INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D44/93

Profits tax – disposal of property – whether profit subject to profits tax.

Panel: William Turnbull (chairman), Graeme Large and Erwin A Hardy.

Dates of hearing: 20 and 21 October 1993.
Date of decision: 3 December 1993.

The taxpayer was a private limited company owned and controlled by two persons. The company acquired certain Letters B which it subsequently sold at a profit. It then acquired to apartments which it also sold at a profit. The company claims that all of the profits were capital gains. The assessor rejected this claim and assessed all three gains to profits tax. The taxpayer appealed to the Board of Review. One of the shareholders and directors of the company who was the dominant shareholder and director gave evidence. His evidence with regard to the Letters B was accepted by the Board but his evidence with regard to the two apartments was rejected by the Board.

Held:

The taxpayer acquired the Letters B as long term capital assets and accordingly the gain on disposal thereof was not subject to profits tax. With regard to the two apartments it was the intention of the taxpayer to trade therein and accordingly the profits arising on the sale thereof were subject to profits tax.

Appeal allowed in part.

Cases referred to:

Lionel Simmons & Others v CIR 53 TC 461
CIR v Livingston 11 TC 538
Marson v Morton [1986] 1 WLR 1343
D61/87, IRBRD, vol 3, 31
In re Herald International Limited 1 HKTC 393
Hillerns and Fowler v Murray 17 TC 77
Shadford v H Fairweather & Co Ltd 43 TC 291
Cunliffe v Goodman [1951] 1 All ER 720
D25/88, IRBRD, vol 3, 294

Wong Kuen Fai for the Commissioner of Inland Revenue.
J J E Swaine instructed by Messrs F Zimmern & Co for the taxpayer.

Decision:

This is an appeal by a private limited company against a profits tax assessment for the year of assessment 1987/88 and two additional profits tax assessments for the years of assessment 1988/89 and 1989/90. In these profits tax assessments the assessor had assessed certain profits on the disposal of property which the Taxpayer claimed were not assessable. The facts are as follows:

1. The Taxpayer was incorporated as a private limited company in Hong Kong in 1980. According to the directors' reports for the relevant years, the principal activities of the Taxpayer were investment and security dealings. At all relevant times, the company's directors were Mr A and Mr B.

2. The Taxpayer was owned by two shareholders namely Mr A and Mr B. Mr A was a wealthy individual who owned 95% of the issued share capital of the Taxpayer. Mr B had been in the employment of Mr A's family for many years and was invited by Mr A to be a shareholder and director of the Taxpayer because of his long association with the family. Mr A owned a significant interest in a property-owning company which had been established by his family and which owned property investments in Hong Kong. The major source of income for Mr A was dividends which he received from this family property-owning company. Mr A and Mr B acquired the Taxpayer in 1980 intending that it would be a vehicle for personal investment purposes.

3. In May 1982, the Taxpayer acquired the following land exchange entitlements:

	Area Square Feet	Purchase consideration $
(a)	14,000	2,240,000
(b)	1,343	194,735
	15,343	2,434,735

The above land exchange entitlements are referred to collectively as 'the Letters B'. The purchase of the Letters B was financed by interest-free shareholder's loans. The reason why the Taxpayer acquired the Letters B was because Mr A wished to make an investment which would act as a hedge against inflation and which would have a long-term growth in value.

4. On 21 March 1987, the Taxpayer sold the Letters B to C Limited for $9,282,515, that is at $605 per square foot. The Taxpayer derived a profit of $6,834,560 on sale of the Letters B.

5. On 13 May 1987, the Taxpayer purchased the following apartments in a block of flats then under construction:

		Purchase Price $
(a)	'Apartment X'	1,584,880
(b)	'Apartment Y'	1,560,240

The Taxpayer also commenced to deal in shares listed on the Hong Kong Stock Exchange during the year 1987.

6. The Taxpayer submitted a profits tax return for the year of assessment 1987/88 and financial statements for the year ended 31 December 1987. In its return, it did not offer the profit from sale of the Letters B for assessment but claimed the loss on securities dealing as an allowable deduction.

