

INLAND REVENUE BOARD OF REVIEW DECISIONS

**Case No. D32/92**

Profits tax – property investment – whether long term investment – whether profit on sale a trading profit.

Panel: Howard F G Hobson (chairman), Roland Chow Kun Chee and Ambrose Lau Hon Chuen.

Dates of hearing: 9, 10, 12 and 13 March 1992.

Date of decision: 16 October 1992.

The taxpayer was a private company which purchased a site on which it erected a number of houses. It subsequently let out some of the houses and sold others. It appointed agents both for the purpose of sale and for the purpose of letting. The taxpayer was charged to profits tax on the profit which it made on the sale of the first houses which it sold. After a lapse of one year the taxpayer sold further houses which had previously been let and submitted that the profits or gains were made on the sale of capital assets.

Held:

The onus of proof is upon the taxpayer to show that the property was purchased as a long term investment. On an analysis of the evidence the taxpayer had failed to satisfy the onus of proof.

Appeal dismissed.

Cases referred to:

D11/80, IRBRD, vol 1, 374  
Richfield International Land v CIR 2 HKTC 444  
Marson v Morton 59 TC 381  
Harvey v Caulcott 33 TC 159  
Chinachem Investments Co Ltd v CIR 2 HKTC 261  
Central Enterprises Ltd v CIR 2 HKTC 240  
Cadwallader v Wheeler [1955] TR 265

Jennifer Chan for the Commissioner of Inland Revenue.  
Taxpayer's tax representative for the taxpayer.

Decision:

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This is an appeal against an 1988/89 assessment to tax on profits derived from the sale of five houses which the Taxpayer contends were by way of the realization of investments.

### 1. BACKGROUND

The following undisputed facts are derived either from the facts set out in the determination of the Commissioner of Inland Revenue or papers produced to the Board:

- 1.1 At all material times the paid-up capital of the Taxpayer was \$10,000. In its Business Registration application form its business was described as 'general trading'.
- 1.2 The Taxpayer, incorporated in late 1983, resolved about a month later to buy a cleared site (the Site) of the former hoses in Place A for \$10,000,000, payable as to \$2,000,000 as a deposit and \$8,000,000 on completion on 29 December 1983.
- 1.3 The then shareholders, of whom Mr K held the majority of the shares, provided the purchase price.
- 1.4 In late 1984 the Taxpayer entered into a contract with a construction company to build 11 houses on the Site, of which three houses (later designated I, J & K) were detached and eight (designated A to H) were semi-detached, at a cost of \$9,731,741.20 in accordance with plans provided by the Taxpayer's architects.
- 1.5 Building commenced in September 1984, that is about 12 months after completion of the purchase of the Site.
- 1.6 On 18 March 1985 the Taxpayer's directors resolved to obtain overdraft (OD) facilities of \$5,400,000 from Bank A.
- 1.7 On 12 July 1985 the Taxpayer charged the Site and buildings then or thereafter to be built thereon to Bank A as security for \$5,000,000 'for redeveloping the property' and assigned all rental to Bank A.
- 1.8 On 13 February 1986 the directors resolved to enter into a landscaping agreement.
- 1.9 On 17 April 1986 the Occupation Permit (OP) was granted that is two years five months after completion of the purchase and one year six months after building commenced.

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- 1.10 On 9 May 1986 the Taxpayer advertised in the SCMP '11 Brand new luxury town houses ... cum pool, tennis court with private garden' for rent: 'rentals from \$48,000 per month up'.
- 1.11 On 13 May 1986 a property agent (Agent B) wrote to the Taxpayer to confirm its appointment to be the Taxpayer's sole marketing agent for letting 9 of the houses. Notwithstanding this exclusivity other agents were also appointed.
- 1.12 On 19 May 1986 and 22 May 1986 the Taxpayer again advertised in the same terms as its first advertisement.
- 1.13 On 10 June 1986 the Taxpayer appointed a property agent (Agent X) as sole letting agent with a proviso that if 'the development be sold this sole agency agreement will not apply to the new purchaser ...'. The appointment of the other agents lapsed.
- 1.14 On 26 June 1986 Agent X recommended certain upgrading work be carried out. It is apparent from that letter that the Taxpayer was also itself arranging for defects to be remedied. Agent X suggested rents ranging from \$45,000 to \$53,000 per month.
- 1.15 In the event on the Taxpayer's behalf Agent X engaged a contractor to carry out remedial and upgrading work.

