

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D36/01

Profits tax – sale of property – section 2(1) of the Inland Revenue Ordinance (‘IRO’) – whether profits derived from the sale of the property assessable to profits tax – whether intention to purchase as family home ‘genuinely held, realistic and realizable’ – whether sole purchase in the name of taxpayers indicative of trading intention – onus of proof.

Panel: Ronny Wong Fook Hum SC (chairman), Dennis Law Shiu Ming and Man Mo Leung.

Date of hearing: 8 February 2001.

Date of decision: 25 May 2001.

The taxpayers are married couple and were the shareholders and the directors of Company B. The taxpayers purchased Property 1 in 1989. The taxpayers held Property 1 through Company B between 1989 and 1996. Company B is their agent in relation to Property 1 and Property 6. The taxpayers decided to rent out Property 1. In or around 1996, the taxpayers wanted to replace Property 1 with a flat in Housing Estate H. The taxpayer did not want to retain Company B when the taxpayers decided to sell Property 1 and decided to acquire Property 5 in their names. In fact, Property 5 is the only transaction in the names of the taxpayers.

Thereafter the taxpayers decided to sell Property 5 because of the bad *fung shui*. This appeal relates to their tax liability pertaining to the gains made in dealing with this flat. It was the taxpayers’ case that the original intention of the taxpayers to acquire Property 5 was for their own residence as a family home and held as the long term investment property of the family.

Held:

1. In order for a tax liability to arise, a profit must be derived in Hong Kong from a trade, profession or business carried on in Hong Kong. Section 2(1) of the IRO defines ‘trade’ to include every ‘adventure and concern in the nature of trade’. The facts of each case must be looked at to see whether a gain was made in the operation of business in carrying out a scheme for profit making.
2. Trading requires an intention to trade and the question to be asked is whether this intention existed at the time of the acquisition of the asset. The Board therefore has to ascertain the intention of the taxpayers on 5 September 1996. The Board has to be satisfied that their intention was to purchase Property 5 as their family home and

INLAND REVENUE BOARD OF REVIEW DECISIONS

such intention is on the evidence ‘genuinely held, realistic and realizable’ (Lionel Simmons Properties Ltd v The Commissioner of Inland Revenue [1980] 53 TC 461 and All Best Wishes Limited v CIR 3 HKTC 750 applied).

3. In the light of the surrounding circumstances, the Board would not place significant weight on the fact that Property 5 was the sole purchase in the names of the taxpayers. The Board is not prepared to accept the assertions of the taxpayers. The Board is not persuaded that the taxpayers have discharged the burden of proof resting upon them.

Appeal dismissed.

Cases referred to:

Lionel Simmons Properties Ltd v The Commissioner of Inland Revenue [1980]
53 TC 461
All Best Wishes Limited v CIR 3 HKTC 750
Salomon v Salomon & Co [1897] AC 22

Fung Ka Leung for the Commissioner of Inland Revenue.

Pauline L G Ng instructed by Messrs Chiu Szeto & Cheng, Solicitors for the taxpayers.

Decision:

Background

1. The Taxpayers (‘Mr and Mrs A’) are husband and wife. They have two daughters born respectively in 1979 and 1982.
2. Company B is a company incorporated in Hong Kong on 22 March 1989. According to its annual return dated 22 March 1996, its issued share capital consisted of two shares of \$1 each registered in the names of Mr and Mrs A. Mr and Mrs A were also the directors of Company B.
3. Company C is another company incorporated in Hong Kong. According to its annual return made up to 13 December 1995, Mr D and Company E were its registered shareholders each holding one share. They were also its directors on the date of this return.

INLAND REVENUE BOARD OF REVIEW DECISIONS

4. On 22 May 1989, Company B acquired a flat at Housing Estate F (' Property 1 ') for \$2,240,000. On the same day, Property 1 was mortgaged in favour of Bank G to secure general banking facilities granted in favour of Company B.

5. According to the tax return of Mr A for the year of assessment 1993/94 dated 1 July 1994, his residential address was at a flat at Housing Estate H (' Property 2 '). He was then employed by Company B. His earnings for the year was \$360,000. Property 2 was provided to him as his quarters.

6. On 29 March 1995, Company C entered into a tenancy agreement in respect of a flat in District I (' Property 3 ') for two years from 1 April 1995 to 31 March 1997 at \$5,700 per month.