7. In May 1988, the Taxpayer sold Apartment Y to Mr W for $1,795,700 and realized a profit of $233,160. The construction of Apartment Y had not yet been completed.

8. In February 1989, the Taxpayer sold Apartment X to D Limited for $3,275,000 and realized a profit of $1,642,330. The construction of Apartment X had not yet been completed.

9. The Taxpayer submitted profits tax returns and financial statements for the years of assessment 1988/89 and 1989/90. The profits on sale of Apartment X and Apartment Y were not offered for assessment in these returns.

10. Pending replies to queries raised, the assessor issued the following loss computation and assessments in accordance with the returns submitted.

Year of assessment 1987/88

(Basic Period: year ended 31 December 1987)

	$
Assessable Profits	NIL
Loss per return carried forward	400,124

Year of assessment 1988/89

(Basis Period: Year ended 31 December 1988)

	$

Profits per return	513,824
Less: Set-off of loss brought forward	400,124
Net Assessable Profits	113,700
Tax Payable thereon	19,329

Year of assessment 1989/90

(Basis Period: Year ended 31 December 1989)

	$
Profit per return	284,271
Tax Payable thereon	46,904

The Taxpayer did not object to the above assessments.

11. The assessor was not satisfied that the profits from disposal of the Letters B, Apartment Y and Apartment X were capital profits. On 13 September 1991, the assessor raised on the Taxpayer assessments as follows:

Year of assessment 1987/88

(Basis Period: Year ended 31 December 1987)

	$
Loss per return	400,124
Less: Profit on disposal of Letter B land exchange entitlement (see fact 4)	6,834,560
Net Assessable Profits	6,434,436
Tax Payable thereon	1,158,198

Year of assessment 1988/89

(Basis Period: Year ended 31 December 1988)

Profits per return	513,824
Add: Profit on disposal of Property Y	

(see fact 7)	233,160
	746,984
Less: Profits already assessed	113,700
Additional Assessable Profits	633,284
Tax Payable thereon	107,658

Year of assessment 1989/90

(Basis Period: Year ended 31 December 1989)

	$
Profit per return	284,271
Add: Profit on disposal of Apartment X (see fact 8)	1,642,330
	1,926,601
Less: Profits already assessed	284,271
Additional Assessable Profits	1,642,330
Tax Payable thereon	270,984

12. The tax representatives objected to the assessments in fact 11 on the grounds that the profits on disposal of the Letters B, Apartment Y and Apartment X were capital profits and should not be chargeable to profits tax.

13. By his determination dated 2 April 1993, the Commissioner of Inland Revenue rejected the Taxpayer's objections and confirmed the assessments.

At the hearing of the appeal the Taxpayer was represented by Counsel. Mr A and Mr W were called to give evidence on behalf of the Taxpayer. The evidence of Mr A with regard to the Letters B was substantially in line with the facts which we have set out above. He said that when the Taxpayer acquired the Letters B there was no intention to sell the Letters B but it was anticipated that they would go up in value and he said that there was a possibility that they could be exchanged for other land which could be used. He said that the intention was to acquire the Letters B as a hedge against inflation with the intention of long-term capital growth. He did not deny that at some time in the future the Taxpayer could sell the Letters B. With regard to the actual sale which did take place Mr A said that in about March 1987 he was approached by a solicitor in respect of an offer by a third party for the purchase of the Letters B. He said that it was decided to accept the offer because it

was too attractive to turn down and he considered that the Letters B had reached a high point in their value and that it would be prudent to realise a profit and reinvest in other assets. We accept the truth of what Mr A said in regard to the Letters B.

With regard to Apartment X and Apartment Y we do not accept the evidence given by Mr A as to the intention of the Taxpayer. He said that in or about May 1987 he and Mr B came to notice a new development in Area X in which his family company had a minority interest. He and Mr B considered the two apartments to be very desirable for a number of reasons all of which we accept but all of which would make the apartments desirable either as long-term investments or as trading assets. For example he said that they had sea view, were being developed by a reputable developer and were of an ideal size. Because of his family connections the two apartments were offered to the Taxpayer on very favourable terms. Mr A went on to say that in or about May 1988 he was approached by a very good friend of his, Mr W who said that he would like to purchase one of the two apartments. He said that Mr W had been a long standing friend of his and because of his close relationship with Mr W he decided to sell Apartment Y to him. He went on to say that having sold one apartment there was then less reason to keep the other and in February 1989 when a very attractive offer for Apartment X was received it was decided to sell this apartment as well. He said that when Apartment X was sold, Mr W also resold Apartment Y at a significant profit because the prospective purchaser wanted to buy two adjacent apartments on the same floor of the building.

