

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D48/90

Profits tax – whether compensation paid by the Government for resumption of land is capital or income – whether interest on resumption payment is taxable.

Panel: T J Gregory (chairman), Winston Lo Yau Lai and Albert Ho Chun Yan.

Dates of hearing: 13 and 14 December 1989.

Date of decision: 28 November 1990.

The taxpayer was a company incorporated in Hong Kong which acquired certain agricultural land in the New Territories. The land was used for farming purposes and was subsequently leased for use as a warehouse. An unsuccessful application was made to the Government to change the use of the land. The land was resumed by the Government and compensation and interest were paid by the Government to the taxpayer. Profits tax was assessed on both the payment for the land and the interest. The taxpayer appealed to the Board of Review.

Held:

The answer to the question whether or not the interest was taxable depended upon whether it was earned by the taxpayer when the taxpayer was carrying on business. The Board held that the taxpayer was carrying on business until such time as the land was resumed by the Government and the compensation paid. Accordingly the interest was taxable. The question whether or not the resumption moneys were taxable depended upon the intention of the taxpayer when it acquired the land. The onus of proof is upon the taxpayer to show that its intention was to acquire the land as a long term capital investment. The taxpayer had failed to discharge the onus of proof.

Appeal dismissed.

[Editor's note: The taxpayer has filed an appeal against this decision.]

Cases referred to:

Taylor v Good 49 TC 277

Simmons v CIR [1980] STC 350

Beutiland Co Ltd v CIR 3 HKTC 184

Wing On Cheong Investment Co Ltd v CIR 3 HKTC 1

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D65/87, IRBRD, vol 3, 66
Marson v Morton [1986] STC 463
Simons Taxes Div B3.2 1561
Miller v Ministry of Pensions [1947] 2 All ER 372
D5/88, IRBRD, vol 3, 144
D11/80, IRBRD, vol 2, 374
CIR v Sincere Insurance Investment Company Ltd 1 HKTC 602
D8/88, IRBRD, vol 3, 161
American Leaf Blending Co Sdn Bhd v Director General of Inland Revenue [1979]
AC 676
D20/75, IRBRD, vol 1, 184

K A Lancaster for the Commissioner of Inland Revenue.
Raymond Tang of Raymond Tang & Co for the taxpayer.

Decision:

1. THE NATURE OF THE APPEAL

The Taxpayer appealed against the assessment to profits tax of compensation, together with interest thereon, paid to it consequential upon the resumption of certain land in the New Territories.

2. THE FACTS

2.1 The Taxpayer

2.1.1 The Taxpayer was incorporated in Hong Kong as a private company.

2.1.2 At all relevant times:

2.1.2.1 the Taxpayer's authorized share capital was \$2,000,000 divided into 2,000,000 shares of \$1 each of which 1,800,000 were issued;

2.1.2.2 1,620,000 of the said shares were owned by another Hong Kong incorporated company, A Ltd, and 180,000 by a Malaysian resident, Mr B;

2.1.2.3 the Taxpayer's directors were Mr B, another Malaysian resident, Mr C and a Hong Kong resident, Mr D; and

2.1.2.4 the Taxpayer's auditor and tax representative was a firm of certified public accountants ('ABC').

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2.2 A Ltd

2.2.1 A Ltd was incorporated in Hong Kong as a private company on a date unknown to the Board.

2.2.2 At all relevant times:

2.2.2.1 A Ltd's authorized share capital was \$5,000,000 divided into 5,000,000 shares of \$1 each of which 2,200,000 were in issue;

2.2.2.2 1,980,000 of the said shares were owned by Mr C and 220,000 by Mr D;

2.2.2.3 A Ltd's directors were Mr C and Mr D.

2.3 Acquisition of land

2.3.1 At a meeting held in June 1974, the directors of the Taxpayer resolved:

2.3.1.1 to negotiate for the Taxpayer to purchase fourteen lots in DD XXX, which is in E Place, and which lots comprised 337,590 square feet; and

2.3.1.2 authorized Mr D to negotiate to purchase another lot in DD XXX comprising 4,356 square feet, tacitly as a trustee for the Taxpayer, and see paragraph 3.4.8 below.

2.3.2 The actual dates on which legal title to the various lots described in paragraph 2.3.1 above (collectively 'the land') were acquired varied but title was obtained to the lots described in sub-paragraph 2.3.1.1 above by two assignments, each in mid-1974, and one conveyance on sale in early 1976. Title to the lot described in sub-paragraph 2.3.1.2 above was acquired by a conveyance on sale in mid-1974.

2.3.3 The total purchase consideration for the land amounted to \$1,716,143, inclusive of commission and brokerage.

2.4 Accounting treatment

At all relevant times the land was classified as a fixed asset in the Taxpayer's audited accounts which were prepared and certified by ABC, refer paragraph 2.1.2.4 above.

2.5 User of the land

2.5.1 By the Taxpayer

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- 2.5.1.1 The land was agricultural land and had for many years been used as what was described in evidence as a 'farm'. Factually, the land had some fruit trees on it and poultry had been free-ranged until ready for market.
- 2.5.1.2 The farm would appear to have been allowed to run down by the previous operators as in the period ended 31 March 1975, there was no income from sales but there was expenditure on a motor vehicle, with cassette player, furniture and fittings for the Taxpayer's 'town' office and on farm implements.
- 2.5.1.3 The Taxpayer operated the farm as had its predecessors until the early part of 1978 when an epidemic destroyed all of the poultry. Thereafter, and until July 1979, only fruit was produced.
- 2.5.1.4 From the audited accounts the Taxpayer's operation of the farm produced the following results:

<u>Year ended</u> <u>31 March</u>	<u>Sales</u> <u>(Gross)</u> \$	<u>Profit</u> <u>(Loss)</u> \$	<u>Accumulated</u> <u>Loss</u> \$
1975	Nil	(51,114.48)	(51,114.48)
1976	44,045.4	(40,139.28)	(91,253.76)
1977	42,988.4	(89,652.56)	(180,906.32)
1978	124,640.7	(98,565.85)	(279,472.17)
1979	Nil	(51,071.29)	(330,543.46)

In each of the above years the Taxpayer depreciated its fixed assets with the exception of the land which was not amortized.

2.5.2 The tenancy

- 2.5.2.1 By an agreement in writing in March 1980 ('the tenancy agreement'), the Taxpayer leased the land to a tenant for a term of three years from 16 July 1979.
- 2.5.2.2 Relevant provisions of the tenancy agreement were:
- 2.5.2.2.1 Clause 2(j): The permitted use was as 'a warehouse and godown only' and the tenant was required to obtain district office approval to the permitted use.
- 2.5.2.2.2 Clause 1: The full rental of \$110,000 per calendar month only became payable on the earlier of 16 October 1979 or the day approval to the modified user was received.

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- 2.5.2.2.3 Clause 2(c): It was the tenant's obligation to 'form' the land, that is make it suitable for the permitted use.
- 2.5.2.2.4 Clause 7: The tenant was able to terminate on immediate notice to and including 15 October 1979 if consent to the change of user had not been received.
- 2.5.2.2.5 Clause 8: The tenant was given the option to renew the tenancy for a further term of two years but either party could determine the tenancy during any renewal on three months' notice.
- 2.5.2.3 The tenant obtained the necessary approval from the district office and in its accounts to 31 March in the years 1980 to 1983, both inclusive, 'turnover' was this rental income. The land was 'formed' by the tenant and was used for the storage of vehicles. In other words the fruit trees were removed.
- 2.5.3 During the term of the tenancy the Taxpayer depreciated its fixed assets with the exception of the land which was not amortized.
- 2.6 Applications to modify the permitted user of the land
- 2.6.1 Mr F and Mr G
- 2.6.1.1 By letter signed by Mr C dated 19 July 1977, the Taxpayer gave a general authority to a Mr F and a Mr G, to liaise and
- 'negotiate with the New Territories Administrative Office and the New Territories District Office in connection with our application to convert and develop all those pieces of land held under Lot Nos [the land identified] [E Place] into a housing estate with the aim and for the purpose of improving, enhancing and benefiting the well being of the residence of the New Territories.'
- 2.6.1.2 Mr F and Mr G were directors of H Ltd, a company which was an association of a group of employees and which acquired residential accommodation for the members of the association.
- 2.6.1.3 Under cover of a letter from H Ltd, signed by Mr F and Mr G dated 25 July 1977, the authority was forwarded to the then Secretary for the New Territories. This letter referred to a prior meeting Mr F and Mr G had had with him and requested favourable consideration and approval to their application for the change of user of the land.
- 2.6.1.4 H Ltd addressed a further letter to the then Secretary for the New Territories on 22 August 1977, referring to a meeting on 5 August 1977 and a meeting on 8

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August 1977 with the district officer, I Place, and the latter's request for further details of the proposed scheme.