## 2. LETTINGS & SALES

The following is a chronological list of lettings and sales.

- 2.1 On 1 January 1987 house F was let at \$40,000 per month for two years. This tenancy was still in force when this house was sold on 23 June 1988 (see 2.5 below).
- 2.2 Also on 1 January 1987 house K was let at \$48,000 per month for two years then again let at \$60,000 per month to the same tenant for a further 2 years to expire on 31 December 1991.
- 2.3 In January 1987 the Taxpayer entered into three agreements to sell:
- |         |                                      |
|---------|--------------------------------------|
| house G | for \$4,820,000                      |
| house H | for \$4,820,000 and                  |
| house E | for \$4,800,000 (total \$14,440,000) |

all with vacant possession. These sales fell in the 1986/87 tax year.

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2.4 On 27 February 1987 a Deed of Mutual Covenant between the Taxpayer and the purchaser of house G was drafted.

2.5 The following lists the subsequent sales and leases:

House D let 23-7-87 to 22-5-88 at \$43,000 per month

House C let 17-8-87 to 12-12-88 at \$41,000 per month

House A let 5-10-87 to 12-12-88 at \$41,000 per month

House J let 1-11-87 to 31-10-89 at \$50,000 per month

House B let 1-12-87 to 3-11-88 at \$46,000 per month

House F sold 23-6-88 at \$6,150,000 (subject to tenancy)

(Note: this sale fell in the 1988/89 tax year)

House D relet 15-7-88 to 12-12-88 at \$50,000 per month

House I let 21-10-88 to 22-10-91 at \$110,000 per month  
(previously occupied by Mr K 5.16 below)

House B relet 1-11-88 to 12-12-88 at \$50,000 per month

House A ) SP agreements signed 4-11-88 and

B ) completed 12-12-88 at \$23,700,000

C ) subject to above tenancies.

D ) Note: these sales fell in the 1988/89 tax year.

By the end of 1988 therefore eight houses had been sold, of the remaining three I & J were let, apparently K was vacant.

### 3. BANK A FACILITIES

Though Bank A's facility letters were not produced, there are numerous Board resolutions concerning facilities granted by Bank A beginning on 18 March 1985 for an OD of \$5,400,000 and increasing in stages to \$10,300,000 by 17 June 1986. The OD was to be secured by a mortgage of the houses in Place A and an assignment of the rents, though of course at that time no houses had been let. It is clear that these OD facilities were to meet the development costs. There are other resolutions about other Bank A facilities which we accept did not relate to the development of the Place A properties. If we correctly understand the evidence of Mr K these other facilities were on-lent by the Company to another company in which Mr K and other had an interest to enable it to engage in import and export trading.

