

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D33/02

Profits tax – sale of property – onus of proof on the taxpayer – section 68(4) of the Inland Revenue Ordinance ('IRO') – intention at the time of purchase.

Panel: Ronny Tong Ka Wah SC (chairman), William E Mocatta and Eugene Oh Jae Hoon.

Dates of hearing: 22, 23 May and 28 June 2002.

Date of decision: 19 July 2002.

The taxpayer was a private company. The taxpayer objected the profits tax assessment on the ground that two properties purchased were capital assets. Mr A who is a director of the taxpayer and gave evidence on its behalf made no attempt to hide the fact that the taxpayer was only used as a vehicle. It is part of his case that the taxpayer was in truth his *alter ego* so that his resources should be treated as the taxpayer's resources.

The key issue on this appeal is what the true intention of the taxpayer was when the two properties were bought. It was contended on behalf of the taxpayer that it intended to hold the two properties in question for long term investment and they were only sold because circumstances beyond the contemplation of the taxpayer had arisen.

Held:

1. The Board considered that it was important to ascertain the taxpayer's intention at the time of acquisition of the properties. In this regard, the taxpayer's self declaration, no matter how formal or elaborated, can never be conclusive (Simmons v CIR 53 TC 461 and All Best Wishes Limited v CIR 3 HKTC 750 followed).
2. Having observed carefully the demeanour of Mr A while giving evidence and having considered all the surrounding circumstances as revealed by the evidence, the Board had no hesitation in rejecting the evidence of Mr A. The Board simply could not regard his evidence as reliable. The Board found that the taxpayer had not discharged its onus under section 68(4) of the IRO.

Appeal dismissed.

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Cases referred to:

Simmons v CIR 53 TC 461
All Best Wishes Limited v CIR 3 HKTC 750

Lee Yun Hung for the Commissioner of Inland Revenue.
Neil Thomson Counsel instructed by Messrs Philip T F Wong & Co for the taxpayer.

Decision:

The appeal

1. This is an appeal from a determination of the Commissioner of Inland Revenue dated 2 November 2001 (‘the Determination’) rejecting the objection of the taxpayer (‘the Company’) to the Revenue’s profits tax assessment for the year of assessment 1994/95 and additional profits tax assessment for the year of assessment 1995/96 as revised and the profits tax assessment for the year of assessment 1995/96 on the ground that two properties (‘Property 2’ and ‘Property 6’ respectively and collectively as ‘the Properties’) purchased by the Company were capital assets.
2. The key issue on this appeal is what the true intention of the Company was when Properties 2 and 6 were bought. On the one hand, it was contended on behalf of the Company that it intended to hold the Properties in question for long term investment and they were only sold because circumstances beyond the contemplation of the Company had arisen.
3. On the other hand, it was the case of the Revenue that the true intention of the Company at the time of purchase could only have been that the Properties would be sold at an appropriate time for a profit. This was perfectly compatible with the fact that the Properties were let out on commercial terms in the meantime.
4. There is no dispute on the approach of the Board. The only issue is how the intention of the Company is to be ascertained against the facts as we know them.

The Company

5. The Company is a private company incorporated on 14 February 1989, one month before the first property (‘Property 1’) was bought. The Company has an authorized and paid-up capital of \$10,000 and \$2 respectively.

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6. Mr A who is a director of the Company and gave evidence on its behalf made no attempt to hide the fact that the Company was only used as a vehicle. Indeed, it is part of his case that the Company was in truth his *alter ego* so that his resources should be treated as the Company's resources.

7. Mr A gave evidence that the Company was formed by him and his brother ('the First Brother') as a vehicle for investment in properties. The two shares of the Company were registered in the names of Mr A and the First Brother respectively. Property 1 was bought as their residence although the First Brother moved out of that residence when he left the Company in circumstances described below. Mr A resided in Property 1 until 1997. Property 1 had since been sold.