2.6.1.5 By Letter dated 8 June 1978, addressed to the district officer, I Place, and signed by Mr C, the Taxpayer rescinded the authority given to Mr F and Mr G.

2.6.2 By the Taxpayer

2.6.2.1 The Taxpayer had been in communication with the district officer, I Place, on a date earlier than 26 September 1977 as by a letter dated 30 September 1977, signed by Mr C, addressed to the district officer, the Taxpayer promised

‘ a formal application comprising of our proposed layout plan together with our proposed development schedule ... as soon as they are ready.’

2.6.2.2 Under cover of a letter dated 30 November 1977, signed by Mr C, the Taxpayer submitted to the district officer, I Place:

‘ ... our application ... to develop the above mentioned lots [the land] into a housing estate.’

Enclosed were the ‘explanatory report’, refer to in next sub-paragraph, ‘a layout plan of all housing units and facilities of the project’, ‘a typical floor plan of each standard unit’, ‘a standard road cross-section plan’ and an ‘explanatory report on the proposed housing scheme’.

2.6.2.3 The ‘explanatory report’ (‘the report’) was a printed document entitled ‘Development Plan Report’ which was twelve pages long with the other documents referred to in the covering letter, see the preceding sub-paragraph, being appendices thereto.

2.6.2.4 By letter dated 1 May 1978 addressed to H Ltd, a letter which was not provided to the Board, but which letter provoked the rescission of the authority given to Mr F and Mr G, refer paragraph 2.6.1.5 above, the district officer rejected the application. As by letter dated 8 June 1978, signed by Mr C, the Taxpayer gave notice of the revocation of the authority and asked for the application to be reconsidered and giving reasons therefor.

2.6.2.5 By letter dated 8 November 1978, signed by Mr C, the Taxpayer submitted a ‘perspective view of our proposed development’ and other information and asked for a favourable response to the application.

2.6.2.6 By further letters dated 26 March 1979 and 4 June 1979, signed by Mr C and addressed to the district officer, I Place, the Taxpayer sought approval to the application.

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- 2.6.2.7 In addition to initiating the correspondence Mr C had at least one meeting with the authorities. This was cited in Mr C's first affirmation referred to in paragraph 2.8.1.2 below.
- 2.6.3 By a firm of chartered surveyors
- 2.6.3.1 On 4 June 1980 a firm of chartered surveyors ('XYZ') commissioned by the Taxpayer wrote to the district officer, I Place, urging favourable consideration of the Taxpayer's application.
- 2.6.3.2 This initial letter was followed up by letters dated 26 July 1980, 21 January 1981 and 13 August 1981.
- 2.7 Resumption
- 2.7.1 By a gazetted notice of resumption, part of the land totalling 300,129 square feet ('the resumed land') was resumed by the Government.
- 2.7.2 The Taxpayer was notified of the resumption by letter dated 26 November 1981, and which letter included an exgratia offer of \$15,299,620 compensation subject to acceptance of the offer and the surrender of the resumed land, free from encumbrances, on or before 21 January 1982. At this time the tenancy agreement was in force and effect and the earliest date vacant possession could be obtained was mid-1982.
- 2.7.3 The Taxpayer was dissatisfied with the quantum of the compensation offered by the Government in respect of the resumed land and litigation ensued.
- 2.8 The litigation
- 2.8.1 Before the High Court
- 2.8.1.1 The Taxpayer issued an originating summons against the Crown in which ten declarations were sought. Essentially, the Taxpayer was seeking declarations which, if upheld, would have had the effect of making the user restriction imposed by the Crown Leases of the land invalid, on the basis that the restriction had been imposed in contravention of the convention dated 9 June 1898 pursuant to which the New Territories were leased to the Crown, and that the Crown Lands Resumption Ordinance had no application to the land. If the Taxpayer were to be successful the effect would be that the land would revert to its ownership free of the user restrictions.
- 2.8.1.2 In support of the application Mr C made an affirmation ('Mr C's first affirmation').

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- 2.8.1.3 In due course the Judge delivered judgment, the effect of which was the refusal of those declarations which would have achieved the objectives referred to in paragraph 2.8.1.1 above.
- 2.9 The compensation agreement
- 2.9.1 Having been unsuccessful in its attempts to frustrate the resumption of the land the Taxpayer faced the inevitable: the only question then remaining was the quantum of the compensation.
- 2.9.2 Under cover of a letter dated 12 August 1986, another firm of chartered surveyors ('JJ') forwarded the Taxpayer's 'counter claim for compensation' to the Government.
- 2.9.3 By an agreement in writing dated 17 December 1987, the Taxpayer and the Government agreed to accept and pay, respectively, compensation of \$16,428,010, together with interest of \$5,212,399, and the Government also agreed to pay to the Taxpayer's surveyors directly a sum of \$158,780 in respect of costs incurred in connection with the claim for compensation.
- 2.10 The compensation, the interest thereon and taxation
- 2.10.1 In its audited accounts for the year ended 31 March 1988, only the interest was shown as income in the profit and loss account and this was offered for assessment in the proposed tax computation. The gain on the surrender of the resumed land was classified as an extraordinary item and was not offered for assessment.
- 2.10.2 In response to the assessor's enquiry the Taxpayer's solicitors in a letter dated 25 July 1987, provided the following information:
- 'At the time of acquisition of this land it was occupied and used for agricultural purposes (that is orchard, chicken farm, etc). There were the usual farm structures, sheds and other outbuildings on the land, part of which (approximately 3,049 square feet forming part of Lot No [identified]) was classified as building land. The agricultural usage of the land continued until the latter part of 1979 and early 1980 when our client company entered into negotiation with one [tenant named] for the letting to them of the entire land, including the unresumed parts, for the use of open storage of motor vehicles. A tenancy agreement [dated mentioned] was signed with [tenant named] which continued to use the land for such open storage until resumption.'

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2.10.3 In response to a further enquiry from the assessor in a letter dated 22 April 1988, a copy of which was not before the Board, ABC provided the following information:

- ' (a) [The report] was prepared by the director [Mr C] personally, and there was no formal development plan report, or instructions to architects in this connection.
- (b) The remaining lots were reduced to \$1 to represent all remaining land which have not been resumed, and cost of purchase of individual lots have not been apportioned.'

2.10.4 By letter dated 6 May 1988, ABC provided the following information:

- ' (a) Our clients do not have any documentary evidence to show the intention, and at the time of acquisition the company intended to keep the land for long term investment until such time when the company resolved otherwise.
- (b) Our clients are not aware of any budget having been drawn up in connection with the intended development, and no other bank or financial institution have been approached to finance the project.
- (c) There are no other work done on the lands from the date of acquisition to November 1977, that the usage remained as that of agricultural until the letting to [tenant named].
- (d) The company decided to proceed to let the lots when it was clear that permission to develop was not forth coming from the Government.'

