INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D35/91

Profits tax – sale of land – whether profit capital gain – onus of proof – section 68(4) of the Inland Revenue Ordinance.

Panel: Anthony F Neoh QC (chairman), Alexander Au Siu Kee and Roland Chow Kun Chee.

Dates of hearing: 26, 27 and 28 March; 2 and 5 July 1990.
Date of decision: 17 July 1991.

The taxpayer was a private limited company which for some years had been actively trading in land. The taxpayer entered into a joint development agreement relating to certain Letter B land entitlements belonging to the taxpayer. As part of the joint development certain land was acquired by tender. Some years later the taxpayer sold its interest in the land for a substantial profit. The taxpayer argued that the profit was a capital gain and was not taxable.

Held:

The onus of proof is upon the taxpayer to prove that the assessment is incorrect. The taxpayer had failed to discharge the onus of proof. The taxpayer had traded in property before and had not proved to the satisfaction of the Board that it did not have an intention to trade in relation to the property in question.

Appeal dismissed.

[Editor's note: The taxpayer has filed an appeal against this decision.]

Cases referred to:

Granville Building Co Ltd v Oxby [1954] 35 TC 244
Hillerns & Fowler v Murray 17 TC 77

E C D'Souza for the Commissioner of Inland Revenue.
Jesse H Y Kwok of Jesse H Y Kwok & Co for the taxpayer.

Decision:

Background

During the year of assessment 1986/87, the Taxpayer sold off its interest in a piece of land ('the land') for $60,170,790.73 resulting in a gain of $42,495,157. This was duly recorded as part of the trading profits of the Taxpayer for the year ended 31 March 1987 but was not offered for assessment in the Taxpayer's tax computations.

The Assessment

2. The assessor considered that the gain on the sale of the land was the Taxpayer's trading profit. On 20 July 1988, he raised on the Taxpayer the following 1986/87 profits tax assessment:

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Loss per return	(3,502,212)
Less: Profit on sale of the land	42,495,157
Adjusted profits	$38,992,945
Add: Disallowable interest	333,534
	$39,326,479
Less: Loss set off	7,157,018
Assessable profits	$32,169,461
Tax payable thereon	$5,951,350

The Taxpayer's Objection

3. The Taxpayer's representatives lodged an objection against the assessment arguing that the assessment of profits tax for the year of assessment 1986/87 based (as it was) on the gain on realization of land amounting to $42,495,157 as trading profit was unsustainable. In support of their contention, they cited the following reasons:

(a) That the Taxpayer was a land investment company whose policy was to acquire numerous pieces of land for long term investment purposes in order to build up a solid fixed asset foundation.

(b) That with this in view the Taxpayer had during the years from 1969 to 1972 gradually acquired a large amount of land. However, during the years that followed, those lots were at various times resumed by the Government and the

land exchanged for Letters B. Since then the value of Letters B kept on appreciating as time passed.

(c) That if the Taxpayer had a profit motive it would have made a quick profit of several hundred times on realization of Letters B. However, the Taxpayer adhered to its original intention of utilizing the Letters B in exchange of land for long term investment purposes.

(d) In 1981 the Taxpayer utilized the Letters B and obtained by tender, jointly with three other companies, the land. Initially, an architectural firm was appointed to draw up plans for development of the land into residential/commercial buildings. However, as the co-owners were not satisfied with that firm's performance, it was resolved in a meeting between the co-owners in mid-1984 to appoint another firm to carry on with the job and at the same time it was agreed to obtain a bank loan to finance the construction costs.

(e) That due to differences of opinion between the co-owners, the efforts to obtain a proposed bank loan became abortive. It was then resolved at a meeting between the co-owners in mid-1985 to finance the development costs on a flat sharing basis with the building contractor. While the Taxpayer insisted on carrying out the building project and to share the flats on completion, however the three other co-owners breached the agreement made in writing during the meeting.

