

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D31/95

**Profits tax** – sale of residential flat – whether capital gain or assessable profit.

Panel: Howard F G Hobson (chairman), Ambrose Lau Hon Chuen and Herbert Hak Kong Tsoi.

Date of hearing: 28 February 1995.

Date of decision: 14 June 1995.

The taxpayer purchased a residential flat in the course of construction. Shortly afterwards the taxpayer sold the flat at a profit. The taxpayer submitted that the flat had been purchased with a view to being a long term investment for rental purposes.

Held:

The length of the period of ownership was short and without convincing evidence of the reasons for an early sale is indicative of trading. The evidence given to the Board was not sufficient to discharge the onus of proof and accordingly the appeal was dismissed.

### **Appeal dismissed**

Cases referred to:

Marson (Inspector of Taxes) v Morton [1986] 1 WLR 1343  
Commissioner of Inland Revenue v Reinhold 34 TC 389  
Taylor v Good (H M Inspector of Taxes) 49 TC 277  
Commissioner of Inland Revenue v Dr Chang Liang-Jen [1977] HKTC 975  
Simmons v CIR STC 350  
All Best Wishes Limited v CIR 3 HKTC 750

Wong Ki Fong for the Commissioner of Inland Revenue.

Taxpayer represented by her husband.

### **Decision:**

This decision deals with an objection raised by a taxpayer against a tax assessment for the year of assessment 1991/92 upon the profits she made on the sale of Flat A. It is her case that the property was bought as a long term investment.

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The Taxpayer was represented by her husband, Mr X who acknowledged his unfamiliarity with the conduct and requirements of Boards of Review. The Commissioner was represented by Miss Wong Ki-Fong.

### 1. Primary Facts

The following are those facts which we believe were accepted by both parties:

- 1.1 On 8 March 1991, the Taxpayer entered into a provisional contract to purchase Flat A, then about to begin construction, for \$1,381,000. The developer offered the flat for sale under two alternative payment schemes, the first being 10% down followed shortly by payment of the remaining 90% and the second being instalment payments with the last instalment (70%) to be made after completion of the flat, which was estimated to take place in July 1991.

The Taxpayer chose the first payment scheme and arranged for Bank G to finance \$1,242,900 of the purchase price which is to say 90% secured by an equitable mortgage under which the Taxpayer was required to make monthly payments commencing in April 1991. As no copy of the mortgage was produced to us we assume that as is commonly the case with equitable mortgages these payments included principal repayment instalments as well as interest, we do not however consider the point to be significant. The Taxpayer herself provided the \$138,100 (10%) difference between the purchase price and the mortgage amount.

The Taxpayer paid monthly mortgage interest from April 1991 to January 1992 inclusive of amounts ranging from \$10,357.50 to \$8,466.66.

The Taxpayer took possession of Flat A on 3 August 1991.

- 1.2 On 6 November 1991 the Taxpayer entered into a provisional contract to purchase another apartment then about to be built namely Flat B for \$1,394,000 largely financed by an equitable mortgage along lines similar to the Bank G equitable mortgage for the property.

- 1.3 By an agreement of 17 December 1991, the Taxpayer agreed to sell Flat A for \$2,130,000 which sale was completed on 4 January 1992. The gross profit on the sale was \$749,000. After allowing for mortgage interest payments, stamp duties and other deductibles the profit for tax purposes was assessed at \$582,330. The appeal is against the imposition of profits tax; the calculation of the net gain does not of itself give rise to any argument.

- 1.4 Possession of Flat B, which is within phase two of that development, was given to the Taxpayer on 13 June 1992.

- 1.5.1 On 28 February 1992 Company H, a Hong Kong company owned jointly with her husband, entered into an agreement to purchase Flat C for \$5,500,000 where she and her family now live, having moved in on 1 July 1992. Flat C

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was purchased with the aid of a mortgage from Bank I, the monthly payments were about \$40,000. The employer of the husband of the Taxpayer either paid Company H a rent of about \$43,000 per month (inclusive of rates and management fees) or refunded the husband that amount which he paid as rent to Company H: it makes no difference to the issue before us which alternative was actually adopted.

1.5.2 Before the purchase of Flat C, the Taxpayer and her family lived in Flat D on the same building which was rented at \$33,000 per month, which rent had also been borne by her husband's firm.