8. Mr A was not precise as to when the First Brother left the Company despite repeated questions from the Revenue and the Board. He was only prepared to say the First Brother left in 'mid 1990'. Thereafter, Mr A's other brother ('the Second Brother') took up the share of the First Brother but only as a trustee or nominee for Mr A as from 29 August 1991, as evidenced by a declaration of trust and power of attorney of the same date. What precisely the capacity of the First or Second Brother was in relation to that one share prior to that date was never made clear by Mr A. Nor did he explain why or how he took over that other share. On record, despite the fact that the First Brother left in 'mid 1990', his share was not transferred to the Second Brother until 29 August 1991. It is Mr A's evidence that nothing was paid to the First Brother for that one share.

9. As will become clear later on, we regard Mr A's evidence as highly unreliable. We are of the view that the First Brother was probably also a mere nominee for Mr A. We are reinforced in that view by the alleged financial dealings between the First Brother and the Company which we will come to consider later on.

10. It is to be noted that no minutes of any kind as regards the Company's intention were produced. There was never any resolution as to what the Company's plan was or what it wanted to do with the various properties it bought over time. The Company, of course, has only a bare existence in the sense that it has only a paid-up capital of \$2 and has no conceivable ability to maintain any investment without the support of Mr A.

The various properties purchased

11. The Company had altogether bought six properties over time. These were:

Property	Purchase date	Purchase price	Mortgaged amount	Sale date	Sale price
		\$	\$		
Property 1	7-3-1989	1,260,000	1,070,000	1-4-1997	6,800,000
Property 2	3-5-1990	840,000	774,000	20-4-1994	3,340,000
Property 3	21-5-1990	1,140,000	1,020,000	--	--

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Property 4	30-5-1990	1,245,000	1,120,000	21-10-1991	2,320,000
Property 5	20-7-1991	900,000	810,000	31-10-1991	980,000
Property 6	9-4-1991	1,640,000	1,480,000	20-7-1995	3,390,000

Purchase of Property 2

12. Property 2 was purchased on 3 May 1990 at a time when the First Brother had either left or was about to leave the Company. At that point of time, the Company was holding Property 1 as a residence for Mr A and his brother. There was an outstanding mortgage on Property 1 giving rise to a monthly instalment of \$13,375. There was no income to the Company. The future of the Company was in doubt. That was hardly the time to invest in another property on a long term basis.

13. At that point of time, Mr A was earning a salary of \$24,250 as an assistant solicitor. The tax return showed that he was paid \$90,000 bonus at the end of that year but he would not be able to rely on that bonus payment in May 1990.

14. Mr A was also paid a housing allowance of \$196,000 for that year, or \$16,333 per month. That would cover the mortgage payment of Property 1 but no more. Property 2 was purchased with a mortgage loan of \$774,000. The monthly instalment was \$8,658. Property 2 was eventually rented out at \$6,500 per month; hardly enough to cover the mortgage payment.

15. The financial statements of the Company showed that at the end of March 1990, the Company was trading at a loss of \$74,835.44. It had a net current liability of \$356,006.58. What is more relevant, the expenses for the year came to \$157,035.44 which included a sum of \$122,022.59 attributed to mortgage loan interest. That is translated into a monthly expenditure sum of about \$3,000 excluding mortgage loan interest. This is not to mention Mr A's own daily expenses.

16. We cannot see how on these bare facts alone, the Company could realistically expect to sustain any investment for an appreciable length of time. Nor could the Company possibly expect a profitable investment return from Property 2 until many, many years later. Even then, it would depend on:

- (a) There was no downturn of the property market.
- (b) Mr A would be in a position to continue to unconditionally support the Company indefinitely.
- (c) Neither the Company nor Mr A would have any contingent liability to meet.

17. The position, of course, would be different if Mr A was merely hoping to sustain Property 2 for a limited period of time until the market was good enough to sell it at a profit.

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Purchase of Property 6

18. It is significant to note that not only the purchase of Property 2 in May 1990 was incompatible with an intention to hold it for long term investment, the Company in fact made two more purchases in that month.

19. On 21 May 1990, within three weeks of the purchase of Property 2, Property 3 was purchased at a cost of \$1,140,000. In due course, a mortgage loan of \$1,026,000 was taken out giving rise to a monthly instalment payment of \$11,118. The rental income from July 1990 was \$9,500.

