit was capital gain not assessable to profits tax.

Panel: Howard F G Hobson (chairman), Vincent Liang Wan Sang and Eleanor Wong.

Dates of hearing: 28 March and 7 April 1995.

Date of decision: 14 June 1995.

The taxpayer purchased a used partly furnished flat. When purchasing the flat he informed the estate agent that he wished to purchase it for rental purposes and after purchasing the flat attempted to let it for rental purposes. The taxpayer was unable to lease out the flat and decided to sell it. At the same time he purchased another new flat which he successfully let out.

Held:

The taxpayer had satisfied the Board of Review that he bought the old flat with the intention of renting it out. The profit or gain was a capital gain not assessable to profits tax.

Appeal allowed

Cases referred to:

Lionel Simmons Properties Ltd v CIR 53 TC 461

Wisdom v Chamberlain 45 TC 92

D32/85, IRBRD, vol 2, 204

D81/90, IRBRD, vol 5, 113

May Chan for the Commissioner of Inland Revenue.

Taxpayer in person.

Decision:

The Taxpayer was assessed to tax for the year of assessment 1991/92 upon profits made on the sale of a residential flat. It is the Taxpayer's case that the profit was an untaxable capital gain. The Taxpayer represented himself, Miss May Chan appeared for the Commissioner.

INLAND REVENUE BOARD OF REVIEW DECISIONS

The Facts

The following are lifted from a statement of agreed facts, augmented by such of the sworn testimony presented to us as we consider was either unchallenged or stood up to cross-examination, and therefore accepted by us as findings of fact.

1. The Taxpayer is a bachelor and a certified public accountant. At the relevant time he lived with his younger sister successively in two rented apartments in Place A. The first flat was rented from 1 January 1990 to 31 December 1991 at \$4,100 per month, the second flat was rented originally from 1 January 1992 to 31 December 1993 and then from 1 January 1994 to 31 December 1995 both lettings being at \$10,500 per month.
2. On the 22 April 1991 the Taxpayer entered into a provisional agreement to purchase Flat X (the subject property) for \$1,410,000. That flat, of about 919 square feet was about three years old, was partially furnished and had been used by the owner for renting out but at the time of the provisional agreement it was unoccupied; it was near to a ferry terminal. The estate agent through whom the Taxpayer's purchase was arranged was Miss I of Company Q, a partner of Company Q. We find as a fact that at the time of the provisional agreement the Taxpayer Miss I that he wanted to let the property out when the purchase was completed. Completion took place on 23 May 1991.
3. The Taxpayer produced \$150,000 of the purchase price from his own savings, the remaining \$1,260,000 was provided by Bank R secured by a mortgage on the subject property providing for repayment by 144 monthly instalments with interest at prime plus 1.25%.
4. Shortly after completion the Taxpayer instructed Company Q to look for a prospective tenancy. Miss I showed at least three prospective tenants around the subject property. One of these was a Mr J who responded to a newspaper advertisement by Company Q. He saw the flat twice and agreed to rent it. Company Q drew up the tenancy agreement which provided for a deposit. Mr J and Miss I attended at the Taxpayer's own office where the agreement was signed, however Mr J did not have his cheque book so the agreement was held in escrow by Company Q pending payment of the deposit. Despite being pressed by telephone by the Taxpayer and Miss I, Mr J failed to produce the required deposit. The Taxpayer thereupon instructed Miss I to treat the deal as abortive and destroy the agreement, which she did.
5. On 16 August 1991 the Taxpayer entered into a provisional agreement to buy Flat Y in Place C then in the course of construction at \$1,788,000 with completion scheduled for about mid 1992. This purchase was financed as to \$358,000 from the Taxpayer's own money and as to \$1,430,000 by way of a mortgage repayable by 412 biweekly instalments of \$7,019 each with interest rates (i) before the issuance of the occupation permit of 0.5% below the prevailing residential mortgage rate (that is prime + 0.75%) (ii) after the issue of the occupation permit of 0.25% below the said prevailing rate unless the

INLAND REVENUE BOARD OF REVIEW DECISIONS

property was leased out in which case the rate would be 2.25% over the best lending rate.

6. On 21 September 1991 the Taxpayer entered into a provisional agreement to sell the subject property for \$2,100,000. That sale was arranged by Company S and completed on 23 October 1991. After allowing for the cost of the purchase, legal and agency fees, mortgage interest and charges for early redemption, advertising, rates and management fees the net profit to the Taxpayer was \$540,176, which is the amount of the assessment and the subject of this appeal.
7. The purchase of Flat Y was completed on 10 June 1992. Some five months later the Taxpayer let that apartment out for a period of two years from 10 November 1992 at \$7,000 per month. On expiry that tenancy was renewed for a further two years at \$11,100 per month.

