

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D44/96

Profits tax – purchase and resumption of property – whether profit assessable to profits tax.

Panel: Robert Wei Wen Nam QC (chairman), Philip Lam Bing Lun and Dianthus Tong Lau Mui Sum.

Date of hearing: 2 April 1996.

Date of decision: 10 September 1996.

The taxpayer company purchased certain land lots. The profit on the subsequent resumption of the land lots was assessed to profits tax. The company contended that the profit was not assessable to profits tax. At the hearing before the Board, a shareholder and director of the company gave evidence.

Held:

The company acquired the land lots, not as long-term investments, but as trading stock. It matters not whether the disposition was voluntary or involuntary. The profit derived from the resumption was assessable to profits tax.

Appeal dismissed.

Cases referred to:

Chinachem Investment Co Ltd v CIR 2 HKTC 308
Simmons v CIR 53 TC 461
All Best Wishes Ltd v CIR 3 HKTC 750
Cunliffe v Goodman [1950] 1 All ER 720
Wisdom v Chamberlain 45 TC 92
Green v J Glicksten & Son Ltd [1924] 14 TC 364
CIR v Newcastle Breweries Ltd [1927] 12 TC 927
Public Trustee v CIR (NZ) [1961] AITR 297
D8/88, IRBRD, vol 3, 161

Ng Yuk Chun for the Commissioner of Inland Revenue.
Pamela Chua of Messrs Ernst & Young for the taxpayer.

Decision:

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Introduction

1. This is an appeal by a limited company (the Company) against the profits tax assessment raised on it for the year of assessment 1991/92, as revised by the Commissioner of Inland Revenue in his determination dated 6 June 1995. The Company contends that certain land lots in Place A which were the subject of the assessment were acquired by the Company as long-term investments and therefore that the profit on the resumption of the land lots is capital gain not assessable to profits tax.

Parties

2. At the hearing of this appeal, Miss Chua of Messrs Ernst and Young, certified public accounts, the tax representatives of the Company, appeared for the Company. Miss Ng appeared as the representative of the Commissioner. Mr X, a shareholder and director of the Company, gave evidence for the Company. No other witness was called.

Grounds of appeal

3. The grounds of appeal filed by the tax representatives on behalf of the Company are as follows.

3.1 'The Commissioner has wrongly assessed the net compensation proceeds of \$7,463,396 received by our client on the Government's resumption of the land lots in Place A. We submit that the land lots were acquired by our client as long-term investments and, therefore, the net compensation proceeds received by our client are non-taxable capital gains under section 14 of the Inland Revenue Ordinance (the IRO).'

3.2 'The purpose of the Company in acquiring the land lots in June 1981 was to look at the investment and future development potential of the properties. This included an intention of the Company to make a general investment, as a hedge against the high inflation rates prevailing at that time.'

3.3 'The fact that a feasibility study in respect of the development of the land lots was actually commissioned and carried out in October 1981 by the Company soon after the acquisition of the properties also demonstrates the Company's original long-term investment intention towards the land lots.'

3.4 'The land lots were held for almost 10 years by the Company before they were resumed by the Government in February 1991. Our client's long period of ownership of the land lots also demonstrates its investment intention towards the properties.'

3.5 'There were no sales organisation or supplementary work done on the land lots to enhance their marketability or facilitate their sales. In fact there was no sale of the land lots as such – the properties being resumed by the Government. Given the fact that the land

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lots were originally acquired for their investment and development potential, a transaction that did not culminate in a sale could hardly be said to be a trading transaction.'

3.6 'Although the land lots themselves were non-income-producing, this factor is not inconsistent with the long-term intention.'

Agreed facts

4. The following facts are agreed between the parties.

4.1 The Company has objected to the profits tax assessment raised on it for the year of assessment 1991/92. The Company claims that the assessor has wrongly assessed the net compensation proceeds of \$7,463,396 received by the Company on the Government's resumption of land lots in Place A. The Company claims that the land lots were acquired by the Company as long-term investments and therefore the net compensation proceeds received are non-taxable capital gains under section 14 of the IRO.