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### 4. ACCOUNTS

- 4.1 The year of assessment 1984/85: The tax computation for the period 18 October 1983 to 31 March 1985 showing no income, and expenses of \$16,261. In the return (dated 4 July 1984, after the Site was acquired but before the contract at 1.4) the nature of business was described as 'general trading'.
- 4.2 The year of assessment 1985/86: From the comparative figures shown in the 1986/87 accounts referred to below we note that for the period 1 April 1985 to 31 March 1986 the Taxpayer again made a loss bringing the cumulated loss to \$311,819. The balance sheet put the land and buildings under construction at \$22,733,636. No houses were let or sold during this period.
- 4.3 The year of assessment 1986/87: The tax computation for the period 1 April 1986 to 31 March 1987 shows a taxable profit of \$1,317,345 (after depreciation allowance of \$415,457) which flows from the sale of houses G, E & H at \$14,440,000 less \$10,787,768.43 (being the cost attributable to these houses and their three-eleventh share of the cost of the Site and other expenses) and rent from house D and some interest income. No objection was taken to the assessment based on this figure, and the tax was paid.
- 4.4 The year of assessment 1987/88: This tax return (wherein the business is described as 'property investment') showed a taxable profit of \$232,594 which was derived from rental income, commissions and interest less expenses. There were no sales during this tax year.
- 4.5 The year of assessment 1988/89: The annual accounts for the period 1 April 1988 to 31 March 1989 (88/89 Accounts) show a profit of \$17,772,279, derived from the sale of houses A, B, C, D, & F (as well as the rents therefrom before sale) and the rent from two of the remaining three houses. During the period a dividend of \$15,000,000 was paid to the shareholders. In response to enquiries the Taxpayer's accountants said that the cost of the land had been divided into 11 equal portions. The tax computation for the year of assessment 1988/89 put the assessable profits at \$381,449. In other words the profits on the sale of these five houses were excluded. The assessor in his assessment added back those profits. It is a slightly reduced version, namely \$18,615,080, of that assessment which is the subject of this appeal.

### 5. WITNESS

The following is a summary of the evidence given by Mr K to which we have added, where appropriate, our comments in square brackets:

- 5.1 He is a director of the Taxpayer and at the material time was the majority shareholder.

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- 5.2 When the Taxpayer bought the Site it was the director's intention that the Taxpayer built houses on it to be held as a long-term investment. However the development took a long time, the quality of the buildings was very poor and though they were advertised for letting there was no response for about seven to eight months so sometime in December 1986 it was decided to sell them.
- 5.3 He said the shareholders had sufficient finance to pay for land and development costs though a 'very small proportion' came from Bank A: small because banks were reluctant to finance developers as the market at the time was bad.
- 5.4 He guaranteed the Bank A facilities and pledged his own deposits to support the Taxpayer's O/D facilities. An overdraft was deliberately chosen because the interest rate was only 1% above the interest rate on his deposits.
- 5.5 Asked why the Taxpayer in his 1986/87 tax return submitted the profits made on the sale of houses G, E & H (see 4.3 above) to profits tax, he replied that at the time he was a foreign visitor in Hong Kong (the Company's statutory records show he is an Indonesian) and he relied upon his accountant (the same firm that represented him at the hearing) who said as these houses were not let they 'might' be liable to tax.
- In answer as to why he had not submitted the profits on the sale in the year of assessment 1988/89 of the other five houses to tax he said his accountant advised that as these had been let they could be treated as a long-term investment.
- 5.6 In addition to the poor response to letting advertisements another reason for the sales was that the Taxpayer would incur a sizeable sum for maintenance and it would not therefore be beneficial to retain the houses.
- [We were provided with a specimen of the tenancy agreements used by the Taxpayer which provides that the tenant shall pay 'the management fees ... and all other outgoings ... charged by the ... Management Committee or Manager ... and increase in ... management fees ... Moreover in the grounds of appeal it was stated that the first three houses were sold 'for the purpose of re-financing the project ...', however no evidence was led to support that statement.]
- 5.7 Mr K's evidence concerning the increases between July 1987 and August 1988 of the Bank A facilities was not easy to follow but as far as we can gather these facilities – at least by August 1988 – were not required for the remaining houses in Place A. Mr K said they were used by other companies (not subsidiaries or associated companies) which had some shareholders in common with the shareholders of the Taxpayer.