2.10.5 The assessor considered that the gain on the surrender of the resumed land was assessable and on 1 December 1988 he raised a profits tax assessment for the year of assessment 1987/88 as follows:

	\$	\$
Adjusted profits per proposed computation before depreciation allowance		5,011,176
<u>Add:</u> Gain on disposal of the resumed land	14,711,868	

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Reimbursement of legal costs	<u>158,780</u>	<u>14,870,648</u>
		\$19,881,824
<u>Less:</u> Legal fee for compensation of resumption of land	3,445,193	
Balancing allowances allowed	<u>1,543</u>	<u>3,446,736</u>
Assessable profits		\$16,435,088
<u>Less:</u> Loss set off		<u>7,811</u>
Net assessable profits		\$16,427,277 =====
Tax payable thereon		\$2,956,909 =====

2.10.6 ABC lodged an objection against the assessment in the following terms:

‘That the leasehold land concerned was acquired as capital and fixed assets of the company, and was not intended for trading purposes. In the circumstances, the compensation received from the Hong Kong Government for the said leasehold land should not be assessable to profits tax.’

2.10.7 Thereafter, the assessor ascertained that the sum paid by the Government directly to the surveyors, refer paragraph 2.9.3 above, was not the reimbursement of legal costs and, therefore, not assessable. The assessor also reconsidered the assessment and proposed to revise the assessment by applying the following formula:

$$\begin{array}{l}
 \text{Total cost of the land} \times \frac{\text{Area of the resumed land}}{\text{Total area of the land}} \\
 \\
 \$1,716,143 \text{ (Note 1)} \times \frac{300,129 \text{ (Note 2)}}{337,590 \text{ (Note 3)}} = \$1,525,709
 \end{array}$$

- Note 1: Refer paragraph 2.3.3 above
 Note 2: Refer paragraph 2.7.1 above
 Note 3: Refer paragraph 2.3.1.1 above

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Applying this formula the revised assessment would be:

	\$
Assessable profits assessed	16,435,088
<u>Add:</u> Profits on surrender of the resumed land under assessed (Note)	<u>190,433</u>
	\$16,625,521
<u>Less:</u> Reimbursement of legal cost	<u>158,780</u>
Revised assessable profits	\$16,466,741
<u>Less:</u> Loss set off	<u>7,811</u>
Revised net assessable profits	<u>\$16,458,930</u> =====

	\$
<u>Note</u> Compensation received	16,428,010
<u>Less:</u> Cost (see formula above)	<u>1,525,709</u>
Profits	\$14,902,301
<u>Less:</u> Already assessed	<u>14,711,868</u>
Amount under assessed	<u>\$190,433</u> =====
Tax payable thereon	<u>\$2,962,930</u> =====

2.11 The Commission's determination

In his determination dated 19 July 1989 ('the determination'), the Commissioner increased the assessment made on 1 December 1988, refer paragraph 2.10.4 above, to accord to the assessor's proposed revised assessment referred to in paragraph 2.10.7 above.

2.12 The Taxpayer's notice and grounds of appeal

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On 10 August 1989 the Taxpayer's new tax representatives ('EFG') lodged the notice of appeal, the grounds of appeal being:

- 2.12.1 That the Commissioner erred in holding that a gain arising from the resumption of certain land was a profit from the disposal of trading stock.
- 2.12.2 That the gain arising from the resumption of the land by the Government is one from the disposal of a capital asset.
- 2.12.3 That the Commissioner erred in including in the assessment the amount of interest of \$5,212,399 paid by the Government on the compensation due representing interest which was received after the Taxpayer had ceased to carry on any business and which should not be taken as profit chargeable to profits tax.

3. THE CASE FOR THE TAXPAYER

- 3.1 The Taxpayer was represented by a solicitor who was assisted by a representative from EFG.
- 3.2 The representative handed to the Board folders of documents together with an affirmation by Mr C, ('Mr C's second affirmation') and it was agreed that Mr C would be taken through this affirmation and then tendered from cross-examination.
- 3.3 In answer to a question from the Board the representative stated that he took no exception to the facts set out in the Commissioner's determination and that those would be supplemented by Mr C's evidence. The sole dispute was as to the Commissioner's reasons which were then read. Thereafter, the grounds of appeal were read.
- 3.4 Having been duly sworn Mr C gave the following evidence:
 - 3.4.1 He was and is a director of the Taxpayer, the other directors being Mr B and Mr D. A Ltd owned 1,620,000 of the issued shares in the Taxpayer and Mr B the remaining 180,000 issued shares.
 - 3.4.2 A Ltd was a holding company and did not trade. A Ltd's issued shares were held as to 1,980,000 (90%) by himself and 220,000 (10%) by Mr D. Accordingly, he had effective control of the Taxpayer.
 - 3.4.3 He was a businessman with various business interests in Malaysia where he resided.

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- 3.4.4 In the 1970's his business interests included investments in farming and agriculture. He referred the Board to the documents with respect to K Farm Ltd and said that its principal objects were to carry on farming and other related agricultural activities. It operated a fifty acre orchard farm and a piggery which provided fertilizer for the orchards.
- 3.4.5 In conjunction with Mr B he had an interest in L Ltd and referred the Board to the documents with respect to L Ltd. Its principal object was to carry on the business of a poultry farmer which it was doing at the material times.
- 3.4.6 In early 1974 he and Mr B decided to invest in Hong Kong. The Taxpayer was then incorporated, the subscribers being himself and Mr D.
- 3.4.7 Mr D introduced him to the farm on the land which had been in business for many years.
- 3.4.8 Between 1974 and 1978 the Taxpayer invested approximately \$1,800,000 in the purchase of the land. He referred the Board to a plan showing the location of the land. The only part of the land not purchased in 1974 was the lot referred to in paragraph 2.3.1.2 above. This lot was purchased by Mr D with monies provided by the Taxpayer. This lot provided access to the remaining lots and sensitive negotiations with the vendors were required. Mr D assigned both lots to the Taxpayer in March 1980. Details of the assignments and conveyances on sale were given to the Board but not copies of the actual instruments.
- 3.4.9 The land was the only land acquired by the Taxpayer.
- 3.4.10 The land was always shown in the Taxpayer's accounts as a fixed asset and depreciation consistently charged against them.
- 3.4.11 The land was purchased as a farm, it was well known and had been there prior to the Second World War, with the intention to continue to run it as a farm. Both Mr B and he had experience in agriculture in Malaysia as he had already described.
- 3.4.12 After acquisition the Taxpayer carried on the business of a chicken farm as well as the traditional fruit tree farming. Mr D was entrusted with the day to day running and he made several visits each year.
- 3.4.13 Over the years following acquisition the Taxpayer incurred expenditure on equipment, road works, farm structures and feed and sold the farm products. Workers were employed but in early 1978 an epidemic wiped out the poultry. The fruit trees were not affected and the fruit was sold.

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- 3.4.14 The farm was not a success and the business was financed by loans from A Ltd and Mr B. Eventually, the losses had accumulated to more than \$330,000. The Board was referred to the audited accounts for the years ended 31 March 1975 to 1979, both inclusive, namely the years during which farming was conducted.
- 3.4.15 The Taxpayer knew when the land was purchased that the user was restricted to agricultural use.
- 3.4.16 By late 1977 there had been three years of unsuccessful operation of the farm. As a businessman he considered it proper to explore other possible uses namely a different type of business or putting the land to a different use which would enhance its value.
- 3.4.17 He decided to apply to the Government for permission to change the user to permit residential development. His application was an enquiry, a testing of 'the temperature of the water before dipping in'. It was done by correspondence with the district office.
- 3.4.18 To make the application more convincing he decided to have a formal development plan report prepared and submitted this with the application to the district lands office. At that time there was a civil engineering project in Malaysia, ('M project'). He had a copy of the report of the project ('M report') and he used this as a basis for preparing a development plan report for the farm. The report he prepared was called a 'development plan report' which, at the time of the appeal, he understood to be an unusual title for a user modification application in Hong Kong. He, personally, prepared this document and actually copied various passages word for word. A copy of M report and the report he had prepared were produced to the Board.
- 3.4.19 The report was informally prepared. Basically the central theme in M report was followed. The plans were prepared by an employee of Mr B. The plans were conceptual without detail. The reference to 'management corporation' was put in for completeness. It was not uncommon for rental properties to be managed by a corporation separated from the developer. The reference was not included as an indication of the intention to sell. The Taxpayer was concerned with enhancing the value of its investment and had not formed any intention to sell. It was much too early to form such intention.
- 3.4.20 No professional advisers had been employed to advise on the report and no architect or professional planner had been engaged. No financial calculation was done and no approaches to secure finance had been made. No market research had been done and there was no budget. There were no detailed drawings, specifications, floor area configuration, pricing etc. There was nothing to indicate what the development would be or what the developed house would look like.