1.6 On 2 October 1992 the Taxpayer sold Flat B for \$1,615,000 yielding a gross profit of \$221,000 which after taking account of mortgage payments and other expenses netted out at \$32,166.55. From the date possession was given in June until it was sold this apartment was evidently never occupied by the Taxpayer and as no evidence was given to that effect we assume it was not decorated or furnished.

### **2. Taxpayer's Testimony**

2.1 The Taxpayer gave evidence on oath and told the Board that she had been in Country P for several years as a student and met her husband while at university there. She returned to Hong Kong in 1986 and was employed successively by two companies. By end 1990/early 1991, she had some savings and considered she was on a salary sufficient to buy a property. (Though she was unable to recall her salary at the relevant time her employer's return for the year of assessment 1991/92 showed an annual salary of \$450,490 and bonus of \$38,370.) She decided to buy a flat to rent out as a way of protecting her assets against inflation. Flat A appeared to meet her requirements and was within her budget. She expected to get a monthly rent of between \$8,000 to \$10,000 based she said, on prices she saw advertised on lamp posts in the area.

2.2 She said she chose the equitable mortgage purchase method because it meant that except for variations in monthly interest rates she knew in advance what her monthly payments would be, unlike the other payment method which could present her with stage payments at short notice. She said the mortgage provided for a prepayment penalty of one month's interest if the property was sold before the expiration of the mortgage term. Though we could not verify this we accept that such penalties are quite common. Nevertheless as the penalty was not claimed as a deduction from the gross profits referred to at 1.6 above, we are unsure whether the mortgagee waived it or the Taxpayer overlooked it.

2.3 The Taxpayer's viva voce testimony as to her efforts to rent out Flat A was entirely lacking in clarity. In effect she reiterated what she had said in her letters to the Revenue, from which the following are verbatim excerpts:

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4 July 1993 letter

‘Subsequently, when I took possession of Flat A in August 1991, I have learnt from other flat owners that it is very difficult to rent the units in this development for a reasonable rental return.’

23 April 1994 letter

‘Since I took possession, I made use of the agents that put their name-card in the mailbox and advertisements in the neighbourhood street lamp-poles to seek for possible tenant. Because I did not know them, telephoning back and forth, asking the same questions each time became very time consuming and sometimes distributing my work too.’

She told us that of the agents she spoke to she could only recall the name of Company J and said that she told them and the other agents that the flat was immediately available and she expected \$8,000 to \$10,000 rent.

The Taxpayer told us that after possession in August 1991 she visited Flat A occasionally to open her mail box which was bulging with letters from estate agents. She began by telling us that she learned from gossiping with people that there were a lot of empty units, later she said she saw they were empty because they had no curtains and there were posters in the windows.

2.4 She told us that as the months passed without getting a tenant, she was becoming ‘desperate’ and ‘distracted’ and saw little prospect of being able to rent the property out over Christmas and Chinese New Year.

2.5 The reasons given to the Revenue for deciding in December 1991 to enter into the agreement to sell Flat A are:

4 July 1993 letter

‘When I heard that a flat on the same building where we rented our home was for sale, what is better for the whole family to move into a flat that is in the same building, without any change of neighbourhood & environment for the adults and children. Without any hesitation I sold Flat A on January 1992 and bought the old flat at the above address to live in.’

9 September 1993 letter

‘After I took possession of Flat A in August 1991. I was not able to rent it out. In the meantime, I heard that Flat C was on sale which is more popular in the rental market.’

It is convenient to point out here (rather than later) that the above quotations are not wholly consistent with the suggestion that it was the inability to rent out Flat A which convinced her to sell. When asked whether the prospect of

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purchasing Flat C had anything at all to do with selling Flat A she said 'Yes' but the reasons she gave for this answer were difficult to follow. Perhaps she was trying to tell us that it was lack of letting interest coupled with constant solicitations from estate agents that first inclined her to consider selling which consideration hardened into a firm decision on learning of the possibility of buying Flat C, if so it is regrettable that she did not get this point over to us. We found her testimony so muddled we are not prepared to draw an inference along the foregoing lines. The reference to 'more popular in the rental market' is slightly disingenuous since any letting by Company H would be back to the Taxpayer's husband or his employer and hence popularity could not really have figured as an inducement to buying.