(f) That while the Taxpayer's intention and proposal had met with obstruction, nevertheless, site formation and piling, etc was carried out according to the plans drawn up in 1982.

(g) That in late 1985 the Taxpayer received a letter from a firm of solicitors inviting the Taxpayer and the other co-owners to sell the land at a price of $103,000,000. Further, the bank, threatening immediate recovery action on loans extended to the Taxpayer, compelled the Taxpayer to sign a letter of intent whereby the Taxpayer was compelled to confirm that should there be an offer at or above $103,000,000 from any party whatsoever, the Taxpayer would accept such offer but at any rate no later than forty-five days after the date the initial offer was received.

(h) That despite forcing the Taxpayer to sign a letter of intent to sell in late 1985 and despite the fact that the forty-five days period stipulated therein had expired, the problems regarding the sale remained unsolved. The bank again applied pressure on the Taxpayer to extend the time to accept an offer to purchase. Eventually, the land was sold (under what was described as extreme pressure on the Taxpayer) at the relatively low price of $60,170,790.73. During the period the bank first pressed the Taxpayer to sell to the actual date of realization, land price appreciated about 20% to 30%.

(i) That under its conditions of grant, the land (which was acquired by tender) could only (prior to compliance with the building covenants and other conditions) be sold once and only as a whole. Since the lot was owned by four companies (that is, the four registered owners) the Taxpayer could not sell unless the three other owners joined in the sale. While the Taxpayer had every intention, and indeed, had made strenuous efforts to pursue its aim to develop the lot so as to retain its share of the development for investment purposes, nevertheless, the Taxpayer was pressed by its banker. The three owners would not co-operate in the development and the Government was imposing heavy fines for delay in fulfillment of the building covenant. The foundation contractor was also threatening to sue for building costs. Under these circumstances the Taxpayer was forced to sell to a party approved by the other three owners and the bank. In fact, the Taxpayer was forced to sell below a better offer which it had independently obtained. The Taxpayer was in no position to bargain. The bank was going to sue its directors on their personal guarantees. All these supported a forced sale which was clearly distinguishable from a normal trading transaction.

4. In response to the assessor's enquiries, the representatives provided the following further information:

(a) Copy of a letter from the bank (through a firm of solicitors) dated 12 August 1985 demanding for repayment of loans.

(b) That the sources (of finance of the original cost of the land of $9,483,305) were from mortgage loans, bank overdraft, etc of years ago.

5. The same objection forms the essential basis of the Taxpayer's present appeal.

The Commissioner's Determination

6. On 3 November 1989, the Commissioner after considering the Taxpayer's objections confirmed the profits tax assessment for the year of assessment 1986/87, showing net assessable profits of $32,169,461 (after set off of loss brought forward of $7,157,018) with tax payable thereon of $5,951,350.

7. The Taxpayer now appeals against this determination.

Agreed Facts

8. The following were the agreed facts put before the Board:

(a) The Taxpayer was incorporated as a private company in Hong Kong. In its profits tax returns, the Taxpayer invariably described the nature of its business as 'property investment'. At all relevant times, the authorised and paid-up capital have remained at $10,000,000 and $5,000,000 respectively.

(b) The Taxpayer has been actively engaged in buying and selling land. A summary of the land sales since the year of assessment 1978/79 is as follows:

Year of Assessment	Sales $	Cost of Sales $	Gross Profits $
1978/79	1,469,884	127,863	1,342,021
1979/80	2,754,950	257,765	2,497,185
1980/81	-	-	-
1981/82	76,516,100	43,090,177	33,425,923
1982/83	9,729,423	465,125	9,264,298
1983/84	14,335,679	4,304,452	10,031,227
1984/85	-	-	-
1985/86	-	-	-

The profits on the above sales were included as trading profits in the profit and loss accounts of the Taxpayer and offered for assessment. The cost of land was invariably classified as a current asset in the balance sheets of the Taxpayer.