7. According to the return of Mr A for the year of assessment 1994/95 received by the Revenue on 3 June 1995, he had two employers for the period between 1 April 1994 and 31 March 1995: Company J and Company B. His earnings from Company J for the period was \$330,000. Company B provided him with his quarter at Property 2.

8. By a tenancy agreement dated 29 January 1996, Company C rented a flat at Housing Estate H (' Property 4 ') for two years from 1 February 1996 to 31 January 1998 at \$16,000 per month. The tenant was given an option to terminate the second year of the tenancy by two months' notice. According to the return of Mr A for the year of assessment 1995/96, Company C was his employer and his earnings from that employment totalled \$450,000 for the year. Company C also provided him with quarters at Property 4.

9. By a provisional agreement dated 14 August 1996, Company B sold Property 1 for \$5,500,000. An initial deposit of \$100,000 was payable on signing of this agreement. A further deposit was payable on 29 August 1996. The balance of \$4,950,000 was payable on completion scheduled on 25 September 1996. After repaying Bank G, Company B received \$3,206,078.72 on completion.

10. By a provisional agreement dated 5 September 1996, Mr and Mrs A purchased another flat at Housing Estate H (' Property 5 ') for \$5,880,000. An initial deposit of \$100,000 was payable on signing this provisional agreement. A further deposit of \$488,000 was payable on 19 September 1996. The balance of \$5,292,000 was payable on completion scheduled on 5 November 1996. The purchase was completed on 5 November 1996 with the aid of a loan of \$2,000,000 from Bank K for \$2,000,000 repayable by 180 monthly instalments of \$20,285.33 each. On the same day, Mrs A applied to the Hong Kong Electric Co Ltd for transfer of account. On 10 December 1996, she paid a deposit of \$2,500 in respect of this transfer.

11. By a provisional agreement dated 26 November 1996, Company B purchased a flat at Housing Estate H (' Property 6 ') for \$6,000,000. The purchase was financed by a loan of

INLAND REVENUE BOARD OF REVIEW DECISIONS

\$3,000,000 extended by Bank L on 3 March 1997 which loan was repayable by 180 monthly instalments of \$30,428.

12. By an agreement dated 23 December 1996, Company B purchased another flat at Housing Estate H (‘ Property 7 ’) for \$5,000,000.

13. By an agreement dated 10 January 1997, Company B purchased a flat also at Housing Estate H (‘ Property 8 ’) for \$6,900,000.

14. By a further agreement also dated 10 January 1997, Company B purchased another flat at Housing Estate H again (‘ Property 9 ’) for \$8,260,000. This purchase was supported by mortgage loans of \$5,520,000. The balance payable on completion amounted to \$1,954,980. This sum was transferred from an account in the names of Mr and Mrs A with Bank K to Messrs Hui & Lam, Solicitors handling this purchase.

15. By a provisional agreement dated 12 January 1997, Mr and Mrs A sold at \$7,650,000 Property 5 which they purchased on 5 September 1996 at \$5,880,000. This appeal relates to their tax liability pertaining to the gains made in dealing with this flat.

16. By an agreement dated 4 April 1997, Company B sold at \$5,700,000 Property 7 which it purchased on 23 December 1996 at \$5,000,000.

17. By an agreement dated 10 April 1997, Company B sold at \$7,400,000 Property 8 which it purchased on 10 January 1997 at \$6,900,000.

18. By a tenancy agreement dated 30 May 1997, Company C rented another flat in District I (‘ Property 10 ’) for one year commencing from 1 June 1997 with rental at \$7,300 per month.

19. According to Mr A’ s return for the year of assessment 1995/96, Company C was his employer for that year. He was paid a total of \$450,000 in respect of that employment. Company C provided Property 4 as his quarter for the period between 1 April 1995 and 31 March 1996.

20. According to Mr A’ s return for the year of assessment 1997/98, Company C remained his employer. He was paid a total of \$465,000 in respect of that employment. Company C provided Property 6 as his quarter for the period between 1 April 1997 and 31 March 1998.

21. By an agreement dated 6 August 1999, Company B sold for \$4,650,000 Property 6 which it purchased on 11 December 1996 at \$6,000,000.

Case of the Taxpayers in correspondence with the Revenue

INLAND REVENUE BOARD OF REVIEW DECISIONS

22. By a letter dated 13 July 1998, Messrs Mok & Tse, tax representative of the Taxpayers, informed the Revenue that:

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1. The original intention of our client to acquire [Property 5] was for their own residence due to:
 - (a) the tenancy agreement of the flat they rented at that time would be expired in six months’ time and;
 - (b) there was a drastic increase in rental value during that time. Our clients feared to pay high rental and decided to acquire a flat in the same area they were living – Housing Estate H.
 2. The reason for disposal of the property was Mr A’s employer agreeing to provide a quarter to him in Housing Estate H so they decided to sell the captioned property. Subsequently they moved into the flat provided by the employer.’