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- 3.4.21 The purpose of the exercise was to find out if an application would be entertained. If the exercise had been successful that would have been the first step, and no more, towards enhancing the capital value of the land. It was his view that a change from agricultural to residential use would enhance the value of the land. It was that view which prompted the application and it was his duty as a director and major shareholder to consider the alternatives open to the Taxpayer as a result of the failure of the farming business.
- 3.4.22 Whilst this was going on the farm was being run, that is through 1977 and until the loss of the poultry in 1978.
- 3.4.23 The report was sent to the district lands office under cover of a letter dated 30 November 1977. In May 1978 the application was rejected. In June 1978 the application was pursued, in response to points raised when the refusal was communicated, but no new material was submitted, and again was refused in December 1978.
- 3.4.24 In June 1978 Mr D became acquainted with XYZ which was familiar with the Government policy in connection with New Territories land. XYZ wrote a letter in June 1980 to resurrect the applications refused. XYZ's assistance, to the best of its recollection, was on a complimentary or friendly basis: it did not charge for the work done. Thereafter the Taxpayer did not pursue the matter further.
- 3.4.25 The Taxpayer did not carry out any construction work on the land.
- 3.4.26 The land was acquired and always treated as a capital asset. The land was purchased and the farm operated as a long term investment. The sole purpose of the application to change the user was to enhance the capital value of the land.
- 3.4.27 By 1979 it had become clear that poultry or fruit farming was not going to be a success.
- 3.4.28 In mid-1979 an approach was made by a company who wished to rent the land for storage of motor vehicles. As a result of negotiations the tenancy agreement was entered into. The tenant obtained permission to use the land for the intended purpose and 'formed' the land. The return on investment was very favourable.
- 3.4.29 The tenancy agreement contained all the terms and conditions to be found in a commercial letting.

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- 3.4.30 In March 1980 Mr D assigned the two lots acquired in his name to the Taxpayer. This was in line with the Taxpayer's intention to regard the tenancy as a long term rental producing investment.
- 3.4.31 At the time the Taxpayer was contented to rent out the land. Land of the area owned and a few yards from the main trunk road was and is very hard to find and easily command high rent from people requiring open storage. Factually, the tenant had sub-let at a much higher rent.
- 3.4.32 But for the resumption the Taxpayer would still be renting out the land.
- 3.4.33 At all material times the Taxpayer had purchased no other land and carried on no other business.
- 3.4.34 The resumption notice of the resumed land was then gazetted and it reverted to the Crown later.
- 3.4.35 The resumed land was the most useful part of the land. The remaining scattered lots could not be used or occupied as a single unit. The resumption frustrated the tenancy agreement prematurely.
- 3.4.36 At all material times the Taxpayer was happy with the rental being received and had no plans to sell or dispose of the land. The tenant's sub-tenancy rental demonstrated the potential for an even higher yield in the future.
- 3.4.37 The Taxpayer had unsuccessfully contested the resumption in the courts. Thereafter, after protracted negotiations compensation was agreed and the formal agreement signed in late 1987.
- 3.4.38 The Taxpayer did not sell the resumed land. The resumption was forced on it but for that the tenancy would have continued and income was earned.
- 3.4.39 After the resumption the Taxpayer had not carried on any business and had received no trading income. The Board was referred to the audited accounts for the years ended 31 March 1980 to 1988, both inclusive.
- 3.4.40 He had no knowledge of the right of the Government to resume land when it was acquired in 1974 and he had not made any enquiries as to this.
- 3.5 Cross-examination of Mr C.
- 3.5.1 He and Mr D were the subscribers to the memorandum and articles of association of the Taxpayer and that they had then transferred the subscriber shares.

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- 3.5.2 He had owed 90% of the issued shares of A Ltd from the outset and that A Ltd owned 90% of the Taxpayer.
- 3.5.3 He was intimately aware of the affairs of both A Ltd and the Taxpayer.
- 3.5.4 A Ltd had two subsidiaries, the Taxpayer and a company with a similar name '[N Ltd]'.
- 3.5.5 His interests in Malaysia included factories and trading companies, including one selling farm equipment.
- 3.5.6 He had no interest in any construction business. As to the other directors: Mr B was in business in Malaysia and, at the material times, Mr D was a toy retailer in Hong Kong.
- 3.5.7 ABC, the Taxpayer's former auditors and tax representatives had been appointed to incorporate the Taxpayer and their appointment had continued notwithstanding the retirement of the then proprietor. They handled the secretarial, audit and tax matters. So far as correspondence from the Inland Revenue Department was concerned they dealt with routine matters but, when necessary, would take instructions from Mr D who had the necessary authority. Mr D had emigrated to Australia in 1986 or 1987 and, thereafter, the witness was the person to be contracted, although he was not always easily contactable.
- 3.5.8 He had submitted the memorandum and articles of association of each K Farm Ltd and L Ltd, respectively, to show that he had experience in farming.
- 3.5.9 The decision to acquire the land in 1974 came about as a result of the recommendation by Mr D, and an old friend of his father. In 1974, whilst he was visiting Hong Kong, Mr D told him the farm was for sale and recommended he purchase it. Mr D took him there to inspect it. The fruit trees were neatly planted. There was a ready income from the fruit in the farm recommended to him. He did not ask for or inspect any accounts with respect to the operation of the farm. Having made his inspection he was happy to make the purchase.
- 3.5.10 He could not remember the 1972 stock markets crash and was not influenced by the fact that in 1974 the property market was depressed. He had the required cash available and having seen the property and the trees he was satisfied he could make money from the fruit. The purchase price was within his available cash resources so he purchased it. The decision to purchase was made two days after the incorporation of the Taxpayer.
- 3.5.11 Having been asked why none of this information had been previously provided to the Revenue he said that he used to deal with the original proprietor of ABC

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and after his retirement he dealt with a Miss O. When the Taxpayer received the assessment she contacted him. He told her the purchase was an investment and she agreed. He told her to act accordingly. He was not aware of what she had written. The correspondence had not been copied to him but he had received a copy of the Commissioner's determination. He had been happy to leave everything to Miss O as she knew what had happened and was of the view that there was no liability to tax. He was unable to explain why the information given in his evidence and the documents produced at the commencement of the appeal had only been provided to the Revenue for the first time at 4 p.m. on the previous day, 12 December 1989.

- 3.5.12 He made no enquires as to the permitted user of the land at the time the decision to purchase was made but he thought it was for a farm. He made no enquiries of the vendor although, later, he found out some were friends of Mr D. He did not know that the vendor was a developer who had not farmed the land. He agreed that he was unable to inspect any accounts as there were none.
- 3.5.13 He said that after completion of the purchase the Taxpayer had built some chicken sheds, employed workers and purchased some chickens. Thereafter a chicken farm and fruit farm were run. The trees fruited twice a year and chickens were ready for market after about six to nine months. The condition of the land on purchase was alright and the only immediate work needed was to replace the fencing.
- 3.5.14 Having referred to the audited accounts for the year ended 31 March 1975, he stated that during this period work improving the farm was taking place and referred to the schedule of 'improvement expenses'. When questioned as to what relationship this expenditure had to farming he explained that the decoration expenses and expenditure on fittings were in respect of the Taxpayer's office which was a room provided by Mr D at his shop premises and which room was made available free of rent. He was unable to explain why there had been no income save for stating that the accounts only covered a nine months period. When pressed he had to agree that there could have been no fruit or chicken sales. He agreed that no forecast of the return on the investment had been made.
- 3.5.15 When questioned as to the relative cost of land in Malaysia he agreed that it was considerably cheaper than land in Hong Kong. He also agreed that food production costs were cheaper in Malaysia. Accordingly, more profits could be made in Malaysia. The investment in Hong Kong was to avoid having 'all his eggs in one basket'.
- 3.5.16 He disagreed that Hong Kong was not noted for its agricultural industry. He referred to vegetable production in the New Territories and stated that the fruit that was produced in the farm was not grown in Malaysia.