(c) In early 1981, the following companies ('the joint developers') entered into heads of agreement to pool their respective land exchange entitlements to tender to the Government for exchange and development of either a piece of land in a new town ('the new town land') or the land:

(i) The Taxpayer;
(ii) X Limited;
(iii) Y Limited;
(iv) Z Limited.

Clause 3(1) of the agreement provided, inter alia, that:

> '3(1) By virtue of the land exchange entitlements aforesaid the parties hereto shall participate in a joint venture to tender … for exchange, development and sale of (a) [the new town land] or (b) … [the land] to be granted in accordance with the respective Particulars And Conditions of Grant …'

Clause 5 of the agreement provided for the method of finance in the following terms:

> '5. FINANCE
>
> Each of the parties hereto shall provide the necessary funds to pay the premium in the exchange in respect of their own land exchange entitlements but all building costs of the new buildings shall be financed by way of loans secured under a building mortgage of the land to be arranged by the parties hereto.'

(d) The joint developers only succeeded in the tender for the land. In mid-1981, the joint developers entered into supplemental heads of agreement obligating the joint developers to develop and sell the land in accordance with the terms of the heads of agreement of early 1981 and certain supplemental terms.

(e) In the Taxpayer's accounts for the year ended 31 March 1981, the cost of the land of $9,483,305.41, comprising land premium of $9,149,698.2 and land cost of $333,607.21, was transferred from cost of land (a current asset) to joint venture current account which was also classified as a current asset.

(f) In the Taxpayer's accounts for subsequent years, the joint venture current account was also invariably classified as a current asset in the respective balance sheets.

(g) In 1986, the Taxpayer sold its interest in the land for $60,170,790.73 resulting in a gain of $42,495,157. At the time of sale, site formation and piling work had been carried out but building construction work had not yet commenced.

The Taxpayer's Evidence

9. The Taxpayer called Mr A, one of its directors, to give evidence on its behalf.

10. Essentially, Mr A confirmed the matters set out in the objection from the Taxpayer's tax representative (set out in paragraph 3 above) and added the following:

(a) That the Taxpayer was a family business founded by him. He regarded the business as his business and made all the decisions without reference to other directors or members of the Taxpayer. Thus there was no need for meetings or minutes save those required to comply with the statutory requirements as advised by the Taxpayer's auditors.

(b) That as he had no accounting knowledge, he left all accounting work with his auditors (who were not called to give evidence). Thus, the classification of his pieces of land and Letters B as 'current assets' was not a matter which he understood.

(c) That he had bought pieces of land with a view to long term investment, and although he had sold pieces of land whenever he was in need of money, he never deviated from this intention.

(d) That as evidence of his aforesaid intention, he referred to the fact that he had chosen Letters B in preference to cash compensation whenever the Taxpayer's land was resumed, and that he had retained his Letters B with the same intention of long term investment save on the occasions when he had to sell some of his Letters B to raise money.

(e) That in entering into the joint development of the land, he had intended to keep flats in the development for long term investment. However, he was unable to implement this intention as the project could not be completed because of pressure from the bank.

(f) That in 1981 he held Letters B of a total value well in excess of $100,000,000 and could have financed the development of the land which required only $50,000,000 to $60,000,000.

11. The Taxpayer produced a valuation report by a firm of surveyors dated in mid-1990 of the Letters B said by the Taxpayer to have been in its beneficial ownership and showing the values set out as follows:

Valuation Date	Area of Letters B	Valuation
Early 1981	112,029 square feet	$105,452,000
Mid-1981	260,644 square feet	$169,702,620
		$275,154,620

12. Mr D'Souza, for the Revenue, was willing to accept the valuation but reserved his position with regard to beneficial ownership and the extent that the Letters B were mortgaged by the Taxpayer.