With due respect to Mr A we are not able to accept his evidence when he said that the two apartments were purchased to be held as long-term investments, that is for rental income. Other than his own statement to this effect there is little or no evidence to support such an intention. We had the opportunity of hearing the evidence of Mr A and whereas we are quite satisfied that the acquisition of the Letters B was as a long-term investment and a hedge against inflation. We are not satisfied regarding the intention of the Taxpayer in relation to the two apartments as stated by Mr A. It is quite apparent that as soon as he was approached by his friend he was prepared to sell one of the two apartments at a comparatively small profit. Shortly thereafter when he received another approach he was prepared to sell the second apartment. It appears to us that either or both of the two apartments were available for sale at any time and there does not appear to us to have been any real intention to retain the two apartments as long-term capital investments for rental purposes. Indeed if this had been the intention of the Taxpayer we would then have expected to see the Taxpayer reinvest the proceeds of sale in other suitable long-term properties for rental income purposes. What the Taxpayer did was little more than a speculation in the property market on favourable terms. The onus of proof is clearly placed upon the Taxpayer by section 68(4) of the Inland Revenue Ordinance and Mr A was not able to satisfy this burden of proof in the evidence which he gave.

Mr W was also called to give evidence but his evidence was of little help to the Taxpayer. He confirmed his long-standing friendship with Mr A and said that he insisted that Mr A should sell one of the two apartments to him for his own use. He said that as a result Mr A agreed to sell Apartment Y to him.

We were shown various minutes of board meetings of the Taxpayer but give little weight to the same.

Mr B was not called to give evidence.

Counsel for the Taxpayer addressed us on the law and the facts. He pointed out that an asset cannot at the same time be both a trading asset and a capital asset and said that an investment does not turn into trading stock because it is sold. He cited to us as his authority Lionel Simmons and Others v CIR 53 TC 461. He pointed out that it is clear that a single isolated transaction may, depending on the circumstances of the case, constitute an adventure in the nature of trade. However he also pointed out the converse which is that an isolated purchase and subsequent sale of an asset when nothing is done in relation to that asset cannot readily be classified as trade or as an adventure in the nature of trade. He cited to us CIR v Livingston 11 TC 538. He suggested that with regard to the Letters B this was just such a case because the Taxpayer plainly was not dealing in Letters B and did nothing in the nature of dealing.

Counsel for the Taxpayer went on to say that it is clear that assets which do not produce recurrent income can be either trading or capital assets and cited to us the case of Marson v Morton [1986] 1 WLR 1343. He said that Letters B were capable of either being a long-term capital investment or a trading asset. In this regard he pointed out that previous Boards of Review had accepted this principle and cited to us D61/87, IRBRD, vol 3, 31.

He went on to point out that the Taxpayer had held the Letters B for almost five years and did nothing other than hold the Letters B.

With regard to the two apartments counsel for the Taxpayer referred us to the Commissioner's contentions and the facts of the case. He placed emphasis on those parts of the evidence which supported his case such as the Taxpayer not having advertised the flats for sale or employing an estate agent. He drew our attention to the fact that Mr W had said that he had persuaded Mr A to sell one of the flats and that with regard to the other apartment the Taxpayer was approached by an eager purchaser willing to pay a premium. He also referred us to the argument put forward on behalf of the Commissioner that there were no rental projections. It is not necessary for us to deal with the lack of rental projections at any length because we are of the opinion that this factor is of little importance one way or the other in the case before us. Counsel for the Taxpayer also made reference to the authorities cited by the representative for the Commissioner to which we refer later.