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- 3.5.17 When asked as a businessman he would be expected to be looking for profits he stated that he had cash and was diversifying. He did not want to effect local borrowings and was only prepared to invest the cash he had available. At the time of purchase profit was not material although the farm had to support itself. The trees were there already and the operation would not involve too much in the nature of running costs. The investment would be good if it did not require costs. The investment would be good if it did not require much in the nature of running expense funding. Whilst he borrowed funds in Malaysia, where he lived and was on top of his operations, he did not want to borrow offshore Malaysia as he would not be on top of the situation. Offshore operations had to be self-sufficient.
- 3.5.18 He had not compared the profitability of the Hong Kong operation with a similar operation in Malaysia.
- 3.5.19 He agreed that the farm had never been self-sufficient. He stated it would have been for the chickens. He agreed that he had done no forecasts as to the profitability of the chickens.
- 3.5.20 Having been referred to paragraph 15 of his second affirmation he said that the approach to the district lands officer by the Taxpayer had been the only approach for a change of user in 1977. He also said that a further application was made when the tenancy agreement was under negotiation. He was then referred to the general authority given to Mr F and Mr G. He said that these gentlemen were friends of Mr D but he knew nothing about them. He said that at this time the Taxpayer was losing money and they were discussing the idea of obtaining a change of user. Mr F was a local villager and Mr G had developed land in the location. Mr D thought they would be able to get an idea of the likely Government reaction. He did not investigate what they did. Having been referred to the letter from H Ltd dated 25 July 1977, he said he knew nothing about it but when he found out he revoked the authority. Mr G had not been authorized to write merely to liaise. He denied knowledge of H Ltd's letter of 22 August 1977. He denied that the decision to use H Ltd was because it was a housing association for a group of employees and that a suggestion that the development would be available to house these employees might facilitate approval of the application. He said that H Ltd had not advised him as to what it had done and he did not know what it had done. However, he did say that he objected to it corresponding with the Government under its name as opposed to the name of the Taxpayer.
- 3.5.21 He was then referred to paragraph 20 of his second affirmation and confirmed the content was correct. He was referred to the Taxpayer's letter of 30 September 1977 and when asked to identify the surveyor he said that the individual was not a Hong Kong or Malaysian authorized surveyor but an

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employee of Mr B who had been in Hong Kong and was competent to do the necessary work. He agreed that the report had been submitted to the Government on 30 November 1977, but the application had been unsuccessful. He said that the report was prepared on an informal basis. He had ascertained that an application for a change of user required plans and neither plans nor specifications existed. He said that the Taxpayer never had the intention to develop the land merely to enhance its value. If there had been an intention to develop he would have gone about it from day one. He agreed that the Government was not told there was no intention to develop. He also volunteered that an artist's perspective had been submitted. When asked why, if there was no intention to build, it was a fact not indicated to Government although there were seven separate requests for approval, he replied that this was the usual practice. When asked what he would have done had consent been given he said that the land might have been sold as the Taxpayer did not have the money to undertake the development. When asked if approval had been forthcoming finance was capable of being obtained he said that he had not thought of that. He said the applications were all done 'on the cheap'.

- 3.5.22 The witness was then referred to the report and said that an extract at page 4, which was read to him, was lifted from M report. When referred to page 12 and the paragraph dealing with selling he said that this was also copied from M report. He denied the section quoted represented that the units in the development would be sold with owners having a say in the management of an estate. He agreed that no feasibility study had been done and denied that there was any agreement as to what should be done if approval was given.
- 3.5.23 He said that he knew that the Government would charge a premium for approving a change of user but denied he knew that other conditions would be imposed and stated that he had not sought advice from the Taxpayer's solicitors. He said that Mr D had told him about such applications at a time when they had discussed the use to which the land could be put.
- 3.5.24 He said he was not aware of the Government's right to resume agricultural land in the New Territories but added that Mr D did.
- 3.5.25 Having been referred to paragraph 24 of his second affirmation he said the Taxpayer did not pursue a change of user after 1980. He was referred to the letter of 4 June 1980 from XYZ to the district officer, and stated that Mr D knew XYZ and that XYZ had experienced in urban renewals. When asked to confirm the letter which had been copied to the client he agreed but said that XYZ had not paid any fees. He denied knowledge of the subsequent letters addressed by XYZ to the Government, even though they were all marked 'cc client'. He said that the Taxpayer had not authorized any further applications after the first rejection.

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3.5.26 He was then questioned about the litigation. He said that the Government resumed the Taxpayer's land. The land was occupied by a tenant and the Government required vacant possession. As the land was tenanted it was not possible to deliver it up with vacant possession. The litigation was as to the Government's right to resume. He confirmed that he had said that the land was acquired as a long term investment and to be farmed. He was not aware that it had been represented to any third party that it had been acquired for redevelopment. He agreed that he had to tell the truth before the courts and was responsible if he did not. He was referred to a passage at page 3 of the judgment in paragraph 2.8.1.3 above, reading:

‘ This meant that the plaintiff could not base a claim for compensation on the reason for which the land had been acquired namely that it had potential development value for housing purposes.’

and was asked whether that was what was represented before the court. He said that the report had been submitted and there was the potential for development. He said that he thought the reference might have been necessary for a declaration being sought. He said that the lawyers were responsible for preparing the papers and framing the declarations. The reference was included to seek higher compensation. He said it did not matter if it was not true. He confirmed the accuracy of the next passage, reading:

‘ The attitude of the plaintiff is best expressed in paragraph 13 and in the first sentence of paragraph 14 of the affirmation made by the chairman of its board of directors, [Mr C], on 28 May 1982 –

“13. The plaintiff is aggrieved by the resumption because it feels that the Government has taken unfair advantage of the situation, in that the Government has long known that the said lands, in the light of the development plans put forward by the plaintiff, had development potential but had kept back from allowing the plaintiff to develop the area on the ostensible grounds that there were insufficient facilities, such as electricity, water, drainage, access etc. Yet the Government has decided to resume the area for temporary housing which required the same facilities but at a much higher level in view of the higher densities of population applicable to such use. Also, the Government well knew that the plaintiff had a tenancy agreement at a substantial rent with [tenant named] (which in turn had sub-let at a far higher rent) for the open storage of motor vehicles in the area, and indeed, had stood by when [tenant named] had expended substantial sums in forming the area and such substantial sums have been reflected by

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suitable diminution the rent charged. It is unfair that with the knowledge as aforesaid set out the Government had chosen to take advantage of resuming the plaintiff's land when there is ample crown land in [E Place] and [I Place] districts.

14. In the beginning of 1982, if the plaintiff were able to continue to collect rent from [tenant named] or any other organization for open storage of motor vehicles, it would be able to collect rent by the end of 1997, in the total sum of slightly over \$23,000,000 even assuming there is no increment in the interim.”

3.5.27 He confirmed that the litigation had been unsuccessful and that at the end of the litigation the question of the compensation was still outstanding. He said that the firm of chartered surveyors engaged to negotiate the compensation, JJ, had been retained by the Taxpayer's solicitors. He said that he knew nothing about a passage quoted from the document enclosed with JJ's letter dated 12 August 1986, reading:

‘1.3.1 The subject lots were purchased by our client in 1974, with the exception of [Lot YYY] which was purchased in 1976. He hoped to develop the land and purchased it with the expectation of obtaining a modification in the crown lease conditions to allow building development. The land had previously been used as a farm and to begin with our client continued to put it to agricultural use.’