2.6 In her letter to the Revenue on 12 May 1993, the Taxpayer said 'very little cost was incurred with regard to decoration of Flat A'. In cross examination she said there was no such expenditure.

2.7 The Taxpayer told us that the reason for the purchase of Flat B was that when she entered into the agreement to purchase that property it had not been built but she expected that it would prove to be a rural 'resort home' with facilities such as swimming pools – to be enjoyed by herself, her husband and their infant children.

2.8 In her letter of 4 July 1993 the Taxpayer's reason for selling Flat B was that Flat C, an old property, 'needed a large sum of money for renovation'. 'Therefore on 2 October 1992, I have to give up my dream of having a resort home in the New Territories, I sold Flat B.' (In her testimony she said that Company H's contribution to that expenditure was \$300,000, and her husband's employer provided a similar sum.) We were later given the impression that the redecoration expenses were incurred after the proceeds of sale of Flat B were received but the point was not made with any clarity.

However in her testimony additional reasons were given, '... when I took possession it was quite a disappointment it is just a very crowded place.', that she had no car and that a friend at a development company told her it was not a good investment and as the property market was not good she should sell even at a loss.

2.9 As regards equitable mortgage of Flat B, a statement the Taxpayer supplied to the Revenue showed monthly mortgage interest payments from December 1991 to October 1992 inclusive fluctuating between \$9,873.77 and \$14,572.32. As mentioned the developer gave possession on 13 June 1992. The Taxpayer gave no evidence as to any expense incurred on decorating this flat, we assume there was none.

We regret to have to say that the Taxpayer's viva voce testimony was in the main woolly and confused and often very difficult to follow.

### Submissions

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The following cases were cited:

By the Taxpayer:

Marson (Inspector of Taxes) v Morton [1986] 1 WLR 1343

Commissioner of Inland Revenue v Reinhold 34 TC 389

Taylor v Good (H M Inspector of Taxes) 49 TC 277

Commissioner of Inland Revenue v Dr Chang Liang-Jen [1977] HKTC 975

By the representative for the Commissioner:

Simmons v CIR STC 350

All Best Wishes Limited v CIR 3 HKTC 750

- 3.1 Miss Wong referred us to section 14 of the Inland Revenue Ordinance (IRO) which in material part reads:

*'..., profits tax shall be charged ... on every person carrying on a trade, ... in Hong Kong in respect of his assessable profits ... from such trade, ... (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part ...'*

'trade' is defined in Section 2 as including:

*'every trade and adventure, and every adventure and concern in the nature of trade'*

- 3.2 She then quoted the following passage from the opinion of Lord Wilberforce expressed in the House of Lords judgement in the Simmons case:

*'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 it at a profit, or was it acquired as a permanent investment?'*

- 3.3 Next she drew attention to the words of Mortimer J in All Best Wishes Limited case:

*'The intention of the Appellant, 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 Appellant was investing in it, then I agree. But as it is a question of fact, no*

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*single test can produce the answer. In particular, the stated intention of the Appellant 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 commonplace 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.'*

- 3.4 Miss Wong reiterated that by section 68(4) of the IRO the onus of proving to a Board of Review that an assessment to incorrect or excessive falls on the Taxpayer.
- 3.5 Of Miss Wong's submissions regarding the facts the following should be mentioned:
- 3.5.1 Purchase of property with a view to selling at a higher price can serve as an inflation hedge just as well as letting. Letting a property prior to sale is not decisive of an investment intention, it is not uncommon to let a property for intermediate income pending an opportune time to sell at a profit. The adoption of an equitable mortgage is not inconsistent with an intention to resell for a quick profit. The sale of the property after only 9½ months from possession calls for a convincing explanation.
- 3.5.2 The efforts at letting were insubstantial. Susceptibility to property agents' persuasion to sell Flat A indicates that the Taxpayer was never firmly committed to holding the flat for long term investment purposes.
- 3.5.3 The Taxpayer's conduct concerning Flat B shows a propensity to trading.