The representative for the Commissioner submitted that the onus of proof is upon the Taxpayer as stated by section 68(4) of the Inland Revenue Ordinance. This is of course correct and accepted by the Board. He drew our attention to the case of In re Herald International Limited 1 HKTC 393 as authority for saying that the question for the Board of Review to decide is not whether the Commissioner was wrong in his determination but whether the assessment is wrong. With this we also agree. When an appeal comes before the Board of Review the Commissioner is not bound by what he has said in his

determination. What the Board must decide is whether or not the assessment against which the Taxpayer has appealed is or is not correct.

The representative for the Commissioner said that it is the intention of the Taxpayer at the time when it acquired the assets which is crucial and said that the subjective intention of the Taxpayer must be tested by the objective facts and circumstances. He cited Hillerns and Fowler v Murray 17 TC 77. With this proposition we are in agreement.

The representative went on to cite a statement by Buckley J in Shadford v H Fairweather & Co Ltd 43 TC 291 at pages 299/300. With due respect we find this citation either irrelevant or difficult to follow because Buckley J is dealing with the facts of a different case and then makes a statement to the effect that a commercial transaction is a transaction in the nature of trade regardless of whether it is selling or letting. Whilst that may have had relevance and meaning in the case in question it does not assist us in the case before us.

The representative for the Commissioner then referred us to Cunliffe v Goodman [1951] 1 All ER 720 as being the authority that the intention to invest must be a definite intention and not a provisional one. Whilst this may be correct it has little relevance to the facts of the case before us.

He went on to say that the effluxion of time in itself cannot turn a trading stock into a capital asset and vice versa unless there is manifest evidence of a change of intention. In the case before us on the facts as we have found them there is no question of a change of intention.

The representative for the Commissioner then went on to make a submission on the facts in relation to the Letters B and cited to us D25/88, IRBRD, vol 3, 294. He referred at some length to the nature of the assets and the fact that they did not produce any income and took us through the evidence before us.

Though we have set out at some length the submissions made by the representatives for the parties it is not necessary for us to deal further with the same or to otherwise set out the law. The law in cases such as that before us is quite simple. One must look at the intention of the Taxpayer at the time when it acquired the three assets in question. One must test whatever subjective statements or evidence there may be against the objective facts. One must come to a conclusion on the evidence before the Board as to what was the intention of the Taxpayer at the time when it acquired the assets. The onus of proof is placed upon the Taxpayer and it is therefore for the Taxpayer to reasonably satisfy the Board as to what was its intention.

We are satisfied that the Taxpayer when it acquired the Letters B did so as long-term capital assets. The intention was to make a long-term investment which would grow in value and act as a hedge against inflation. There was no intention on the part of the Taxpayer to trade in the Letters B.

The situation with regard to Apartment X and Apartment Y was very different. At the very most the Taxpayer had a tenuous intention to hold the apartments for rental income purposes. It is clear that at the same time the Taxpayer had the intention of selling the two apartments or either of them as soon as the opportunity arose at a profit. That is simply trading. It proceeded to do so as soon as it received an offer from Mr W and an offer from a third party. We attach little importance to the statement by Mr A and Mr W that Mr W insisted on purchasing Apartment Y because he was a close, long standing friend of Mr A. This ignores the fact that Mr B, who did not come forward to give evidence, also had a financial interest in the Taxpayer and thereby in the Apartment Y. If it had been the intention of the Taxpayer to retain the two apartments for long-term rental income purposes it was clearly possible for the Taxpayer so to do. It was under no obligation to Mr W. There was no real reason why it should sell either or both of the apartments so quickly. On the other hand if the Taxpayer was speculating in the property market at that time it would be very natural for it to do what it did, namely, to sell the two apartments before the same had been completed. This is typical conduct of a property speculator.

For the reasons given we allow this appeal so far as the Letters B are concerned but dismiss the appeal so far as Apartment X and Apartment Y are concerned. Accordingly we order that the assessment for the year of assessment 1987/88 be annulled and that the additional profits tax assessments for the years of assessment 1988/89 and 1989/90 be remitted back to the Commissioner so as to take into account and reinstate the carry forward loss which the Taxpayer incurred in respect of the year of assessment 1987/88 and make any other consequential amendments thereto.