20. On 30 May 1990, the Company purchased yet another property, Property 4, at a cost of \$1,245,000. A mortgage loan of \$1,200,000 was taken out giving rise to a monthly instalment payment of \$11,943. This property was not completed until 30 June 1991 so that there was no rental income until July 1991. The rental income then was \$9,000, still considerably short of the monthly instalment of \$11,943.

21. It was in these circumstances that the Company purchased Property 6 on 9 April 1991 at a cost of \$1,644,000. At that time, Mr A's salary was still \$24,250 but he might know that his salary was about to be increased to \$30,000. His housing allowance was increased to \$23,750 at the same time giving a total income figure of \$53,750.

22. Against that, he was paying a combined mortgage payment of \$45,094: \$13,375 + \$8,658 + \$11,118 + \$11,943. The only rental he was collecting was \$6,500 from Property 2 and \$9,500 from Property 3 giving a total income of \$16,000.

23. With the new purchase of Property 6, he faced a further mortgage monthly payment of \$14,528.32. Property 6 would not be ready for occupation until January 1993 so that even with the increased monthly income Mr A was short of \$5,872 before any daily expenses he or the Company might have to meet.

24. Furthermore, within three months of the purchase of Property 6, Property 5 was purchased on 20 July 1991 at a cost of \$900,000. That gave rise to yet another mortgage loan of \$810,000 and a monthly instalment of \$8,224. By July, however, Property 4 was either about to be or was rented out at \$9,000 and Property 5 was rented out in August 1991 at \$5,000 so that the total income of Mr A including total rental income was barely enough to pay off all mortgage payments.

25. The financial statements of the Company showed that as at March 1991, the Company was trading at a loss of \$198,200.66. It had a current liability of \$112,301.9 and the expenses for the year was \$477,360.66 which included a sum of \$368,234.66 attributable to

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mortgage loan interest. The Company's expenses alone (excluding the mortgage loan interest) were therefore about \$9,000 per month.

26. There was no indication as to how these expenses let alone the daily expenses of Mr A himself were to be paid. Even if Mr A had savings over the years, he could not possibly expect the situation to improve within the foreseeable future so that it was very likely that his savings would eventually be depleted.

27. We cannot see how on these facts anyone can seriously suggest that the Company or Mr A was in a position to acquire or sustain any investment. Alternatively, there was simply no realistic expectation that a profit could be returned from any investment in the foreseeable future.

Rental forecast for Property 2

28. Mr A, however, told us that not only Property 2 and Property 6 were purchased for rental income but that he had actually asked his accountant to do a rental forecast for each property *before* the purchase. According to Mr A, he gave all the necessary data like rate of interest, the amount of rental return and the rate of increase of projected rental income to the accountant who was asked to calculate the projected profit of the investment.

29. He produced a rental forecast for each of Property 2 and Property 6 as evidence in support of his declared intention to acquire the Properties as a long term investment.

30. The rental forecasts are undated documents. Mr A claimed that these were in fact produced *before* the respective purchases in order to assist him in deciding whether to go ahead with the alleged investments. We have the most serious doubts as to whether this is true.

31. Property 2 was purchased on 3 May 1990 but according to Mr A the provisional agreement was made in April 1990. The mortgage loan was taken out on 20 June 1990 and Property 2 was not rented out until 'late September 1990'. And yet, the author of the rental forecast of Property 2 was able to predict in April 1990 the exact figure of the monthly mortgage payment determined in late June 1990 and the exact rental obtained in late September.

32. Furthermore, the projected rental was increased at a rate of 20% every two years for the next 20 years in order to produce a respectable rental return for the property. Even at this wholly unrealistic rate, according to this schedule, the Company would not be able to obtain a positive return until the year 1994, some four years after the purchase.

Rental forecast for Property 6

33. Property 6 was purchased on 9 April 1991 while still under construction. The mortgage loan was taken out on 15 April 1991 but the premises were not rented out until 27

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months later.

34. And yet, Mr A was able to predict precisely the amount of rental he would eventually get when the property was rented out in January 1993. He claimed that the rent he obtained in 1993 was the prevailing rent in April 1991. He was, thus, predicting that the rental market for this property would remain static for the first 27 months but thereafter would steadily increase at the rate of 20% every two years for the next 20 years! Even then, the 'investment' would not produce a positive return until 1999, some eight years after the purchase.