### **Submissions of the Taxpayer**

- 4.1 The Taxpayer's representative pointed out that the Commissioner gave only two reasons for concluding that the purchase and sale of Flat A amounted to a transaction in the nature of a trade. First 'The Taxpayer, being an accountant, should have done some research on the rental market and the reasonable income she could expect from the property before its acquisition'. Second '... the Taxpayer has failed to show that she had made any effort to solicit a tenant for the property.' Mr X's observation is correct, the determination is sparse, however we do not think the Commissioner is obliged to express his reasons in depth, it is enough that the reasons as set out are compatible with the facts. In the instant case the body of the determination makes no mention of Flat B nor of Flat C, and though they are referred to in the appendixes to the determination, it would seem that they had no impact which the Commissioner thought worth mentioning in his reasons. Nonetheless it does not seem to us that when an appeal comes before a Board of Review that the representative of the Commissioner is obliged as a matter of law, practice, custom or etiquette to confine himself to the approach and reasons to be found in the determination.

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This must be so because very often new evidence is adduced before Boards of Review and occasionally new case law may indicate that whilst a given finding was correct it was arrived at by the wrong route.

- 4.2 Mr X referred us to the nine badges of trade referred to in Marson v Morton (based upon the six items mentioned in the 1955 UK Royal Commission on taxation of profits) and quoted extensively from the judgement. He also took the point that old case law may have to be viewed in the context of the social attitudes and mores prevailing at the time.
- 4.3 The Rheingold case was support for the proposition that an admission that property is bought to resell is not of itself sufficient to fix the owner with entering into an adventure in the nature of trade.
- 4.4 He contended that Taylor v Good lent support to his argument that in the instant case the mere purchase of Flat A could not be treated as an adventure in the nature of trade.
- 4.5 Finally our attention was directed to Dr Chang's case where the Board of Review decided that despite the large size of Dr Chang's share portfolio and the number of his transactions he had not embarked upon an adventure in the nature of trade.

We think the real substance of Mr X's submission as applicable to the facts before us is this. Even if the Board were to conclude, contrary to her stated intention, that the Taxpayer bought Flat A with a view to reselling it, that conclusion of itself is insufficient to label the transaction as an adventure in the nature of trade. One must test the latter against the badges of trade, drawn from Marson's case, to which he had referred.

### **5. Deliberations**

- 5.1 The following is a chronological summary of relevant events:-

8 March 1991	Flat A Purchase Agreement.
3 August 1991	Possession of Flat A.
August 1991	Possibility of Flat C becoming available.
6 November 1991	Flat B Purchase Agreement.
17 December 1991	Flat A Sale Agreement.
4 January 1992	Completion of the sale of Flat A.
28 February 1992	Flat C Purchase Agreement.

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April 1992	Possession of Flat C.
13 June 1992	Possession of Flat B.
2 October 1992	Flat B Sale Agreement.

5.2 We agree with Mr X that intention alone is not decisive (Marson), though it must be present (Simmons), there must also be some characteristic indicative of an adventure in the nature of trade. That characteristic may be intrinsic to the article the subject of the purchase and sale: in their wisdom judges have found that neither toilet paper nor whisky are inherently investment media. We accept that an undecorated and unfurnished residential apartment in Hong Kong lacks any characteristic which of itself leads to a strong bias one way or the other. Certainly in Hong Kong for many years since developers built high rises for resale rather than letting buyers have been purchasing flats in the expectation of selling at a profit and that speculative activity can be said to have developed into a fairly identifiable type of business, one of the attractions of which is that so long as the buyer guesses right and property prices continue upward he need do nothing more than hold the property and in many boom periods simply wait for the estate agents to call him with offers. This business does not therefore require an administrative set up. But of itself a bare undecorated newly built flat is neutral.

5.3 We shall now consider the nine badges of trade as referred to by Sir Nicholas Brown-Wilkinson VC in Marson remembering that they track most of the six badges referred to in 1955 report of the Royal Commission on Taxation and that the list is not exhaustive.