Oral evidence

The Taxpayer gave evidence on oath. He told us, as he had maintained in his original explanations to the assessor, that he had bought the subject property because he wanted to own his own home but was afraid that due to the then escalating prices in the property market if he kept on waiting until he found the ideal residence he would not be able to afford it. The predominant purpose was to get a foothold in the market by buying, as a hedging vehicle to safeguard his purchasing power, a nice flat at a price he could manage in an acceptable area not too far from commercial centres such as Tsimshatsui or Hong Kong Central. He did not select the subject property with a view to it eventually becoming his permanent residence though it was one in which he felt he could reside if he needed to do so: as he put it that was 'the last reason' on his list. He thought that if he owned a flat it would improve his marriage prospects once he decided to get married. He believed that in waiting to find the ideal apartment before committing himself he risked price rises outstripping his purchasing power. His strategy on acquiring the subject property was to rent it out. Though he had not made a detailed study of the rental returns to be expected at Place B where the subject property was he had studied newspaper advertisements and judged that he could expect to get a return of about 8% or 9%. He decided to buy property in Place B because he had noticed that the prices there were lower than these in the city areas such as Taikoo Shing. On his first visit to Place B he did not contact any agents. On his second visit he saw several properties suggested by Mr K of Company Q. Having seen the subject property he made up his mind a few days later when the price was agreed. He instructed four estate agents (all of whom he named, which included Company Q) to try to find a tenant. His former boss, who lived in Place B, also advertised the flat for let by putting a notice on the communal notice board.

While waiting for a tenancy to be arranged he visited the flat many times, arranging club membership, utility facilities, collecting mail, carrying out cleaning etc and came to realize that Place B was more inconvenient than he had originally thought.

He believed the rent which Mr J had agreed to was between \$10,000 and \$11,000; he thought the period was one year. After that deal fell through the Taxpayer did not withdraw the instructions he had given to the four estate agents to look for tenants.

INLAND REVENUE BOARD OF REVIEW DECISIONS

In August 1991 he saw an advertisement concerning the balloting of flats to be developed at Place C and decided to apply and if he was successful he would then 'exchange the property', meaning he'd sell the subject property. Of his reasons for this exchange the main ones seem to be that Flat Y involved lower outgoings during the 10 months until its occupation permit compared with the subject property if it continued to be unlet, the relative convenience of the location of Place C and the belief that this factor would prove to be attractive to tenants. He also believed that as he was buying from the developer the flat would be more valuable when completed. His intention regarding the use of Flat Y was the same as for the subject property. Although he signed the provisional agreement for Flat Y before he had sold the subject property he said if he could not sell the latter he would move into it thereby saving rent at Place A.

Although Flat Y was about one third smaller than the subject property he deliberately chose one of the small flats at Place C because he could not know at the time what he would get for the subject property when, assuming he was successful in the ballot, he put it up for sale. He mentioned that to avoid the mortgagees imposing higher interest rates he did not advise them that he was letting out the mortgaged properties. In the event he used the balance of the proceeds of sale remaining after the \$358,000 he used for Flat Y in the purchase of a property in China, which he still owns.

It took the Taxpayer about five months before he was able to find a tenant for Flat Y but his outgoings during that period were much less than they would have been for the subject property during a similar period of vacancy. He paid tax on the rent received for Flat Y.

In response to a question from the Board the Taxpayer said he had owned a flat in Place D in about 1982 which he had rented out, he sold it four years later, the sale was not the subject of a profits tax assessment.

The Taxpayer was cross examined quite thoroughly and properly by the Commissioner's representative but we saw nothing in his answers which to any serious degree cast doubt upon his evidence in chief or the representations he had made in his correspondence with the Revenue.

Miss I in her evidence confirmed the abortive tenancy of Mr J and much of the evidence given by the Taxpayer about his expressed purpose in buying the subject property. She said she thought the agreed rent for Mr J's letting was about \$9,000 or \$10,000 per month and the letting was for one year plus one year. She mentioned that after Mr J's deal fell through Company Q continued to show potential tenants the subject property but no one made an offer. We accept the truth of Miss I's evidence.

Submissions

Based upon the evidence given by the Taxpayer and his demeanour during the hearing and the lack of any serious inconsistency with his correspondence with the Revenue we accept that he bought the subject property with the intention of letting it out. We do not therefore propose to review the contentions of Miss Chan with regard to that issue.