3.5.28 He said that the Taxpayer had authorized its solicitors to appoint the chartered surveyors and to authorize them to negotiate the amount of the compensation. The amount of the compensation was all that interested the Taxpayer. If they represented that the Taxpayer had the intention to redevelop that was only to increase the amount of the compensation. He was not concerned with what JJ said. He agreed that it was irrelevant that JJ had made a blatantly false representation when pursuing the compensation claim and that it was permissible to make any claim to exaggerate the compensation. He denied he had the same attitude to tax and added that if the Taxpayer had intended to redevelop it would have done so straight away.

3.5.29 The witness was then referred to the tenancy agreement. He said that the Taxpayer had decided to let as farming had proved unprofitable and that at the time the tenancy was expressed to commence the intention to redevelop had been abandoned. He repeated that he did not know that XYZ had written to the district office after the date of the tenancy agreement.

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- 3.5.30 The witness did not reply to a question relating to the effect of a declaration that the Government had no right to impose any restriction on the user of the land.
- 3.5.31 He agreed that it was claimed that the Taxpayer had not conducted any business since the resumption of the land. Having been referred to the Taxpayer's audited accounts for the year ended 31 March 1988, and the tax return for the year of assessment 1987/88, which he agreed was signed by Mr D, the witness confirmed declared profits of \$4,982,018. He agreed that having lost the litigation the negotiations as to the quantum of the compensation continued until December 1987. He denied that claiming compensation was a business, although he was referred to the Taxpayer's power to surrender land as stated in its memorandum.
- 3.5.32 The witness confirmed his evidence that the Taxpayer had continued its farming until 1980 when the tenancy agreement was created. He was then referred to the Taxpayer's tax return for the year of assessment 1978/79, which was endorsed 'no trading during year ended 31 March 1979, namely from 1 April 1978', and was asked to explain this discrepancy. He replied that there was fruit to sell but agreed that the audited accounts disclosed no sales. The witness was referred to the Taxpayer's audited accounts for the year ended 31 March 1980, and agreed that the profit and loss account showed no income or cost of farming sales and that the profit for the year was attributable to rental income. The witness said that it was academic to argue whether farming went on until the tenancy agreement was executed or had ceased somewhat earlier. He could no longer remember the year but there had been some \$10,000 income from the fruit but there had been no sales of chickens.
- 3.6 Re-examination of Mr C:
- 3.6.1 He was Chinese by race as were his parents who had emigrated to Malaysia from China. His family was 'overseas Chinese' and 'overseas Chinese' had a tradition of returning money to China.
- 3.6.2 His family had investments in Malaysia, Singapore and the United States. The non-Malaysian investments were a diversification and the motivation for diversification was the occasional racial tension which occurred in Malaysia. Profit was not a motivating factor for diversification.
- 3.6.3 The witness was referred to the two assignments and explained that the confirmors were the individuals who had contracted to purchase the named lots as the Taxpayer had not been incorporated, refer the recitals thereto.
- 3.6.4 ABC had been left to handle the Taxpayer's affairs and he only became concerned when the assessment was raised. However, there had been no

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consultations as to the objections to the assessment and ABC had not asked for either documents or information.

- 3.6.5 His background in farming was apparent from the documents produced at the appeal. The Taxpayer had farmed the land and this was apparent from its audited accounts.
- 3.6.6 The first request he had received for documents had been made by his solicitor for the purposes of the appeal. Miss O of ABC had been instructed to telephone him if she needed information. When he heard of the assessment he had telephoned her and been told there was no problem. Then he had been told the objection had not succeeded and that an appeal could be lodged. At that stage the witness had contracted the Taxpayer's solicitors.
- 3.6.7 When instructing ABC to incorporate the Taxpayer the farming object was not specifically requested: he had asked for everything to be included. K Farm Ltd and L Ltd were 'tailor made' companies. The accountants had been given specific instructions.
- 3.6.8 He and Mr D had subsidized the Taxpayer.
- 3.6.9 He did not know that the previous owners of the land had not farmed it. When he inspected there was no representative of the vendor present. After purchase money was spent on improvements. The supporting schedules to the audited accounts provide details. In the years ended 31 March 1976 and 1977 additional improvements were made. Farm implements were also purchased. The farm was to be run by Mr D. There was no trading income in the year ended 31 March 1974 but there was in subsequent years. Farming continued until the loss of the chickens.
- 3.6.10 He did not know Mr F or Mr G of H Ltd and the authority given to them was limited. He had not had any reports of their liaison with the district office between July and November of 1977. It was when he received a letter from the district office addressed to H Ltd that he became aware of what they had done. He felt the correspondence should have been addressed to the Taxpayer and not H Ltd. He had told Mr D that they were not authorized and the authority was then cancelled.
- 3.6.11 He had not discussed housing for civil servants with anyone. He confirmed his earlier evidence as to the person who had done the survey and confirmed that this individual's work had been annexed to the report. He had not been paid for his work.
- 3.6.12 He was aware of XYZ's first letter to the district office but not of their later letters.

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- 3.6.13 He remembered making his first affirmation. Although it was a long document he remembered it gave the history of the land, the use to which it had been put and referred to the report.
- 3.6.14 The application for change of user was not to enable the Taxpayer to redevelop: it was made to enhance the value of the land as everyone knows that residential land is more valuable than agricultural land. If the application had been approved the Taxpayer did not have the money to proceed and he was neither a resident nor sufficiently experienced.
- 3.6.15 JJ's submission was worded to maximize the claim for compensation. When the farm failed a redevelopment became attractive but the matter was taken no further than the report.
- 3.6.16 The tenant had taken possession before the tenancy agreement was signed, hence the rental income from July 1979.
- 3.6.17 The report contained large passages which were taken directly from M report and included with no or very little modification. He had personally prepared the report. Save for the plans and some of the calculations he had had no assistance. No architect had been employed. After the initial rejection the only additional work done was the artist's perspective.
- 3.6.18 After the resumption the Taxpayer did nothing apart from the claim for compensation.
- 3.7 Questions from the Board
- 3.7.1 The litigation was pursued on the basis the Taxpayer intended to redevelop the land. This was stated in his first affirmation. The content of the first affirmation was true.
- 3.7.2 The compensation claim was pursued on the basis the Taxpayer intended to redevelop the land.
- 3.7.3 The Taxpayer was pursuing this appeal on the basis that there had never been an intention to redevelop.
- 3.8 Further questions from the Taxpayer's representative
- 3.8.1 He had not recently been provided with a copy of his first affirmation and could not recollect the content in detail. He could not say whether the litigation was concerned with the Taxpayer's intention to redevelop or whether there were other issues at stake.

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3.8.2 By November of 1977 the Taxpayer was considering a redevelopment. The litigation related to the wider issue of the right of the Government to resume.

3.9 Question to the Taxpayer's representative

The representative was asked whether the witness had or had not made any representation to the court as to the Taxpayer's intentions as to a redevelopment of the land. The Board was told that the plaintiff did put forward the position that without consent the use could not be altered but went on to aver that the Government had no legal right to restrict the user.

4. SUBMISSION ON BEHALF OF THE TAXPAYER

4.1 The Taxpayer's ownership of the land could be divided into the following five phases:

4.1.1 The purchase:

The Taxpayer says the land was purchased as a farm, the use to which the land had been put since before the Pacific War.

4.1.2 The use following purchase:

It was used as a fruit farm, supplemented by chickens rearing. Money was spent on improvements, roads, fences, and equipment, and labour was employed. The farm did not work out and the directors, as businessmen, sought another use.

4.1.3 Application for change of user:

The report was far from a formal application, an application which would secure a detailed examination of the application. It was an attempt to persuade the district officer to agree to a change of user and, hence improve the value of the land. The intent of the Taxpayer did not go far enough to change the character of the holding – a farm. Approval to the change of use would have opened another avenue of business for the Taxpayer.

4.1.4 The use following the refusal of the application for a change of user:

The application for the change of user was unsuccessful. The alternative to farming was to secure a tenant. The rental recouped the cost of the land within eighteen months – a good investment return by any standards.

