INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D45/92

Profit tax – gain or profit on sale of land.

Panel: William Turnbull (chairman), Ma Ching Yuk and Yu Yui Chiu.

Dates of hearing: 22 and 23 September 1992.
Date of decision: 14 December 1992.

The taxpayer acquired two pieces of agricultural land. Shortly after acquisition the two pieces of land were sold at a profit. The taxpayer submitted that the two sites had been acquired as capital assets and it was not the intention of the taxpayer to trade when it acquired the sites.

Held:

The burden of proof is on the taxpayer. The taxpayer had not been able to discharge the burden of proof. Accordingly the profit on the sale of the two sites was assessable to profits tax.

Appeal dismissed.

Cases referred to:

Marson v Morton [1986] STC 350
Lionel Simmons Properties Ltd v CIR 53 TC 461
Cunliffe v Goodman [1950] 1 All ER 720

Chiu Kwok Kit for the Commissioner of Inland Revenue.
Wong Che Ming of Wong Poon Chan Law & Co for the taxpayer.

Decision:

This is an appeal by a private limited company against an assessment to profits tax wherein the Taxpayer was assessed to tax on a gain or profit which it made on the sale of two pieces of land. Those facts which were not in dispute are as follows:

1. The Taxpayer was incorporated as a private company in Hong Kong in mid-1987. At all relevant times its issued and paid up capital was $2.

2. The Taxpayer acquired two pieces of land, one near Site A and one near Site B. Site A was acquired in late 1987 and Site B was acquired a month later. The use of both sites was restricted to agricultural and garden ground uses only.

3. The Taxpayer's costs of acquisition of the two sites amounted to $1,833,856 which was financed by interest-free loans from a director, Mr X, and a beneficial owner, Mr Y.

4. Mr X was the managing director of a company. He had been previously employed by the Hong Kong Government. Mr Y was a practising solicitor. Both Mr X and Mr Y were knowledgable with regard to land in Area X which included both Site A and Site B.

5. The Taxpayer had two shareholders and two directors, one of whom was Mr X. Mr Y used the services of his secretary to be a nominee shareholder and nominee director on his behalf.

6. The Taxpayer failed to submit its profits tax return for the year of assessment 1988/89 within the stipulated time. On 12 March 1990 the assessor raised on the Taxpayer a tax assessment showing estimated assessable profits of $1,100,000 with tax payable thereon of $187,000.

7. By letter dated 11 April 1990 the Taxpayer objected to the assessment on the ground that the board of directors considered that there was no assessable profit incurred during the year ended 31 March 1989.

8. To validate the objection the Taxpayer submitted its profits tax return for the year of assessment 1988/89 together with supporting accounts and schedules which included its audited accounts.

9. In its accounts for the year ended 31 March 1989 the Taxpayer disclosed that there was a surplus on realisation of land investment in the sum of $1,480,890. This amount was treated as an extra-ordinary item and was not offered for assessment.

10. The two sites were not put to any use during the period of ownership by the Taxpayer but shortly after acquisition the Taxpayer arranged to have the sites cleared.

11. Shortly after the acquisition of Site A an application was made on behalf of the Taxpayer for an in situ exchange with the Government. The effect of such an exchange would have been to permit the Taxpayer to have developed Site A by the construction thereon of a number of houses. After acknowledging this application for an exchange the Government informed the Taxpayer that it was not prepared to consider such an exchange because the application had not received any planning support within the Government and because the land was situated within a country conservation area. At the same time as the application was rejected the Government informed the Taxpayer that it took a serious view

of the clearance which the Taxpayer had caused to take effect and which had included obtaining illegal access to the site and involved fencing which had been constructed on Government land. The Government indicated that legal action was being contemplated and subsequently the Government did institute certain legal action.

12. The Taxpayer repeated its application for an in situ exchange and asked the Government to reconsider the matter by letter dated 12 February 1988 and again by letter dated 1 March 1988. Both these requests for reconsideration of the application were rejected by the Government by letters dated 24 February 1988 and 20 April 1988 respectively.

13. The Taxpayer did not further pursue the application for an exchange of land. Instead the Taxpayer decided to sell the land which it proceeded to do by means of offering the same for public auction with the assistance of the services of Mr X and in due course was successful in selling the land to a third party and realised a gain or profit thereon.

14. At the time when the first application for an exchange in situ was made the Taxpayer caused a lay-out plan to be prepared for Site A showing a number of houses which could be constructed upon Site A. A copy of this lay-out plan was given to the Government with the application for an in situ exchange.

15. No application was made to the Government in respect of Site B for any in situ exchange or otherwise. The Taxpayer decided to sell the same which it did to a third party soon after it had sold Site A and it made a gain or profit on the sale thereof. Both Site A and Site B were sold by the Taxpayer in September 1988.

