

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D42/95

Profits tax – purchase and sale of flat – whether profit subject to profits tax.

Panel: Audrey Eu Yuet Mee QC (chairman), Erwin A Hardy and Manuel Rosas Woo.

Date of hearing: 25 May 1995.

Date of decision: 28 July 1995.

The taxpayer purchased a flat and sold the same at a profit soon thereafter. The assessor assessed the profits to profits tax. At the hearing before the Board of Review evidence was given to explain why the property was sold soon after purchase.

Held:

The Board accepted the evidence given on behalf of the taxpayer and allowed the appeal.

Appeal allowed.

Cases referred to:

D8/90, IRBRD, vol 5, 113

Lionel Simmons Properties Ltd v IRC 53 TC 461

Mei Yin for the Commissioner of Inland Revenue.

Taxpayer represented by her husband.

Decision:

1. The Taxpayer appeals against the determination of the Commissioner of Inland Revenue dated 23 November 1994 which confirmed in part the profits tax assessment for the year of assessment 1991/92 arising from her purchase and sale of a property known as 'the Property' in District A.

A. BACKGROUND

2. The following facts are not in dispute:

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- (a) The Taxpayer purchased the Property by a provisional agreement for sale and purchase dated 12 January 1991.
- (b) The purchase price was \$838,350 with an initial deposit of \$83,835.
- (c) The Taxpayer obtained a mortgage from Bank X for \$750,000.
- (d) The monthly mortgage payment was about \$7,200.
- (e) The Property was uncompleted at the time.
- (f) By a provisional agreement for sale and purchase dated 14 July 1991, the Taxpayer sold the Property for \$1,100,000 while it was still under construction.
- (g) By another provisional agreement dated 7 August 1991, the Taxpayer purchased another property known as Property B in District B for \$1,300,000.
- (h) She obtained a mortgage of \$960,000 from Bank Y.
- (i) Property B was let almost immediately and is still held by the Taxpayer for rental income.

B. THE ISSUE

3. To be liable for profits tax under section 14 of the Inland Revenue Ordinance (the IRO) chapter 112, the profit arising from the sale must be derived from trading. The relevant case law is well established. The sole issue before us is: what was the intention of the Taxpayer when she purchased the Property?

C. THE EVIDENCE

4. The Taxpayer was represented by her husband. He was the only witness. He is a civil servant. He has been with the Government for the last 25 years. His wife now works part time in a restaurant but was not working at the time the Property was purchased. He resides with his wife and their son (about 12 years old) at Property C which was purchased in about 1990 under the home purchase scheme. Under this scheme, he obtains a monthly assistance in the region of \$13,000. The amount has varied and he tries to keep it roughly in line with the amount of the monthly mortgage for his residence. However this monthly assistance will cease by the end of 10 years, at which time he will still owe the bank some \$600,000. It has always been his intention to save some money in order to repay this loan.

5. He and his wife were married in 1979. They lived in a self-owned flat in District D. They sold the flat in 1982 and moved to rented premises in District E because they could not find someone to look after their son. In 1987, he purchased a flat in District F under the home purchase scheme. He sold the flat in District F in 1990 and bought the

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present flat they are now residing in. Apart from the properties mentioned, neither his wife nor he has ever purchased any other property.

6. The sale of the flat in District D taught him the importance of buying or investing in real property. After many years, they managed to save a modest sum. They went everywhere looking for a property to hold as a long term investment. They were keen to buy a property in District B which was then a well-known development about 10 years old. Their sole criterion was that they would be able to afford the down payment and the monthly payment. The property would only need a 10% down payment. Although Property B was slightly more expensive, the important difference was not the difference in price but the down payment. The bank would only offer 65 – 70% mortgage for Property B and they could not afford the remainder from their modest saving.

7. The whole family went to see the show flat at the Property construction site for many Sundays planning and thinking about it. They were to invest almost their entire savings. In addition, they would have to pay a monthly mortgage of about \$7,200. That would mean a reduction in their standard of living. They could just about manage it by cutting down some of their expenses.

8. In the end, they decided to buy the Property. It was about 440 square feet in area. He said that their intention was to hold on to the Property until 1997 when the monthly assistance would cease. But he also said that if the property price rose and they could sell the Property and change to Property B, they would do so. In about July 1991, the property market did rise and they sold the Property very quickly.

9. At the same time of the sale, they went ahead with the purchase of Property B. It was about 470 square feet and the price \$1,300,000. During his evidence, he explained that there was a shortfall of about \$120,000 which came about as follows:

	\$
Purchase Price	1,300,000
<u>Less: Mortgage</u>	960,000
<u>Less: Gross Proceeds</u>	261,650
<hr/>	
Balance	78,350
<u>Add: Solicitors Fee</u>	
<u>Add: Stamp Duty</u>	
<u>Add: Miscellaneous Expenses</u>	
Total Shortfall	120,000

10. He said that some of the shortfall was met from their savings and some from the overdraft facilities he had with Bank Y and Bank Z. He had been making use of overdraft

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facilities from time to time, particularly for payment of tax. He did not have financial assistance from their parents.