4.1.5 The resumption:

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This had been unsuccessfully contested.

The land started out as, continued and concluded as an investment and while owned there was only one period when consideration was being given to something other than an investment. The investment character was not altered until forced by the resumption.

- 4.2 The ‘facts upon which the determination was arrived at’, set out in section 1 of the determination were not comprehensive and the omissions were covered in Mr C’s second affirmation. Further some of the findings of ‘fact’ are not explained and some are misconstrued. In particular:
- 4.2.1 Fact 1 (7): the purpose of quoting sub-clauses 4(d) and 4(f) of the tenancy agreement is not explained. If the purpose was to demonstrate that the tenancy was temporary this was a misconstruction of standard provisions.
- 4.2.2 Facts 1(12) and 1(13): the Commissioner failed to deal with the actual use of the land by the Taxpayer as a farm, a use which was apparent from an examination of the audited accounts, and the subsequent letting when farming was proved uneconomical.
- 4.3 The Commissioner ignored the agricultural use to which the Taxpayer put the land including the period when the applications for change of user were being made. This ignored clear evidence of the Taxpayer’s intention to hold the land as a long term investment.
- 4.4 The Commissioner failed to consider the effect of the tenancy agreement. This was further evidence of the Taxpayer’s intention to hold the land as a long term investment.
- 4.5 The determination ignored the fact that events consistent with the intention to hold the land as a long term investment took place before and after the applications for the change of user and it was submitted that the applications did not break the continuity of that intention.
- 4.6 The report was prepared informally by Mr C with the help of Mr D. The ‘reason’ given by the Commissioner in section 3(3) of the determination refers to a passage at page 12 of the report. If this passage is read it will be seen that it is far from definitive or sufficiently definitive to demonstrate a clear intention to change the character of the asset. It was submitted that reference to ‘owners of the home units’ was no more than the completion of a narrative describing the proposed development in general terms. It is not uncommon for a development to be managed by an entity distinct from the owner. The sole purpose of the application for the change of user was to enhance the value of the

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land. This application did not amount to a change of intention: no building work was done, no architects were approached and no attempts were made to put together the necessary financing.

- 4.7 The Commissioner did not find that the acquisition was an ‘act of trading’ by the Taxpayer. He appears to have imputed a trading intent as at the date of acquisition because of the application for the change of user. It was submitted that it was not possible to impute from a subsequent event a retrospective intent. Further, it is implicit that had a feasibility study been available the Commissioner would have accepted the intention was to effect an investment. The imputation of a trading intent could not and ought not to have been made.
- 4.8 The Taxpayer had the capital to make the acquisition. No mortgage was created and there was no evidence of speculation, as would be the case of a dealer with small capital. Further, the audited accounts show that the losses were financed by loans from the shareholders.
- 4.9 Resumption is an act of involuntary disposition. If the tenancy agreement is evidence of the intention to hold the land as an investment, which it was submitted it was, in the absence of resumption the investment intention would have continued and no trading intention could have been imputed. But for the resumption the Taxpayer would have been letting the land to this day. Even if the land had been acquired as a trading asset, by 1979 it was clear that the intention had been changed to one of investment.
- 4.10 After the land was resumed the tenancy was prematurely determined and the Taxpayer ceased business. Until the interest was received from the Crown the only other income was bank interest. The receipt of bank interest and the interest received from the Crown were not derived from the ‘carrying on [of] a trade ... or business in Hong Kong’ within the meaning of section 15(1)(f) of the Inland Revenue Ordinance.
- 4.11 The issue is whether the compensation and interest are the gain arising from the disposal of trading stock or the disposal of an investment.
- 4.12 Authorities:
- The Board was referred to the following authorities, from which passages were cited:
- 4.12.1 Taylor v Good 49 TC 277
- 4.12.2 Simmons v CIR [1980] STC 350
- 4.12.3 Beutiland Co Ltd v CIR 3 HKTC 184

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- 4.12.4 Wing On Cheong Investment Co Ltd v CIR 3 HKTC 1
- 4.12.5 D65/87, IRBRD, vol 3, 66
- 4.12.6 Marson v Morton [1986] STC 463
- 4.12.7 Simons Taxes Div B3.2 1561
- 4.13 In response to a question from the Board the representative stated that he did not agree that when farming ceased to be possible a sale of the land would have been a better course for the Taxpayer.
- 4.14 After the overnight adjournment the representative was permitted to supplement his submission:
- 4.14.1 He handed the Board a copy of Mr C's first affirmation.
- 4.14.2 It had been put to Mr C that in the litigation his case was based on the intent to develop and in this appeal his case was based on the intent to invest, that is statements of convenience. It was assumed that the Revenue was basing this on the extracts from the judgment quoted at paragraph 3.5.26 above. The Board would be able to see if Mr C had said in his first affirmation what the Judge had written.
- 4.14.3 The Board was then referred to the first of the passages quoted in paragraph 3.5.26 above and the representative made the following comments:
- 4.14.3.1 The learned Judge's remark is not borne out by Mr C's first affirmation. There is nothing in the first affirmation as to the Taxpayer's reason for effecting the purchase.
- 4.14.3.2 The remark is not a finding of fact. A finding of fact was not required. The litigation was concerned with the right of the Crown to resume land and if it did the basis on which the quantum of compensation was calculated, that is on the basis of agricultural land or non-agricultural land, in other words the open market value. The intention for which the land was acquired was of little relevance in the litigation.
- 4.14.3.3 In the absence of evidence as to the Taxpayer's intention at the time of acquisition the learned Judge's remark was pure speculation.
- 4.14.3.4 Even if the remark was taken at face value it does not impact the Taxpayer's case. The fact that the land had the potential to be used for housing did not make it trading stock. A development could be for long term investment. To

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determine the intent the tests have to be applied, refer the Marson case and Simons Taxes.

- 4.14.3.5 The Board was referred to a passage in Mr C's first affirmation in paragraph 13 reading:

‘ ... Government had long known that the said lands, in the light of the development plans put forward by the plaintiff, had development potential

The Board was requested to note that this affirmation was made in 1982. Mr C had advised the Government of the potential through the report, which had been delivered on 30 November 1977, some five years earlier. It was no more than a statement of fact. Government also knew of the tenancy agreement as it had been registered. Again a statement of fact. The learned Judge's comment and the content of the affirmation were of no significance and do not adversely impact the Taxpayer's case.

5. SUBMISSION OF THE REVENUE

- 5.1 As a preliminary point the representative of the Commissioner asked leave to submit the correspondence addressed by JJ on behalf of the Taxpayer with respect to the claim for compensation. The representative for the Taxpayer did not object to the Board having the documents on the basis that it was a JJ originated document as opposed to document originated by the Taxpayer or by Mr C. The Board said it would wish to examine the papers and the Taxpayer had the right to comment on the document.
- 5.2 The Commissioner's assertions with respect to this case could be summarized by the following six statements:
- 5.2.1 The Taxpayer did not acquire the land in question as an investment.
- 5.2.2 The small amount of farming activity carried out on the land was not indicative of the intention to hold the land for long term investment purposes.
- 5.2.3 All along the Taxpayer acquired the land for development for resale.
- 5.2.4 Upon leasing out the land the Taxpayer did not change its original intention.
- 5.2.5 In view of the preceding four statements the land held by the Taxpayer was a current asset and the profits from the sale of that asset are assessable to profits tax.