4.2 The Company was incorporated as a private company in Hong Kong on 12 September 1978. At all relevant times, the Company's nature of business has been described in its profits tax returns as 'Property Investment'. Starting from the year of assessment 1985/86, the Company also carried on the business of commission agent on property transactions.

4.3 During the year 1981, the Company purchased the following 3 properties:

- (a) By a deed assignment dated 29 May 1981, the Company purchased the 8th floor of an office building in Place B (the office property).
- (b) By a deed of assignment dated 18 June 1981, the Company purchased the land lots in Place A (the land/land lots).
- (c) By a deed of assignment dated 26 September 1981, the Company purchased a flat in Place C (the flat).

4.4 All three properties were classified as trading stock from year to year since their purchase in the Company's accounts. Profits on sale of properties grouped under trading stock were previously offered for assessment and duly assessed.

4.5 The flat was held for a period of 8 years before it was sold in September 1989. During the period of ownership, no rebuilding allowance was claimed. It was occupied by Mr X, a director of the Company, from 1 April 1983 to 31 March 1987, as a tenant for a rent of \$3,000 per month. Therefore, for over 2 years, the property became rent free directors' quarters which was occupied by Mr X.

4.6 In its profits tax return for the year of assessment 1989/90 the Company declared assessable profits (that is, before set-off of loss brought forward from previous

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years) of \$516,718 which was arrived at after exclusion of profit on disposal of the flat in the amount of \$224,042. The assessor, was, however, of the opinion that the profit on disposal of the flat was revenue in nature and hence issued to the Company the following loss computation:

Year of assessment 1989/90

Profits per return	\$516,718
Add: profit on disposal of property	<u>224,042</u>
	\$740,760
<u>Less: loss b/f set-off</u>	<u>740,760</u>
Net assessable profits	\$Nil ===

Statement of loss

Loss b/f	\$850,530
<u>Less: loss set off for the year</u>	<u>740,760</u>
Loss c/f	\$109,770 =====

4.7 In its profits tax return for the year of assessment 1990/91 the Company declared that it suffered loss of \$1,597,437 during the year. The assessor accepted the return and issued the following loss computation to the Company:

Year of assessment 1990/91

Assessable profits	\$Nil ===
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Statement of loss

Loss b/f	\$109,770
Add: loss for the year	<u>1,597,437</u>
	\$1,707,207

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4.8 In its accounts for the year ended 31 March 1992, the Company reclassified its office property from trading stock to fixed asset. The property was let out for rental during the periods from 18 March 1982 to 17 March 1984 and from 18 March 1985 to 17 March 1987. Since then, the property was used by the Company as its own office premises.

4.9 In its profits tax return for the year of assessment 1991/92 the Company declared assessable profits of \$355,245 which was arrived at before inclusion of \$7,463,396 being the net proceeds on resumption of land by the Government. The amount of the net proceeds, treated as an extraordinary item in the accounts and not offered for assessment, was arrived at as follows:

Cash compensation received from the Government	\$9,528,246
<u>Less: cost of land</u>	<u>2,064,850</u>
Net proceeds	\$7,463,396
	=====

4.10 The assessor considered that the net proceeds on resumption of the land should be assessable to profits tax. Accordingly the assessor raised on the Company the following profits tax assessments:

Year of assessment 1991/92

Profits per return	\$355,245
Add: Accommodation expenses incurred by director in Hong Kong	2,140
Net proceeds on land resumption	<u>7,643,396</u>
	\$8,000,781
<u>Less: approved charitable donations</u>	<u>39,471</u>
	\$7,961,310
<u>Less: loss b/f set off</u>	<u>1,707,207</u>
Net assessable profits	<u>\$6,254,103</u>
Tax payable thereon	\$1,031,926

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4.11 On behalf of the Company, the former representatives lodged a valid objection to the above assessment on the ground that the net proceeds on land resumption should be considered as a capital gain not assessable to profits tax. The former representatives also asked the assessor to reconsider their previous claim that the profit on disposal of the flat in the year of assessment 1989/90 was capital in nature.