- (i) 'Although a one-off transaction is in law capable of being an adventure in the nature of trade, obviously the lack of repetition is a pointer which indicates there might not here be trade but something else.' We are of the view that we are entitled to consider the subsequent purchase and sale of Flat B and if we believe that was in the nature of trade then we can take that into account in assessing the Taxpayer's attitude towards Flat A.
- (ii) Obviously the transaction of Flat A was not related to the Taxpayer's normal job. We do not however think this is particularly influential bearing in mind our earlier comments about Hong Kong's market in apartments.
- (iii) The nature of the subject matter. As mentioned we think Flat A, bare and undecorated, is neutral, but see (vi) below.
- (iv) Was the transaction of Flat A carried out in a way typical of trading? We do not think the method of purchase or sale would be any different for a long term investment.

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- (v) The source of finance was 10% from the Taxpayer and 90% by mortgage. Mr X said this method of buying was a factor more indicative of long term investment than of trading. We are inclined to agree that if a buyer purchases one flat in the expectation of disposing of it quickly before he has to produce the substantial 70% required under the other method of purchase he will not bother with a mortgage. If on the other hand he has in mind buying several flats for the same purpose he may decide to go for mortgages to increase his gearing. Or if though his intention is selling, he is concerned that the resale market might drop he may decide to take the 90% mortgage rather than risk the inability to get an adequate mortgage when the 70% falls due. Much therefore depends on the buyer's own capital situation. In this case we consider that the equitable mortgage system is ambiguous.
- (vi) No work was done on Flat A after the purchase. It seems to us that the Vice-Chancellor's example (second-hand machinery) regarding this badge is not appropriate to an apartment in Hong Kong. As we have said a bare flat of itself is neutral but, contrary to the suggestion in this badge that work done on the object of the sale may be indicative of an intention to sell, if the Taxpayer had chosen to decorate Flat A to make it more attractive, particularly as the letting market was said to be slack, we think that would have been more in line with letting than selling. In the latter case, unless the selling market turned adverse, there would be little point in decorating.
- (vii) This badge (resale in lots) does not arise.
- (viii) Our views as to the purchaser's intentions 'as to resale' at the time of purchase are dealt with later.
- (ix) We accept, the Taxpayer's statement that as the purchase was the first she had made she experienced a sense of excitement, but we do not think that pride played any part in the purchase of Flat A since it does not share the sort of uniqueness associated with a valuable painting or perhaps a chateaux.

5.4 The above badges do not include the 'length of the period of ownership' mentioned in the Commission's report. In the present case strictly speaking ownership lasted only 4½ months though if timed from the provisional agreement then it would be 9½ months. Either way it was short and without convincing evidence of the reasons for an early sale is indicative of trading.

5.5 Turning now to the question of the Taxpayer's intention at the time of purchase. We entirely agree with Miss Wong that the Taxpayer's evidence regarding attempts to let Flat A was lacking in substance. As to the reason for selling, according to her she did not decide to sell Flat A until early December 1991 when she says she gave in to the persistence of an estate agent. In other words, it seems we are to infer that the sale of Flat A was not precipitated by the

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need for cash to purchase or decorate Flat C as seems to be implied by the 4 July 1993 letter. What is far from understandable is the Taxpayer's decision, manifest in November 1991, to buy Flat B thereby taking on a second set of monthly mortgage payments, in the order of \$9,000 to \$10,000, at a time when not only was she experiencing difficulties with Flat A but also had become aware from about August of 1991 that there might be the happy prospect of Flat C becoming available. As mentioned Flat B formed part of phase two of that development which is proving to be one of Hong Kong's larger high rise developments. It must have been quite apparent from phase one of that development that phase two was not going to be a tranquil rural retreat. This leads us to believe and we so find as a matter of fact that Flat B was bought more with an eye to resale than occupation. Though the purchase and sale of that property is not in issue, as already mentioned we believe that our conclusion concerning that property is an aspect which can properly be taken into account when deliberating on the intention behind purchase of Flat A. In general the Taxpayer's testimony displayed considerable confusion of thought and though we certainly do not believe she was attempting to mislead us we think that her confusion of thought, when coupled to the short period of ownership and our finding regarding the later acquisition of Flat B, was indicative of an attitude which at the time of purchase of Flat A was ambivalent, that is to let or sell as the circumstances suited her, and we so find as a matter of fact. We also find that such an attitude is not consistent with a commitment to a long term investment.

We therefore find that the Taxpayer has failed to discharge her onus of proof and accordingly dismiss this appeal.