23. By letter dated 17 August 2000, Messrs Mok & Tse further informed the Revenue that:

- ‘ All along the employer of Mr A rent [*sic*] a flat from the market so to provide a quarter to him. In February of 1996, a tenancy agreement was reached, in which the rental for the first and second year’s rental was fluctuated. Being the director of [Company C], Mr A had his duty to keep the quarter expenses stable but there was a trend of increasing rental of residential premises at that time. In order to achieve the above purpose, his wife [Mrs A] was requested to search and to acquire a property. In September of 1996 [Property 5] was purchased hurriedly with the intention to let this to [Company C] as the director’s quarters. After the property was handed over to our client’s for decoration, they found that the flat was like a cage. [Mrs A] was so discouraged but was instructed to search another one. Luckily in December of 1996 [Property 6] was introduced and acquired by their company called [Company B]. After that Mr A’s family moved into [Property 6], and [Property 5] was of course disposed [*sic*], incidentally there was a profit.’

The sworn testimony of Mr A

24. He is a structural engineer holding a master degree. He started his own business in the year of assessment 1990/91.

25. He purchased Property 1 in 1989. His stay in Property 1 was not a happy one. The flat faced a cemetery located not more than 50 yards away. His wife became indisposed and his

INLAND REVENUE BOARD OF REVIEW DECISIONS

two daughters reported seeing ghosts walking in the corridor of that apartment. It was not viable to dispose of Property 1 as it was then ' a negative equity' . He therefore decided to rent out Property 1.

26. In the year of assessment 1992/93, he succeeded in securing a contract involving high risks. He used Company C to execute that contract and Company B to hold his investments. In 1996, the shares in Company C were held by trustees with 50% thereof on his behalf. That company was then involved in a construction dispute which he wanted to avoid. He now holds 99.9% of that company.

27. In or around 1996, property prices in Hong Kong escalated rapidly. Given his long association with Housing Estate H, he decided to replace Property 1 with a flat in Housing Estate H. The new Housing Estate H flat would be used as a family home and held as the long term investment property of the family.

28. He did not want to retain Company B when he decided to sell Property 1. A substantial part of the rental collected by Company B from Property 1 went to its auditor and it was cumbersome to keep track with its affairs. He therefore decided to acquire Property 5 in his name and that of his wife.

29. He inspected Property 5 once prior to its purchase. The decision to purchase was made within hours. He was then heavily engaged in his construction projects and property prices were escalating wildly. Drastic increase in rental value was part of his concerns leading to the purchase.

30. Having cooled down from the buying frenzy, he discovered that the balcony of Property 5 was enclosed by iron bars generating a cage-like feeling. He enlisted the assistance of his friend Mr M. Mr M was knowledgeable in *fung shui*. Mr M's advice was negative. The family therefore decided to dispose of Property 5.

31. Mrs A was responsible for selling Property 5. He did not decide on the sale price which was dictated by market force. He has no recollection in relation to the various stages of the negotiations.

32. They took immediate steps to look for another property and Property 6 was located. Because of the state of the market, they entered into an agreement to purchase Property 6 before selling Property 5. They were advised by their bank to acquire Property 6 in the name of Company B in order to obtain finance.

33. Property 9 was purchased in the name of Company B as a long term investment. Property 8 and Property 7 were purchased in the name of Company B for the purpose of providing

INLAND REVENUE BOARD OF REVIEW DECISIONS

staff quarters and to accommodate consultants of Company C. The two flats were sold when Company C experienced tight cash flow.

34. He did receive drafts and copies of correspondence exchanged between his tax representative and the Revenue. He did not pay attention to the details as drafted by his tax representative. He was careless in not advertent to the other reasons leading to the disposal of Property 5. He was technically in error in informing the Revenue that they obtained from Company B loans to pay for the down payment and the mortgage instalments.