4.12 The plan for which the Government resumed the land lots was eventually shelved due to some unfavourable conditions.

4.13 Following further correspondence with the Company through its tax representatives, the assessor maintained the view that the net proceeds on resumption of the land should be assessable to profits tax but conceded that the flat and the office property were the Company's capital assets ab initio. To take into account the actual amount of approved charitable donations made by the Company, the assessor subsequently considered that the profits tax assessment for the year of assessment 1991/92 should be revised as follows:

Profits per return	\$355,245
Add: Accommodation expenses incurred by director in Hong Kong	2,140
Net proceeds on land resumption	<u>7,643,396</u>
	\$8,000,781
<u>Less: Approved charitable donations further allowed</u> (\$117,000 - \$39,471)	<u>77,529</u>
	\$7,923,252
<u>Less: Loss b/f set off</u> (\$1,707,207 + \$224,042)	<u>1,931,249</u>
	<u>\$5,992,003</u>
Tax payable thereon	\$988,680
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4.14 The above revised assessment was confirmed by the Commissioner in his determination dated 6 June 1995.

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Facts not in dispute

5. The following facts are not in dispute.

5.1 In a feasibility study report commissioned by the Company and dated October 1981, the architect was of the opinion that because of their location and scattered distribution, the land lots had little development potential unless more lots were purchased and there was a more definite Government planning of the area. The conclusion of the report reads as follows:

‘In view of the physical location and distribution of the subject lots, we are of the opinion that comprehensive development of residential or recreational projects on such lots is not feasible. Development of individual village houses subject to application to and grant from Government may be feasible but the marketability is questionable due to their remote location and limited end users.

Furthermore, the developer has to construct a village standard track linking the subject lots and also to the pier which has to be upgraded. However, such work would involve right of way over other private lots.

Therefore, we can conclude that the subject lots are of little development potential and its viable use cannot be considered unless more lots are purchased to link up the subject lots and until Government has a more definite planning of the area.’

5.2 By gazette notice, the Government announced that the land lots were to be resumed in Place A.

5.3 The Hong Kong Year Book 1982 contains the following statements:

‘The situation in 1981 was against a background of historically high interest and inflation rates, relatively low growth rates in domestic exports and a relatively weak Hong Kong dollar.’

Scope of evidence

6. What was at one stage in question was the status of the flat, the land lots and the office property. As the assessor has conceded, and the Commissioner has confirmed, that the flat and the office property were the Company’s capital assets ab initio (see paragraph 4.13 and 4.14 above), we are only concerned with the status of the land lots, and shall deal with the evidence only in so far as it is relevant to that issue.

Documents excluded by consent

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7. Miss Chua prepared two bundles of documents for use at the hearing: an agreed bundle and a bundle of the Company's documents (the Company's bundle). The agreed bundle included a letter dated 30 March 1993 from the Company's former tax representatives (the former representatives) to the Commissioner lodging an objection against the profits tax assessment for the year of assessment 1991/92 (see paragraphs 4.10 and 4.11 above), and setting out the grounds of objection. The letter is hereinafter referred to as the letter of objection. Two of the appendices to the letter of objection were not included in the agreed bundle. They were respectively a purported letter dated 18 July 1988 making an offer for the land lots and a purported reply from the Company rejecting the offer. Miss Chua's explanation was that the Company was not relying on the two appendices. Likewise, Miss Ng informed us that the Commissioner was not relying on them either. The parties having agreed not to rely on those documents, it was not for the Board to ask why. The Board's function was to adjudicate on the case as presented. The Board therefore treated the two letters as non-existent.