11. Since it was his repeated emphasis that they purchased the Property because it was the only one they could afford and that the down payment took up almost all of their savings accumulated over many years, it became relevant to know how much savings was left or could be accumulated over the short period between January and August 1991 (during which period he was also paying the monthly mortgage for the Property) in order to meet the shortfall of \$120,000. He was asked if he would like to produce further documents relating to the source of the funds for the \$120,000 shortfall. The hearing was adjourned and he was given 14 days during which he could produce further documents if he so wished.

12. He put in a further written submission dated 5 June 1995. He explained that the shortfall as calculated in his testimony was wrong. It should be only \$40,414.90.

	\$
(a) Purchase Price of Property B	1,300,000.00
(b) <u>Less</u> : Mortgage from Bank Y	<u>960,000.00</u>
	340,000.00
(c) <u>Less</u> : Proceeds from the sale of the Property	<u>339,520.10</u>
	479.90
(d) <u>Add</u> : Solicitors' etc fees	<u>39,935.00</u>
(e) Additional amount paid	<u>40,414.90</u>

In his earlier calculation, he mistook the net proceed for the gross proceed. The gross proceed of \$339,520.10 is worked out as follows:

	\$
(a) Selling price of the Property	1,100,000.00
(b) <u>Less</u> : Amount paid to Bank X to discharge the mortgage	<u>757,329.98</u>
	342,670.10
(c) <u>Less</u> : Solicitors fees	<u>3,150.00</u>
(d) Net amount received	<u>339,520.10</u>

He further explained that the shortfall of \$40,414.90 was met in the following manner:

- (a) His wife commenced work as a part-time teller with Bank Z on 1 April 1991 and resigned on 11 July 1991. During this period, she earned \$10,642.

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- (b) In February 1991, he received an amount of \$37,926.62 being home purchase allowance and in July 1991, he received an amount of \$8,424.45 being back-pay for that year.
- (c) He could also make use of overdraft facilities he had with Bank Y or Bank Z. But he no longer has the documents for the period.

13. The Revenue put in a further written submission challenging the Taxpayer's source of funds for the \$40,414.90 shortfall. It must be difficult for the Taxpayer to recall several years later the source of fund for each payment and we do not expect this to be done in every detail. When the shortfall was initially said to be \$120,000, it was large enough to give rise to some concern. But since it is now resolved that the shortfall was only \$40,000 odd, the picture is very different. We do not find it necessary to go into the exact source of funds for payment of this shortfall.

D. THE REVENUE'S CASE

14. The following points were urged upon us by the Revenue.

- (a) The Property was sold before generating any rental income. It disproves the Taxpayer's case that the intention was for long term investment for rental income.
- (b) The comparative attractiveness of the Property should have been fully considered before acquisition. The sale as soon as property price rose indicated an absence of intention to hold the Property as a long term investment.
- (c) The short period of ownership gives rise to a strong presumption in favour of trading.
- (d) The Taxpayer sold the Property before it was completed, thus saving stamp duty.
- (e) The use of the sale proceeds to purchase Property B was irrelevant. A trading transaction does not become a capital gain because one decides to reinvest the proceeds in residential accommodation for oneself (see Board of Review Decision D8/90, IRBRD, vol 5, 113 at page 116).

E. REASONS FOR DECISION

15. The thrust of the Revenue's case boils down to the short period of ownership. The Taxpayer has a good answer for that. The Taxpayer and her husband bought the Property not so much because they found it attractive. They bought it because that was the best they could afford at the time. In fact their preference was to buy Property B. Thus it is not difficult to see why they quickly sold the Property when the opportunity came along.

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Did this amount to trade? We have to go back to the well known dictum of Lord Wilberforce in Lionel Simmons Properties Ltd v IRC 53 TC 461 at page 491G:

‘Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment? Often it is necessary to ask further questions: a permanent investment may be sold in order to acquire another investment thought to be more satisfactory; that does not involve an operation of trade, whether the first investment is sold at a profit or at a loss. Intentions may be changed.’

16. In this case, the Taxpayer’s husband explained that they were all along looking for a long term investment and they ended up with the best one they could afford. If the opportunity came along to change it to a better investment, they would do so. If not, they would hold on to it and it was within their financial ability to do so.

17. Quick sale is often relied upon as an indication that the taxpayer was trading but in this case the quick sale is consistent with the Taxpayer’s case of a change of investment.

18. Board of Review Decision D8/90 is clearly correct on its own facts. If the purchase of the property was by way of trading, it cannot become an investment because the proceeds of sale is invested in a capital asset. But if the sale is by way of a change of investment, then the reinvesting of the sale proceeds in another capital asset is clearly relevant. We note that Property B has always been let and is held up to now. There is nothing to indicate it was not a purchase by way of investment but since this matter is not before us, we shall say no more about it.

19. We have no hesitation in accepting the Taxpayer’s case and we find that the profit did not arise from trade. We allow the appeal accordingly.