16. At the time when Site A and Site B were acquired Mr X and Mr Y were close personal friends and they and their families had been close friends for many years.

17. Following the objection of the Taxpayer to the estimated assessment for the year of assessment 1988/89 the matter was referred to the Commissioner of Inland Revenue for his determination. By his determination the Commissioner rejected the objection of the Taxpayer but reduced the amount of the assessable profits and the tax payable thereon to $1,044,803 and $177,616 respectively in accordance with the accounts which had been filed.

18. The Taxpayer duly appealed to this Board of Review.

Mr Y gave evidence and explained that his partner had declined to appear before the Board to give evidence. Likewise his secretary who he said was his nominee shareholder and director was not called to give evidence.

Mr Y in his evidence informed the Board that he and his long standing friend, Mr X, had decided to go into real estate business together. For this purpose the Taxpayer was used and was jointly owned beneficially by himself and Mr X. He said that Mr X had previously worked with the Hong Kong Government as an estate surveyor. He said that the

Taxpayer combined the skills of himself and his partner. He said that he and his partner had knowledge of Area X of Hong Kong where Site A and Site B were situated. His partner heard of these two pieces of agricultural land which were available for sale. One piece (Site A) was situated some distance away from Area X but close to a main road. The other piece (Site B) was closer to Area X and was also situated close to a main road.

He said that Site A had been offered for sale by auction and Mr X was of the opinion that it might not be sold at the auction in which case it might be possible to buy it at an attractive price. In the event that is what happened. Site A was withdrawn from the auction sale and was purchased by the Taxpayer at an attractive price.

He said that Site A comprised approximately 38,000 square feet and was classified as a country area. It was situated close to two country park areas. He said that he and Mr X thought that it would be possible to exchange Site A with the Government for an in situ exchange. This would mean that Site A could be used for the purpose of constructing houses and he said that it was the intention of himself that the houses when constructed could be used for leasing purposes as long-term investments. He said that there was a proposal that the town centre of Area X would be developed, that Area Y would likewise be developed and the construction of an institution would greatly increase the value of the land. He said that this was a long-term investment because it would take some years to process the application for the in situ exchange. It would then be necessary to construct the houses and it would be necessary to let the same to tenants for some time. In answer to a question he said that the value of the property would substantially increase after the favourable factors which he had mentioned had occurred including the construction of the institution. He indicated that it would then be an opportune time to sell the houses which had been constructed. He said that it was a surprise to himself and Mr X that the Government had been so firm in rejecting the application for an in situ exchange. He said that the attitude of the Government was so firm against the exchange that the Taxpayer decided to sell both Site A and Site B. He said that he thought that there was also financial pressure on Mr X at that time because of the collapse of the world stock markets and the Hang Seng Index. He said that he himself had no financial problems at that time.

Mr Y was asked what would have been the intention of the Taxpayer at the time when it acquired Site A and Site B if the Government decided to reject the application for an in situ exchange. Mr Y said that it would be possible to use the two sites as open storage areas for containers or for car parking. However he agreed that the rent which would be likely to be received for such use would be very small compared with the cost of the land. He indicatd that land for such purposes in more attractive parts of the New Territories would be in the region of $1 per square foot per month but that the rent for sites such as the two in question would be less than half of this amount.

Little evidence was given with regard to Site B except that it was purchased by the Taxpayer shortly after Site A and was likewise sold shortly after Site A. Mr Y said that it was a smaller less attractive site than Site A. He said that no lay-out plans were made with regard to Site B and that though consideration was given with a view to applying for an in situ exchange similar to that done for Site A no such application was made. He said that he

did not know exactly the details regarding the sale of Site A except that Mr X had offered it for sale by auction. He did not know whether or not it had been sold by auction or by private treaty. He said that Site B had been sold at approximately the same time to the same purchaser who acquired Site A.

The representative of the Taxpayer addressed the Board on the case of the Taxpayer and briefly referred to the legal principles. He cited the case of Marson v Morton [1986] STC 350 and the Badges of Trade referred to therein. He also referred us to Willoughby on the Taxation of Income at pages 19 and 20 paragraph 2-11A.

He submitted on behalf of the Taxpayer that the two sites which had been acquired by the Taxpayer were capital investments and that the profit or surplus arising on the sale thereof should not be subject to Hong Kong profits tax. He said that the case primarily depended upon its facts.

The representative of the Taxpayer referred us to two board minutes of the Taxpayer which stated that Site A and Site B were purchased 'for the purpose to build several Town Houses thereon for investment holdings'. Each of the minutes states that Mr X and the secretary of the representative of the Taxpayer were the two directors present but as recorded above neither of these persons were called to give evidence and we are unable to place any weight on these minutes.

The representative for the Commissioner submitted that the onus of proof is upon the Taxpayer because only the Taxpayer has the knowledge of what was intended and submitted that the Taxpayer had not discharged this onus of proof. He said that Mr Y who had given evidence was not a director of the Taxpayer company at the relevant time and that much of the evidence of Mr Y had related to what Mr X might or might not have thought or intended. He pointed out that this was hearsay and of little value.