Document not admitted in evidence

8. The Company's bundle included a copy of the minutes of a board resolution of the Company dated 10 June 1981. It was not an agreed document and Miss Ng objected to its production on the ground that the Company was unable to produce the original minutes for inspection. Mr X explained in evidence that Mr Y of the former representatives who had the custody of the original minutes had informed Mr X that he had lost the original minutes. The Board explained to Mr X that, unless Mr Y came before the Board and proved the loss, the copy minutes could not be put in evidence. After the lunch adjournment, Miss Chua informed the Board that the Company did not wish to call Mr Y. The copy minutes were therefore not admitted in evidence.

Classification as trading stock

9. It has been mentioned (see paragraph 4.4 above) that the land lots were classified as trading stock in the accounts of the Company. Normally the way an asset is treated in the accounts is contemporaneous evidence of intention towards that asset (see Chinachem Investment Co Ltd v CIR 2 HKTC 308). However, in the present case, the other two properties, the office property and the flat, which were also classified as trading stock in the accounts were conceded by the assessor to be capital assets ab initio (see paragraph 4.13 above). That, in our view, had the effect of neutralising the land lots' classification as trading stock. We have therefore decided to give no weight to that classification.

Legal principles

10. The following legal principles are in our view particularly applicable to the present case.

10.1 *'One must ask, first, what the Commissioners were required to find. 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*

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disposing of it at a profit, or was it acquired as a permanent investment? ... What I think is not possible is for an asset to both trading stock and permanent investment at the same time, nor to possess an indeterminate status – neither trading stock nor permanent asset. It must be one or other ...’ (per Lord Wilberforce in Simmons v CIR TC 461 at 491).

10.2 ‘The intention of the taxpayer, at the time of acquisition, and at the time when he is holding the asset is undoubtedly of very great weight. And if the intention is on the evidence genuinely held, realistic and realisable, and if all the circumstances show that at the time of the acquisition of the asset, the taxpayer was investing in it, then I agree. But as it is a question of fact, no single test can produce the answer. In particular, the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of the evidence. Indeed, decisions upon a person’s intention are commonplace in the law. It is probably the most litigated issue of all. It is trite to say that intention can only be judged by considering the whole of the surrounding circumstances, including things 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’ (per Mortimer J in All Best Wishes Ltd v CIR 3 HKTC 750 at 771).

10.3 ‘Not merely is the term “intention” unsatisfied if the person professing it has too many hurdles to overcome, or too little control of events; it is equally inappropriate if at the material time that person is in effect not deciding to proceed but feeling his way and reserving his decision until he shall be in possession of data sufficient to enable him to determine whether the project will be commercially worth while. A purpose so qualified and suspended does not in my view amount to an “intention” or “decision” within the principle. It is mere contemplation until the materials necessary to a decision on the commercial merits are available and have resulted in such a decision. In the present case it seems to me that ... she never got, in respect of the first scheme, to a stage at which she could decide on its commercial merits, nor, in respect of the second scheme, to the stage of actually deciding that the scheme was commercially eligible unless, indeed, she must be taken, not merely to have repudiated her architect’s authority, but to have decided that it was commercially ineligible. In the case of neither scheme did she form a settled intention to proceed. Neither project moved out of the zone of contemplation – out of the sphere of the tentative, the provisional and the exploratory – into the valley of decision’ (per Asquith LJ in Cunliffe v Goodman [1950] 1 All ER 720 at 724).

10.4 ‘Therefore, the learned judge held, as I understand it, that because it was a hedge against devaluation it was not a trading adventure ... For myself I cannot take that view at all. In the first place, it seems to me that, supposing it was a hedge against devaluation, it was nevertheless a transaction entered into on a short-term basis for the purpose of making a profit out of the purchase and sale of a commodity, and if that is not an adventure in the nature of trade I do not really know what is. The whole of the transaction was to make a profit. It was expected that there would be devaluation, and the reason for wanting to make a profit was that there would be a loss on devaluation; but does not make any difference, it seems to me, to the fact that the motive and object of the whole transaction was to buy on a short-term basis a commodity with a view to its resale at a profit. That, as it seems to me, is an adventure in the nature of trade, and I think the Commissioners so found

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as regards the first transaction as well as the second' (per Harman LJ in Wisdom v Chamberlain 45 TC 92 at 106).