Submissions on behalf of the parties

35. It was submitted on behalf of the Taxpayers that:

- (a) They had chosen to pay 66% of the purchase price of Property 5 out of their available resources and borrowed only the difference of 34%. Mr A could well afford the monthly repayment with his annual income of \$595,000 per annum.
- (b) They took steps to transfer the electricity account in respect of Property 5. A deposit was paid. This is wholly consistent with an intention to reside therein.
- (c) Company B was a company vehicle which the Taxpayer could easily have used for their purchase in order to minimise their personal risks. The personal risks were heightened by the inclusion of Mrs A as a joint tenant.
- (d) They did not have a history of property speculation.
- (e) Company B and Company C are separate corporate entities and there is no justification to lift the corporate veil. The Taxpayers however asserted that Company B held Property 1 and Property 6 on trust for the Taxpayers as they financed the purchase. They further asserted that Company B held Property 8, Property 7 and Property 9 on trust for Company C. In support of this latter contention, a profits tax assessment against Company C for the year of assessment 1996/97 was annexed as part of counsel's written closing submission. We regret such improper attempt to introduce evidence after the hearing. We attach no weight to that assessment. We also note that the assertion of trusteeship in favour of Company C surfaced for the first time in counsel's closing submissions.
- (f) They held Property 1 for about nine years. The market was good and it was a good time to sell Property 1.

INLAND REVENUE BOARD OF REVIEW DECISIONS

- (g) They had worked for many years and were frustrated in not having their own property to live in.
- (h) The acquisition 'was impulse buying'. After cooling off and after consulting their *fung shui* master friend, the Taxpayers decided to sell the flat.
- (i) Mere sale of an investment is not itself evidence of trading. There is no clear evidence to support a change of intention.
- (j) Short term ownership is indicative of trading but not conclusive evidence. The whole circumstances must be considered.
- (k) The Taxpayers purchased Property 6 and lived in it for about a year. They sold Property 6 after two years. This is totally incompatible with any earlier intention to trade.
- (l) The incomplete account in the correspondence between the Revenue and the Taxpayers arose as a result of Mr A's 'rather inattentive attitude'.

36. It was submitted on behalf of the Revenue that:

- (a) Bearing in mind the reported earnings of Mr A for the year of assessment 1995/96 (\$450,000), the loan of \$2,000,000 was probably the maximum available from Bank K. The monthly repayment of \$20,285.33 would be about 54% of Mr A's average monthly earnings of \$37,500.
- (b) Little weight should be given to the transfer of electricity account by Mrs A. She was merely trying to ensure continuous supply of electricity.
- (c) The tenancy agreement in respect of Property 4 was for two years expiring on 31 January 1998. When the Taxpayers purchased Property 5, the tenancy still had 16 months to go. There is no evidence to substantiate any genuine concern in relation to the level of rent.
- (d) The Taxpayers' position in relation to Company B is highly inconsistent. On the one hand, the Taxpayers seek to associate themselves with Company B's dealings with Property 1 and Property 6. On the other hand, the Taxpayers try their best to distance themselves from other dealings of Company B. All the circumstances should be looked at.

INLAND REVENUE BOARD OF REVIEW DECISIONS

- (e) The assertion that Company B held Property 7, Property 8 and Property 9 on trust for Company C was first made in counsel's closing submissions. No evidence was adduced in support of such contention. Such assertion is also inconsistent with counsel's further statement that Company C paid rent to Company B in respect of both Property 7 and Property 8.
- (f) Bearing in mind the inconsistencies between the case projected in the correspondence passing between the parties and the case now being advanced on behalf of the Taxpayers, the current case of the Taxpayers should be viewed with care given the level of education of Mr A.

The applicable principles

37. In order for a tax liability to arise, a profit must be derived in Hong Kong from a trade, profession or business carried on in Hong Kong. Section 2(1) of the IRO defines 'trade' to include every '*adventure and concern in the nature of trade*'. The facts of each case must be looked at to see whether a gain was made in the operation of business in carrying out a scheme for profit-making.

38. In Lionel Simmons Properties Ltd v The Commissioner of Inland Revenue [1980] 53 TC 461 at 491, Lord Wilberforce pointed out that trading requires an intention to trade and the question to be asked is whether this intention existed at the time of the acquisition of the asset. We therefore have to ascertain the intention of Mr and Mrs A on 5 September 1996. We have to be satisfied that their intention was to purchase Property 5 as their family home and such intention is on the evidence '*genuinely held, realistic and realisable*'.

39. As pointed out by Mortimer J (as he then was) in All Best Wishes Limited v CIR 3 HKTC 750:

' It is trite to say that intention can only be judged by considering the whole of the surrounding circumstances, including thing 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.'