INLAND REVENUE BOARD OF REVIEW DECISIONS

We concur in Miss Chan's observation that the fact that a property is bought and let out does not preclude the possibility that the letting is only a temporary expediency, that is, the letting is not per se incompatible with an intention to trade. The question is 'Was it [the subject property] acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment?' (Lionel Simmons Properties Ltd v CIR 53 TC 461 at page 491)

In response to this the Taxpayer reminded us of the words of Lord Wilberforce in the Simmons case:

'A permanent investment may be sold in order to acquire another investment thought to be more satisfactory; that does not involve an operation of trade, whether the first investment is sold at a profit or at a loss.'

As regards the Taxpayer's main reason for buying the subject property, namely as a hedge against inflation, Miss Chan cited the case of Wisdom v Chamberlain 45 TC 92 which was concerned with an accountant who, acting on behalf of Mr Norman Wisdom (an English comedian who enjoyed considerable success at the time, about the early 1960's), bought silver bullion, largely with money borrowed from brokers at high interest, because Wisdom was afraid that the pound sterling was about to be devalued which he believed would adversely affect his wealth. The details need not be recited here, suffice it to say that the first venture lost money but the second made a large sum which the General Commissioners concluded were transactions in the nature of trade. Miss Chan particularly drew attention to the following passage in the ruling of Norman L J in the appeal against the decision of Goff J in the court of first instance:

'Therefore, the learned Judge held, as I understand it, that because it was a hedge against devaluation it was not a trading adventure; and, notwithstanding the other findings of the Commissioners, he held that, if they had rightly appreciated the facts, that was the conclusion to which (as I think he would have said) they must have come.'

'For myself I cannot take that view at all. In the first place, it seems to me that, supposing it was a hedge against devaluation, it was nevertheless a transaction entered into on a short-term basis for the purpose of making a profit out of the purchase and sale of a commodity, and if that is not an adventure in the nature of trade I do not really know what is. The whole object of the transaction was to make a profit. It was expected that there would be devaluation, and the reason for wanting to make a profit was that there would be a loss on devaluation; but that does not make any difference, it seems to me, to the fact that the motive and object of the whole transaction was to buy on a short-term basis a commodity with a view to its resale at a profit. That, as it seems to me, is an adventure in the nature of trade, and I think the Commissioners so found as regards the first transaction as well as the second.'

INLAND REVENUE BOARD OF REVIEW DECISIONS

In reply to this the Taxpayer says it was not his intention to sell within a short period nor to make a short term profit and cited the words of Salmon L J which appear shortly after the above quotation:

'The evidence shows clearly that it was because of his expectation that devaluation would probably come that he entered into the transactions in question. He did not sell out the Respondent's assets: he did not dispose of his Government securities and stocks and shares and redeploy those assets by investing the proceeds in silver. If he had done so, the case might have been quite different.'

For our part we think the distinguishing feature between the facts of Wisdom's case and those before us is this. It was never Wisdom's intention to keep the silver but to resell it when the pound devalued which he thought would be soon at a profit or dispose of it at a loss if devaluation did not occur : in short the subject matter of and the circumstances, for example high interest rate and the short period of credit surrounding the purchase, presupposed a quick trade. On the other hand the purchase of real estate is not of itself an indicia of trading. The 'hedging' of which the Taxpayer spoke was of a different character to that in Wisdom's case: the latter involved protection against loss by making a trading profit whereas the claimed intention of the Taxpayer was to buy before it became too late.

Miss Chan next referred to D32/85, IRBRD, vol 2, 204, however the circumstances of that case are so different from those before us that we are unable to derive any assistance from it. In the other Board of Review decision to which she referred D81/90, IRBRD, vol 5, 113, the taxpayer's co-venturer did not join in the appeal but instead paid tax on his share of the profits and the Board did not accept the taxpayer's evidence, we do not think therefore that it offers any help either.

Miss Chan referred to the short period of ownership of the subject property as an indicia of trading. Granted that needs explaining and the explanation given by the taxpayer, and accepted by us, is that he calculated that it would be financially better to change his investment to Flat Y which he managed to let out and continued to do so.

Conclusion

The Taxpayer has convinced us on the balance of probabilities that he bought the subject property with a view to obtaining a base in the property market, before it became too expensive, with the intention of renting it out until such time as he found another property which he wanted to occupy as his home whereupon he would use the proceeds of the former to finance the latter. In the event he experienced difficulty letting the subject property and that fact coupled with the Flat Y advertisement set him to thinking about reducing his outgoings at least for the building period, by applying to buy a flat there where he believed the chances of letting were greater than at Place B and if his application succeeded he would sell the subject flat. In short we accept that the subject property was not bought with the intention of selling it by way of an adventure in the nature of trade.

We therefore allow this appeal and direct that the 1991/92 assessment be annulled.