10.5 'A point taken by the Taxpayer but later abandoned was that since the land had been compulsorily resumed, what had happened was not a sale and was not a trading activity. Having regard to the provisions of section 14 of the IRO, we find that the point is irrelevant. If the land was purchased as a trading rather than as a capital asset, it matters not whether its disposition was voluntary or involuntary: see Green v J Glicksten & Son Ltd [1924] 14 TC 364, CIR v Newcastle Breweries Ltd [1927] 12 TC 927 and contrast the different wording of the legislation in Public Trustee v CIR (NZ) [1961] 8 AITR 297. The sole question is whether the land was purchased as a trading asset or as a capital asset' (D8/88, IRBRD, vol 3, 161 at page 163).

Letter of objection

11. Miss Chua informed the Board that the Company was not relying on any representations made by the former representatives in two letters in the agreed bundle, one of them being the letter of objection (see paragraphs 4.11 and 7 above). In our view, that did not preclude cross-examination on that document as part of the surrounding circumstances mentioned in All Best Wishes Ltd v CIR, cited in paragraph 10.2 above. In fact, Miss Ng did use the letter of objection to cross-examine Mr X, as she was entitled to.

Mr X's and his father's intention treated as intention of the Company

12. Mr X, the only witness for the Company, was 42 years old and a shareholder and director of the Company. He was first appointed a director in 1978. In 1981, the year when the land lots were acquired, Mr X and his parents were the only directors and shareholders of the Company. Mr X sought, without success, to produce the copy minutes of a board resolution dated 10 June 1981 as evidence of a resolution passed to purchase the land lots (see paragraph 8 above). However, Mr X and his father had taken the decision to purchase the land lots, and the purchase was financed with funds from the directors. Given those facts, we find that the intention of Mr X and his father towards the land lots at the time of the acquisition represented the intention of the Company.

Facts found

13. From Mr X's testimony, we find the following facts.

In chief

13.1 Mr X's father told Mr X that an estate agent was offering for sale land (that is, the land lots as it turned out to be) in Place A and the land had high potential as there would be a development. Mr X and his father therefore decided to purchase the land.

13.2 The estate agent gave Mr X's father only two days to decide whether to purchase. There was no time to take any action except for a search at the Land Registry.

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They did not inspect the property before the purchase. After the purchase the Company commissioned a feasibility study report on the land lots. The report was unfavourable. After receiving the report, neither Mr X nor his father took any action. Mr X did not know that the land lots were scattered until he had read the report. It would be difficult to link up the plots. Development and construction would be difficult. It would be necessary to apply for re-zoning.

13.3 In 1979 Mr X first learned about the possibility of the Government's plan in Place A from newspapers and news reports. In 1983 he heard the news that plan was to be shelved.

13.4 In 1990 Mr X heard the news that the Government resumed the plan in Place A.

In cross-examination

13.5 The former representatives had sent the letter of objection on behalf of the Company.

13.6 At the time of the acquisition of the land lots, the Company had no fixed plans for future development.

Mr X's statement of intention

14. The statements of intention made by Mr X in the course of his testimony is summarized below.

In chief

14.1 Mr X and his father decided to purchase the land lots for long-term investment purposes. It was for long-term investment purposes in order to fight the high inflation.

14.2 Development would be difficult. But they had no plan to sell the land lots; they held the properties as long-term investments.

14.3 They did not consider selling the land lots on hearing the news that the project would be shelved; they had bought them as long-term investments.

In cross-examination

14.4 Miss Ng read out the following passage from the letter of objection:

'The properties in question are scattered in Place A acquired by our client in 1981 with an intention to develop them as resort houses or village type houses for lease...'

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She pointed out to Mr X that in the letter of objection there was no mention at all of an intention to acquire a general investment for a hedge against inflation. Mr X stated that 'I found out that Mr Y was not doing a good job so I asked Ernst & young, an accountants' firm, to answer my question.' When asked whether he informed Mr Y about the Company's intention to have a hedge against inflation at the time when the letter of objection was being prepared, Mr X stated that he informed Mr Y verbally about the intention to have a hedge against inflation. It was put to Mr X by miss Ng that the alleged intention to have a general investment for a hedge against inflation was only a subsequent invention, an afterthought.