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- 5.8 In cross-examination he said he considered that the period from December 1983 when the Site was acquired to January 1987 when houses G, E & H were sold was a long time.
- 5.9 Asked if the directors had carried out a feasibility study the witness stated that the property market was then very poor and if they had carried out such a feasibility study the shareholders would not have embarked on the project, so they simply planned (against the current trend) to lease after development, using \$25,000 per month unit as minimum guide which should recoup the investment in seven years.
- 5.10 Mr K said that having decided on selling, the idea was not to sell them all but only a small portion. [This remark is not wholly consistent with the heavy maintenance reasoning mentioned at 5.6.] It was because only a few were to be sold that he used a small estate agent, Agent A, rather than a big one like Agent X. [Agent A advertised all 11 houses for sale.]
- 5.11 He made the point that by embarking on a policy of letting he realized that the Taxpayer would be unable (due to the Landlord and Tenant Consolidation Ordinance) to terminate tenancies if he wished to sell with vacant possession and in his experience a better price could be expected for a property sold with vacant possession than subject to a tenancy. In cross-examination he acknowledged that the houses sold subject to tenancies fetched a better price than those sold with vacant possession but put that down to prices increasing generally in the interval. He later acknowledged that he had no prior property development experience.
- 5.12 In cross-examination Mr K said that submitting the profits from the first three houses to tax was a 'mistake' on the part of the Taxpayer's accountants.
- 5.13 The OD facility was used to pay the construction costs as the interest rate was less than drawing on the available construction loan.
- 5.14 At first Mr K said E, G, H were readily saleable because they had harbour views but confirmed he would have no objection to selling A, B, C instead if an offer had been made.
- 5.15 He further acknowledged that by January 1987, having let out three houses F, K & J, there was no urgency to sell more of the houses.
- 5.16 He occupied House I during some part of 1987 and 1988 because the Taxpayer was unable to let it.

## 6. SUBMISSIONS

BY IRD:

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- 6.1 The representative for the Commissioner of Inland Revenue submitted that we were concerned to establish the Taxpayer's intention at the time of the purchase of the Site. In which regard he referred us to passages in:

D11/80, IRBRD, vol 1, 374

Richfield International Land v CIR 2 HKTC 444

Marson v Morton 59 TC 381

Harvey v Caulcott 33 TC 159

Chinachem Investments Co Ltd v CIR 2 HKTC 261

Central Enterprises Ltd v CIR 2 HKTC 240

Cadwallader v Wheeler [1955] TR 265

- 6.2 She pointed out that submitting profits on earlier sales to tax can colour the interpretation to be put upon later sales (Richfield). That is to say the trading 'admission' for the three sales in the year of assessment 1986/87 colours the five sales in the year of assessment 1988/89. Moreover the accountants had not given evidence to support Mr K's assertion that the submission of the 1986/87 profits to tax was a mistake. Having submitted to profits tax on the first three houses, the burden of showing subsequent sales were merely the realization of an investment is a heavy one (Central Enterprises at 256 and Harvey v Caulcott and Cadwallader v Wheeler).
- 6.3 She referred us to the badges of trade (Marson 391 at F) and gave us her views and though we have considered them we do not propose to deal with them in this decision.
- 6.4 The categorization (that is Fixed Assets/Land under development ...) in the accounts is neutral.
- 6.5 In December 1986 before any leases were concluded Agent A advertised all the properties for sale and put together sales brochures. In determining the period we should recognise that the real elapsed time is not from the issue of the OP but from October 1986 when the upgrading was concluded.
- 6.6 She further submitted that the allocation of the Site price amongst the 11 houses was unnecessary if there was no intention to sell.
- 6.7 Sale with tenants achieved better prices than with vacant possession.



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- 6.8 The proviso to Agent X's letter 10 June 1986 (referred to in the last sentence to 1.14 above) indicated that Taxpayer had in mind the possibility of selling.