40. We were reminded by the Taxpayers' counsel of the rule in Salomon v Salomon & Co [1897] AC 22. As stated by paragraph 1.3 of Gore-Browne on Companies 44th edition, '*the fact that one shareholder controls all, or virtually all, the shares in a company is not a sufficient reason for ignoring the legal personality of the company.*' Paragraph 2.1519 of Palmer's Company Law 25th edition pointed out that '*Generally speaking, the courts are more inclined,*

INLAND REVENUE BOARD OF REVIEW DECISIONS

in appropriate circumstances, to “lift the veil” of corporateness where questions of control are in issue than where a question of ownership arises.’ What is significant in this case is the Taxpayers’ own treatment of the role of Company B. They wish to have the veil of Company B lifted in their favour via their plea of agency in the case of Property 1 and Property 6. They wish to distance themselves from Company B in the case of Property 7, Property 8 and Property 9. No cogent evidence has been adduced before us to justify this distinction. On the contrary, there is evidence indicating that the Taxpayers paid \$1,954,980 to support the purchase of Property 9.

Our decision

41. Property 5 was purchased after the disposal of Property 1. The Taxpayers held Property 1 through Company B between 1989 and 1996. This is a pointer in favour of the Taxpayers although the length of such ownership might well be attributable to the need to recover from the negative equity position.

42. The Taxpayers say that they decided at that juncture to purchase their own home. The Revenue says that they decided to ride with the market by the purchase of Property 5. We have to ascertain the true intention of the Taxpayers in the light of the surrounding circumstances.

43. Property 5 is the only transaction in the names of Mr and Mrs A. It is a one-off transaction in their personal names. They are the *alter ego* of Company B. It is admitted that Company B is their agent in relation to Property 1 and Property 6. Given their payment of \$1,954,980 in completing the purchase of Property 9, it is likely that Company B likewise held Property 9 on their behalf. There is no clear evidence as to the financing of Property 7 nor Property 8. Those two flats are said to have been purchased for staff of Company C. We view that assertion with grave suspicion. There is no evidence to indicate that any of these two flats was being used for such purpose. Rentals for the two flats in District I (Property 3 and Property 10) were respectively \$5,700 and \$7,300 per month. Rental for Property 4 in Housing Estate H stood at \$16,000 per month. It was more convenient for Company C’s staff to go to the new airport from District I. On the evidence before us, we are not convinced that Company C was prepared to incur substantial expenditure to provide their staff with quarters when they could obtain suitable premises at attractive rates. Property 7 and Property 8 were probably part of the trading activities of Company B. Property 8 and Property 9 were purchased on the same day. No minutes of Company B have been produced to demonstrate that they were held for different purposes. No explanation has been furnished to demonstrate the desirability of holding Property 9 as a long term investment. Property 7 and Property 8 are the subjects of further debates between Company B and the Revenue. We do not wish to make any finding in relation to those two flats. It suffices for us to say that in the light of these surrounding circumstances, we would not place significant weight on the fact that Property 5 was the sole purchase in the names of the Taxpayers.

INLAND REVENUE BOARD OF REVIEW DECISIONS

44. We accept the submission of the Revenue that the Taxpayers' banker was unlikely to extend loan in their favour in excess of the sum of \$2,000,000. Mr A was the sole bread-winner. His then earnings could not support any loan of more than \$2,000,000.

45. There is no evidence of any renovation being done to Property 5 to convert it into a family home. The transfer of the electricity account gives some but very limited support to the Taxpayers' case. The purchase of Property 6 is of greater significance. The weight of this factor is however diminished by the fact that the Taxpayers did not reside in Property 6 in their own rights. Property 6 was quarters provided to them by Company C. The assertion of the Taxpayers that Company B held Property 6 as their agent is therefore misleading.

46. In the final analysis, this case turns on the credibility of Mr A. The pre-hearing correspondence between the Revenue and the Taxpayers casts a long shadow over his credibility. It was asserted on behalf of the Taxpayers that rental pressure prompted the acquisition of Property 5. The Taxpayers however lived in quarters provided by Mr A's employers before and after the purchase of Property 5. It is now claimed that *fung shui* played a part in the decision to dispose of Property 5. No such claim was made in the pre-hearing correspondence. It is conceded that the purchase of Property 5 was 'impulse buying'. That flat was sold within a spell of about five months. In these circumstances, we are not prepared to accept the assertions of Mr A. We are not persuaded that the Taxpayers have discharged the burden of proof resting upon them.

47. For these reasons, we dismiss the Taxpayers' appeal.