The Board's Conclusions

13. The Board notes the declaration made with apparent conviction in the course of the Taxpayer's evidence that it was the intention of the Taxpayer to acquire land for long term investment. Yet the Taxpayer's own documents do not appear to us to accord with this declared intention.

14. The Taxpayer's first object appearing in its memorandum of association was to 'purchase for investment or resale and to traffic in land and house and other property ... '. In its notification to the Revenue of its commencement of business, it declared that it was '[early 1969] when we first purchased land and building for redevelopment and for sales'.

15. Since its commencement of business, the Taxpayer has represented in its accounts (which formed part of its tax returns) that it was an active trader in land and property. We note, in particular, the following matters:

(a) From the day of commencement of business, the Taxpayer has classified the 'cost of land' as a current asset in its audited balance sheets, representing that the Taxpayer regarded land as trading assets.

(b) In the year of assessment 1980/81, land with a book cost of $1,176,490 was transferred from current asset ('cost of land') to fixed asset ('house building') and the assessor was advised that the change did not reflect any change of intention, namely, that the Taxpayer continued to regard the land (despite the reclassification in the balance sheet) as trading assets.

(c) The profits on sales in the years ended 31 March 1979, 1980, 1982, were included as trading profits and assessed to profits tax.

(d) In the year ended 31 March 1983, amounts of $639,764 and $994,959 were transferred to fixed asset from the current asset accounts but the Taxpayer never suggested that the transfer gave rise to any change in the tax position nor did the Taxpayer respond to enquiries by the Revenue as to whether or not there was any change in intention.

(e) The Taxpayer's paid-up capital has never increased beyond $5,000,000. Over the years dividends were paid essentially out of profits from sale of land and buildings, inclining one to think that the Taxpayer harboured no intention to build up a capital base for long term investment.

(f) The lack of intention to build up a capital base for long term investment is further reflected by the rentals recorded by the Taxpayer in its annual accounts over the years. These were grossly insufficient to service the interest on the loans which the Taxpayer had had to incur to finance its land acquisition and development activities. The Taxpayer could only have hoped to service the interest on its loans by sale of its assets.

(g) Such evidence as was put before the Board by the Taxpayer regarding bank loans suggest that the term loans extended to the Taxpayer for working capital rarely extended beyond twelve months. This meant that the Taxpayer had to finance repayment from sales.

(h) A comparison of the gross profits with rental receipts for the years ended 31 March 1970 to 1984, made it clear that save in 1983, the gross profits far exceeded rental receipts. In 1985 and 1986, there were losses in the amounts of $6,295,092 and $3,837,383 compared to rentals of $265,612 and 'NIL' respectively. This state of affairs suggests that the centre of gravity of the

business of the Taxpayer lies in the sale of land and not in the receipt of rentals. That cannot be consistent with the retention of land for long term investment purposes.

16. The Board therefore finds that it is the Taxpayer's general practice to acquire land for the purposes of trade, and as a general rule, land acquired by the Taxpayer constituted the trading stock of the Taxpayer. Consequently, profit upon sale of land would attract profits tax under the Ordinance.

17. What all this comes to is that notwithstanding the Taxpayer's general practice of trading in land, it nonetheless says that in regard to the Letters B which were used to exchange for the land, such general practice was inapplicable. The Board will have to consider this contention in the light of the provisions of section 68(4) of the Ordinance, which states:

> '68(4) The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.'

18. The Letters B which were used in exchange for the land included a certain batch consisting of 15,813 square feet which in turn came from a larger batch from the same lot number consisting of a total 92,838 square feet. After the joint development agreement in relation to the land was signed, 42,025 square feet of these Letters B were sold and offered for assessment to profits tax in the year ended 31 March 1982. Since these Letters B all came from one lot, the Board, if it were to find in favour of the Taxpayer, would have to find that in relation to a portion of the lot, the Taxpayer had formed an intention to keep that portion for long term investment whereas for the rest, the Taxpayer had traded. To come to such a finding, the Board requires cogent evidence. The Board has not only to be guided by the provisions of section 68(4) of the Ordinance, but we were reminded by Mr D'Souza of the following passages in Simon's Taxes:

> 'It is an important point, in many cases of this type, that a person may be concurrently a dealer and an investor in real estate. But the burden of proof on a land dealer, who also claims to hold pieces of land as investments is a heavy one.' (B3.612 in Simon's Taxes at page 1736)
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> It goes on to state at page 1740:
>
> 'A building or land dealing company has more difficulty than an individual in proving that it is also an investor. This was shown in Granville Building Co Ltd v Oxby.'

19. As the Taxpayer's case is critically dependent upon its declaration of intention of buying land for long term investment, we were further reminded by Mr D'Souza of the following dictum of Lord Hanworth MR in Hillerns & Fowler v Murray 17 TC 77 at page 87:

> ‘ But a declaration of an intention by the persons charged will not do to secure immunity from the Income Tax Act. The question is: what is the character to be attributed to the acts done by the partners in relation to the Income Tax Act? The quality and the characteristics to be attached to the acts are all questions of fact, because they are questions of degree.’

20. Therefore, to secure exemption from the charging provisions of the Ordinance, the Taxpayer will have to show that all the acts which found the Taxpayer’s case are of such ‘quality and characteristics’ as will prove the Taxpayer’s alleged intention to acquire for the purpose of long term investment the portion of the land whose Letters B were used to exchange for the land.

21. Although Letters B are shown in the Land Register as having been derived from the lots which were surrendered in exchange for them, they represent (as can be clearly seen from their terms) no more than a contractual right to an entitlement to future exchange of land. As such, they are not land, and one square foot of exchange entitlement in a Letter B is indistinguishable from another square foot. In the light of the Taxpayer’s general practice of treating its land as trading stock, one would expect, if exceptional treatment was indeed intended, the Taxpayer to have set aside an identifiable portion of the original pieces of land intended for such exceptional treatment and segregated this portion from the general pool of land and Letters B which it traded until it was time to exchange this portion for the land. No such evidence was put before us. Indeed, the Taxpayer had so far as we can see treated all pieces of land and Letters B as a pool of interchangeable commodities.

22. Further, the joint development agreement signed in early 1981 is more consistent with the Taxpayer’s general practice of trading in land than with an exceptional practice of retaining land for long term investment. Clause 3(1) of the agreement states that ‘the parties shall hereto participate in a joint venture to tender ... for exchange, development and sale ...’. Clause 3(2) sets out the shares of the parties and states that ‘the said shares shall be the share of the parties hereto ... and all profits and losses shall be shared accordingly’. Clause 4 requires unanimous agreement for, inter alia, ‘the prices of the units of the new building’. The supplementary agreement of mid-1981, reaffirms that the ‘parties hereto shall proceed to develop and sell’ the land. When the joint venture ran into difficulties in obtaining a building mortgage, the method agreed upon was to allocate flats in the new building to the contractor in order to finance development. But otherwise, there was no other variation to the common intention of selling the flats.

23. In the circumstances, the fact that the Taxpayer held Letters B of a total value far in excess of the development cost of $50,000,000 to $60,000,000 for the land is of no assistance to the Taxpayer in this appeal. The fact is that there is no evidence to suggest that the Taxpayer was willing to sell part of these Letters B to finance the development. Indeed at all times, the Taxpayer together with the other parties of the joint venture had wanted to finance the development (other than the initial outlay of Letters B and premium) from either bank borrowings or the sharing of flats with the contractor.

24. Therefore, we are not persuaded that the Taxpayer had discharged its burden of proof that the assessment under appeal was excessive or inaccurate and thus, we dismiss the appeal.

25. Finally, we would like to thank the representatives on both sides for their careful arguments and able assistance to the Tribunal. In particular, we would like to thank Mr D'Souza for his meticulous research into the accounts and documentation.