### BY TAXPAYER'S REPRESENTATIVE:

- 6.9 No written submissions were handed up nor were we addressed at the opening. We believe however that the Taxpayer's case can be taken to be that set out in the grounds of appeal, namely:
- 6.9.1 The first external manifestation of the Taxpayer's claimed intention to hold the properties long-term is the letting advertisements shortly after the OP was issued.
- 6.9.2 The word 'trading' in the Taxpayer's title was there because the Company originally intended to trade in timber and feathers.
- 6.9.3 The development of the Site was seen at the outset as supplementary to the Taxpayer's other business [this was not borne out by the evidence] hence the reason for originally describing the Taxpayer's business as 'general trading' in its first tax return.
- 6.9.4 The CIR failed to recognise that some houses could be held as a long-term investment and others for sale. Hence houses E, G & H were sold to refinance the project [but see our comment on this aspect at 5.6 above].
- 6.9.5 The Taxpayer's small capital base is no bar to long-term investment; adequate finance was available through the shareholders and Bank A.
- 6.9.6 No adverse inference should be drawn from the lack of a feasibility study.
- 6.9.7 As fixed assets the five houses in question should be entitled to rebuilding allowance.
- 6.10 In reply to the comment in the Revenue's submissions to the effect that no one from the accountant firm had been called to corroborate Mr K's assertion that the accountants had wrongly advised him resulting in mistakenly submitting the profit on the sale of the first three houses to tax the Taxpayer's representative (who is evidently a member of the accountant firm) said the reason why his firm was not giving evidence was that 'they did not want to prejudice themselves'. This is a clear case of conflict of interest and in our opinion whether or not there is any substance in the implied allegation by Mr K of negligence on the part of the accountant firm, this firm should not have represented the Taxpayer in this appeal. It nevertheless follows that Mr K's evidence remains uncorroborated on a particularly important matter.

### 7. DELIBERATIONS

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- 7.1 Our first reaction to the evidence of early leasing advertisements and engagement of estate agents was not unnaturally favourable to the Taxpayer's contention of a long-term investment. In addition there was nothing to suggest that the Taxpayer, with its shareholders and Bank A backing, did not have the financial resources to enable it to keep the houses as a long-term investment. We were however surprised that an overdraft was chosen rather than a long-term reducing mortgage because the former is more consistent with trading. However bearing in mind Mr K's own evidence that the property market was poor at the time the delaying OP was issued, we did not reject the possibility that leasing was a temporary expedient pending improvement of the sale market.
- 7.2 On closer examination of the facts and the evidence given by Mr K we came to the conclusion that the first reaction was superficial. In particular Mr K's explanations as to why in December 1986 they decided to sell, namely because leasing was not going satisfactorily and because of the high maintenance cost the latter explanation is not borne out by the maintenance figures of \$34,088 for the year of assessment 1987/88 and \$26,746.81 for the year of assessment 1988/89 nor is it compatible with the tenants having to bear the maintenance costs. No reference was made in the grounds of appeal to the need to sell because leasing had been unsuccessful. Mr K told us that the intention to sell in December 1986 was restricted to a small number yet Agent A advertised all of the houses for sale. An additional reason he gave for selling the five houses in 1988 was that the proceeds were to be used in another development however he said that the development came to nothing. Against this we reminded ourselves that \$15,000,000 was paid as a dividend following the sales and the shareholders loan had by that time been repaid. We therefore place no reliance upon Mr K's evidence in this particular respect.
- 7.3 Although not of itself particularly important we should perhaps mention that the Board's minute relating to the purchase of the Site was silent as to the Taxpayer's intentions after development.
- 7.4 The quoted proviso to Agent X's letter of 10 June 1986 manifests an intention on the part of the directors to keep open the possibility of selling the houses; in other words they had not ruled out that course of action.
- 7.5 It will be recalled that Mr K said he thought the retention of the first three houses should have qualified as a long-term investment. From this coupled with the remark at 7.4 we infer that he had no fixed intention to retain any of the houses after two years and that the intervening lettings were a short-term expediency until the selling market reached a satisfactory level. Nor do we consider in the context of this development that two years should qualify as long-term. We therefore reject Mr K's testimony that submitting the profit on the sale of the first three houses was a mistake.

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It is for the Taxpayer to satisfy us on the balance of probabilities that the property was purchased as a long-term investment. The Taxpayer has failed to do this for the reasons referred to above. Accordingly we find as a matter of fact that the Taxpayer had formed no intention to hold the developed Site as a long-term investment and therefore dismiss this appeal.