The representative for the Commissioner said that it was necessary to ascertain the intention of the Taxpayer at the time when it had acquired the two sites. It was the subjective intention of the Taxpayer which must be tested by the objective facts and circumstances. He submitted that if the intention of the Taxpayer at the date of acquisition was undecided, to turn the sites to account by development either for sale or for rental, then the sites could not be regarded as capital assets. He referred us to the case of Lionel Simmons Properties Ltd v CIR 53 TC 461 where Lord Wilberforce at pages 491/492 had said 'what I think is not possible is for an asset to be 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 the other, even though, and this seems to me legitimate and intelligible, the company, in whatever character it acquires the asset, may reserve an intention to change its character. To do so would, in fact, amount to little more than making explicit what is necessarily implicit in all commercial operations, namely that situations are open to review.'

The representative for the Commissioner went on to submit that a person cannot intend to do something which is not within its power and cited to us the case of

Cunliffe v Goodman [1950] 1 All ER 720. He said that in the present case the Taxpayer did not have within its power the ability to develop the two sites for rental purposes and that any intention to do so could only be provisional or conditional. The representative reviewed the facts and submitted that the Taxpayer had not acquired the two sites as capital assets but had embarked on an adventure which was of a trading nature.

Mr Y in the evidence which he gave was clear and lucid and on occasions very frank. The question which we must decide is whether or not at the time or times when the Taxpayer acquired Site A and Site B it did so intending to redevelop the sites and retain the houses which it would then own for rental purposes. Mr Y in his evidence stated that that was the intention of the Taxpayer. However as in so many cases of this type the statement made by Mr Y is of a self-serving nature and must be tested against the rest of his evidence and against the objective facts.

Prima facie a company which acquires two sites of land and sells the same shortly after acquisition at a profit would appear to be trading unless there is clear evidence to the contrary. In the present case there is no such clear evidence. Perhaps if Mr X had been willing to come forward and give evidence the case for the Taxpayer might have been stronger. However for whatever reason he did not give evidence and Mr Y said that it was not possible for him to ask Mr X to give evidence. Much of the evidence of Mr Y was in relation to what his partner, Mr X, did or intended. Indeed the sale of the two sites appeared to have been entirely handled by Mr X with little knowledge or input from Mr Y. Mr Y in his evidence said that so far as he was concerned it was the intention of the Taxpayer to retain the sites as long-term investments until such time as the value thereof had increased when the houses would be sold. It was not entirely clear what either Mr Y or the Taxpayer really had intended. In answer to one question in cross-examination Mr Y, when asked the meaning of a statement which he had made to the effect that the Taxpayer after completion of the houses would rent them out and then subsequently sell them, said, 'it depends on the market. If the price is good we will sell. The option is open at that time. At the moment when we purchased our intent was to rent out for a few years.' It is difficult for us to interprete the real intention of the Taxpayer in the light of evidence to this effect and in the light of the fact that Mr X who was stated to be the dominant person did not give evidence.

Having carefully considered the facts and the evidence before us we have come to the conclusion that the Taxpayer has not been able to discharge the burden of proof placed upon it. If it had been the real intention of the Taxpayer to develop these two sites and retain the houses for rental purposes we would expect to hear or see much stronger evidence than that which is before us. We are not satisfied that the intention of Mr X who was the dominant party was the same as the evidence given by Mr Y. Having reviewed all the facts and evidence we find as a fact that it was the intention of the Taxpayer to acquire the two sites with a view to applying to the Government for an in situ exchange, to develop the exchanged sites for residential purposes and to sell the residential units as soon as an opportune time arose which was expected to be when the institution was completed. In such circumstances we find that the profit or gain made by the Taxpayer on the sale of the two sites was a trading gain and not a capital gain.

We mention that with regard to Site B there is very little if any evidence to suggest that it was the intention of the Taxpayer even to apply for an exchange in situ and to construct houses on the exchanged site.

In reaching the decision that we have, we are also mindful of the fact that at the time when the Taxpayer acquired the two sites it was known that the two sites were in a countryside conservation area and that there was no guarantee or assurance that the sites could be exchanged in situ for residential purposes. We do not accept the evidence of Mr Y that it was a practical business proposition to purchase the two sites in question for use as open storage or car parking. This would appear to have been an after thought by Mr Y rather than a genuine intention of the Taxpayer at the time when the sites were acquired. It appears to us that in this regard it was the intention of the Taxpayer to acquire the sites in the hope that an exchange could be arranged and houses built for sale but the alternative was to sell the land as it was if the application for exchange was refused and this is what in fact happened in the event.

For the reasons given we dismiss this appeal and confirm the determination of the Commissioner.