35. If one is to compare the rental forecast for Property 2 with that of Property 6, one will see that while Mr A was expecting the rental income for Property 2 to rise at a steady rate of 20% every two years between 1991 and 1993, he was predicting that the rental market relevant to Property 6 would remain static for the same period but that the rental market for Property 6 would take off immediately after the Company started renting out the property.

Reliability of the rental forecast

36. Mr A also called Mr B, an accountant, who claimed that he was the author of these two rental forecasts. His evidence, however, did not take the matter any further. He was unable to produce any document as to when these forecasts were made nor could he give the precise date or dates as to when he made them. He admitted that he had no personal knowledge as to when Property 2 and Property 6 were bought. All he was told by Mr A was that his calculations were needed before these properties were bought.

37. The rental forecasts, of course, were not financial statements. Mr B accepted anyone with a calculator could produce them. No special accountancy training was needed in order to prepare these documents. All the basic figures were given to him by Mr A. However, he did venture to give an explanation as to how the projected rental of \$85,000 was arrived at in the rental forecast for Property 6. That explanation, nevertheless, was quite different from that given by Mr A in the witness box.

38. These forecasts were not nor did they purport to be proper forecasts. Mr B admitted that Mr A told him to use a constant rate of interest and rate of increase of rental 'to make it easier to calculate'. There was no attempt to allow for rates or other outgoings or expenditure to keep the Properties properly maintained.

39. We regret to say we simply cannot accept these rental forecasts were made *before* the purchases of Property 2 and Property 6 were made and we find Mr A's evidence to be wholly unreliable. Insofar as necessary, we also reject the minutes dated 3 May 1990 referring to the rental forecast of Property 2 (if it referred to the same forecast) as having been made on that day.

Contribution of the First Brother

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40. It was part of the Company's case that it was set up as a joint venture between Mr A and the First Brother. This was Mr A's evidence. However, Mr A was never able to properly explain what contributions the First Brother made to the Company.

41. Mr A originally said he and the First Brother would each contribute 50% to the venture. And yet, after much probing by the Board, he admitted the First Brother had only advanced a total of '\$250,000'. This was apparently not repaid by the Company until 1991. Although the First Brother left in 'mid 1990' (Mr A was never prepared to say precisely when the First Brother left the Company), the one share he held in the Company was not transferred to the Second Brother until August 1991 to be held in trust in favour of Mr A.

42. It is, of course, Mr A's evidence that in August 1991, the Company was holding all six Properties 1, 2, 3, 4, 5 and 6 for long term investment. Indeed, he was projecting all of these 'investments' would eventually produce a positive return for the Company. And yet, he paid not a single cent to the First Brother in taking over his share.

43. We find Mr A's evidence that the First Brother was a full partner of the joint venture wholly unconvincing and Mr A's evidence that he was able to sustain these 'investments' with the help of the First Brother plainly unreliable.

Sale of the Properties

44. Under the skilful cross-examination of the Revenue, Mr A accepted that the Properties were sold even though the conditions for investment had in fact improved. The Revenue sought to rely on this to question Mr A's intentions when the Properties were purchased.

45. We do not believe it is necessary for us to have regard to what happened when the Properties were sold to come to a conclusion as to the outcome of this appeal. What is important is to ascertain the taxpayer's intention at the time of acquisition of the property: Simmons v CIR 53 TC 461.

46. In this regard, the taxpayer's self declaration, no matter how formal or elaborated, can never be conclusive. As Mortimer J (as he then was) said in the much cited case of All Best Wishes Limited v CIR 3 HKTC 750 (at page 771):

'In particular, the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of evidence.'

Finding

47. Having observed carefully the demeanour of Mr A while giving evidence and having

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considered all the surrounding circumstances as revealed by the evidence, we have no hesitation in rejecting the evidence of Mr A. We simply cannot regard his evidence as reliable.

48. In these circumstances, we find that the Company had not discharged its onus under section 68(4) of the IRO. The appeal must therefore be dismissed and the Determination is hereby affirmed.