In re-examination

14.5 In 1981 the intention was to hedge the inflation rate because the inflation rate at that time was very high and the US dollar versus the Hong Kong dollar was very fluctuating at that time. So he purchased the piece of land for the purpose of long-term development and investment for his company.

The Company's case

15. The Company's case which emerges from Mr X's statements of intention at paragraphs 14.1 and 14.5 above appears to be this: its intention in purchasing the land lots was to acquire a long-term investment as a hedge against inflation. In cross-examination, Mr X claimed that he had informed Mr Y verbally about the Company's hedge-against-inflation intention at the time the letter of objection was prepared. Confronted with the fact that there was no mention at all of the hedge-against-inflation intention in the letter of objection which Mr Y wrote and lodged on the Company's behalf, Mr X stated that 'I found out Mr Y was not doing a good job so I asked Ernst & Young to answer my question.' Mr Y was not called to give his account of the facts. Without hearing and evaluating Mr Y's evidence, we are unable to accept the truth of Mr X's allegations. Nor, indeed, can we accept that the Company acquired the land lots with the alleged long-term hedge-against-inflation intention. Mr X's statements of intention at paragraph 14 above are, therefore, not accepted.

16. The Company has abandoned the case of an intention to develop for rental income as presented by the letter of objection. Indeed, given the fact that at the time of acquisition the Company had no fixed plans for future development (see paragraph 13.6 above), it is difficult to see how such a case could have been established, or how it could be said that the intention was genuinely held (see paragraph 10.2 above). Further, with so many hurdles to overcome and so many imponderables (see the feasibility study report at paragraph 5.1 above), any such intention could hardly have amounted to a realistic and realisable intention as required by All Best Wishes v CIR (see paragraph 10.2 above), or a settled intention as required by Cunliffe v Goodman (see paragraph 10.3 above).

Conclusion

17. On the facts, we conclude as follows.

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17.1 Attracted by the high potential they believed the land lots had to offer should the plan be carried out in Place A, Mr X and his father decided that the Company should purchase the land lots. They did so without inspecting the properties, without even knowing that the land was not in one piece but in scattered plots, and without forming any long-term investment or development intention towards the land lots. The Company acquired the land lots, not as long-term investments, but as trading stock.

17.2 After the acquisition, the Company took the exploratory step of obtaining a feasibility study report. It was unfavourable, and no further action was taken. It was argued that the fact that the feasibility study was commissioned and carried out demonstrated the Company's long-term investment intention. We disagree. The commissioning of the feasibility study was in itself a neutral step. The report dealt with the question of feasibility without any preconceived ideas as to whether the developed estate was to be retained for rental income or was to be sold at a profit.

17.3 It was also argued that the Company's long period of ownership demonstrated its long-term investment intention. Again, we disagree. Given the fact that the plans were shelved in 1983, the long period of ownership was not inconsistent with the land lots being trading stock. Furthermore, we agree with Miss Ng's submission that effluxion of time cannot turn a trading stock into a capital asset and vice versa, unless there is manifest evidence of a change of intention. In the present case, there is no question of a change of intention: the same intention continued from first to last, and the status of the assets was determined upon acquisition and never changed.

17.4 The grounds of appeal draw attention to the fact that there was no sale and no trading transaction, the land lots being resumed by the Government. However, given the fact that the land lots were purchased as trading assets, it matters not whether the disposition was voluntary or involuntary (D8/88, IRBRD, vol 3, 161; see paragraph 10.5 above).

17.5 For all the above reasons, the Company has failed to discharge its onus to prove that the assessment under appeal was incorrect or excessive.

Decision

18. It follows that this appeal fails and that the assessment under appeal as revised by the Deputy Commissioner is hereby confirmed.