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- 5.2.6 The Taxpayer continued to carry on business until it had settled its claim with the Government which occurred in the Taxpayer's financial year ended 31 March 1988.
- 5.3 Before dealing with the six points specified in the preceding paragraph the representative referred the Board to paragraph 3(3) of the determination which reads:
- ‘On the facts before me, I cannot accept the company's claim. The company has produced no evidence to show that either the land or the proposed development was intended for long term investment. Neither was there any feasibility study as to the viability of development for rental income made by the company. On the other hand, page 12 of the report indicated that the developed flats were intended for sale. In the circumstances, I am of the view that the land was the company's trading stock ab initio so that the profits arising therefrom are chargeable to profits tax.’
- 5.4 Section 68(4) of the Ordinance, which was quoted, places the onus on the Taxpayer. It was for the Taxpayer to satisfy the Board, on balance of probabilities, that the profit or gain in question was not taxable. The Board was referred to Miller v Ministry of Pensions [1947] 2 All ER 372.
- 5.5 The representative then returned to the initial six points referred to in paragraph 5.2 above.
- 5.5.1 That the Taxpayer did not acquire the land as an investment.
- 5.5.1.1 The Board was referred to paragraph 1(2) of the determination in which the Commissioner quoted from the Taxpayer's application for a business registration certificate in which the nature of the business was described as ‘agents, property and share investment, etc’. The representative questioned whether it was likely that a company intending to farm would take out a business registration certificate in which farming is not mentioned.
- 5.5.1.2 A relevant factor for consideration was the state of the property market at the time of purchase. It was usual for a purchaser to seek advice on the value, whether the asking price was too much, and whether the market was at a peak or in a slump. The witness had said in evidence that he did not enquire as to Hong Kong's economic situation and that he was not concerned whether property prices were high or low. His main concern appeared to be whether he had sufficient money as he did not wish to borrow. He gave the impression that the price had not relevance.

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5.5.1.3 On the other hand, Mr D, a director, was a resident. Even if the Board were to accept that the witness was not aware of the situation locally Mr D would have been. The representative then referred the Board to D65/87, IRBRD, vol 3, 66 and the passage appearing at page 71 reading:

‘Contrary to expectations, the Hong Kong economy suffered a serious downturn form about mid-1973. In about April 1973 the stock market had crashed and the property marking became depressed. There was an economic recession which lasted until about 1976 though there were signs of improvement from mid/late 1975. It became difficult to rent out premises.’

The Commissioner contended that there was evidence different to the Taxpayer’s version as to its reasons for purchasing the land. The market was at all time low, which made it an opportune time to purchase, and the land had development potential. The witness said he was not aware of the development potential when he acquired the land and that he was not aware of the resumption legislation or the Government’s resumption policies. However, the Board had evidence before it that Mr D knew people in the New Territories and that Mr D was a resident of Hong Kong. There had been no evidence form Mr D but it was submitted that the way the Government dealt with agricultural land in the New Territories was notorious. This would be known to Mr D. The Board was asked to consider the location of the land: it was near I Place new town and the location put the land in the best position for a change of user. There was a need for housing whereby the Government might reasonably be anticipated to be more amenable to a change of user.

5.5.1.4 Mr C had said that he was a businessman. Was he a businessman merely interested in doing business or making profits? Mr C’s evidence was that when he was considering making the investment in the land he did not make any profit forecast or obtain an appraisal of the land and he did not seek to examine the past accounts with respect to the operation of a farm on the land. But how does that establish that the Taxpayer was investing in land. He did not know whether the Taxpayer would get a return on its investment. He had said that he saw the trees but that does not justify saying that the products would produce an adequate return.

5.5.1.5 When the case was before the Commissioner all the Commissioner had was the correspondence from the legal and accounting representatives of the Taxpayer. Very little indication was given to the Commissioner that the directors of the Taxpayer had any experience in farming. The Board might consider it relevant for a person who states that he is investing in farm land to farm it to show his experience and his potential to make a success of the farm.

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- 5.5.1.6 The witness had been asking why no prior indication of expertise in farming in Malaysia had been given to the Commissioner. The documents which had been put before the Board in the appeal were received at 4 p.m. on 12 December 1985, the day preceding the first hearing day which had put the Revenue at a disadvantage as it had been unable to investigate the documents. However, the evidence produced as to farming experience in Malaysia are articles of association and returns of allotment of shares. It is significant that no accounts had been produced to show that farming had been carried on. The memorandum gave the Malaysian companies power to carry on businesses other than agriculture. No evidence has been given of the acquisition of the 50 acres referred to in paragraph 4 of the Mr C's second affirmation and the Board should consider that 'evidence' as a self-serving statement. The Board was requested to consider the weight to be afforded to that statement.
- 5.5.1.7 The Taxpayer's representative's comments as to passages quoted to the witness in cross-examination from the judgment of the learned Judge do not detract from the questions put to the witness as to his preparedness to give false answers if it was in the Taxpayer's interest. Mr C's second affirmation had been made independently and Mr C's evidence conflicted with what he had said in the litigation and what JJ had said in correspondence. Additionally, how did Mr C's experience relate to farming in Hong Kong or to a farm which had been left in charge of Hong Kong resident toy retailer.
- 5.5.1.8 Despite the Taxpayer's assertions to the contrary the Taxpayer's account shows no income for the first nine months and, further, there was no evidence to show the purchase of a farming business. The farm was not a going concern as the vendors had not farmed the land for some fifteen months.
- 5.5.1.9 No intention as to the use to which the land was to be put or for which it was acquired was shown in the relevant board minutes. The evidence was that Mr C had discussed the Taxpayer's business with Mr D whilst there were no documentary evidence to support these discussions. One would have thought that a written record was essential in case the shareholders got into dispute.
- 5.5.1.10 The Commissioner had asked the Taxpayer for evidence that the land had been purchased as a long term investment. The Revenue appreciates that the witness had said that he left these matters in the hand of the accountants ABC. It was certainly the case that all letters from ABC were copied to the Taxpayer. Accordingly, the Taxpayer must be deemed to have been aware of what was being written. It may have been that Mr C had not seen the letters but that was irrelevant to the appeal and if it was relevant the relevance was only to any dispute between the witness and his fellow directors. The Revenue had asked for evidence of intention to invest and the only thing ABC had said was the land was shown as a fixed asset in the accounts throughout but there was no other evidence. So far as classification and accounts is concerned the Board was

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referred to D5/88, IRBRD, vol 3, 144 at page 145 and the paragraph f to the headnote reading:

‘The treatment of property as a “fixed asset” in the taxpayer’s accounts is, by itself, inconclusive of its true nature.’

It was submitted that the surrounding circumstance can support a classification but they are not conclusive. The classification has to be examined in the light of surrounding circumstances but if they do not support the statement in the accounts then that statement is irrelevant. The Board was requested to note that the farming activities had been on a small scale and a profit was never made. The Commissioner did not accept the Taxpayer has proved the intention to acquire and investment.

5.5.1.11 The Taxpayer appeared to rely on the fact that Mr C had experience in farming as establishing intention. Mr C’s evidence was that he relied on his expertise that he did not consider having an appraisal necessary. He did no more than visit and see the trees. He also, gave evidence of the repatriation of funds to the families’ traditional homeland, something which was not disputed. However, even if that was true has it to be true that there has to be no concern as to profitability? A lack of concern as to profitability is incompatible with an investment motive.

5.6 In the Revenue’s submission other points fell for consideration:

5.6.1 A real businessman would seek to maximise profits. It had been alleged that the purchase of the land was a diversification of interests, which could be true. However, a prudent man would want the asset to be protected and profitable. The Revenue questioned why an experienced farmer with the ability to buy acres in Malaysia, as opposed to square feet in Hong Kong, would buy a small area in Hong Kong when the profitability was in question. As to the Government policy with respect to agricultural lands specially in areas near to new towns, for example, I Place, Mr D would be familiar and would have been able to advise Mr C.

5.6.2 The onus of proof was discharged. It had been questioned whether the learned Judge had heard evidence to make the statements he made, particularly that at page 3 of his judgment quoted at paragraph 3.5.26 above. The representative could not see why the Judge would say something without good reason. It had been said that this part of the judgement was irrelevant. It was submitted that it was very relevant as the argument was put forward in support of an allegation that the Government had acted illegally or unfairly. The only evidence adduced before the High Court was Mr C’s first affirmation. The Board was asked to make its own decision as to whether the Judge would include such a statement in his judgement if there was no justification for it.

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- 5.7 The amount of the farming activities:
- 5.7.1 Much emphasis had been placed on this. However the fact of the matter is that this was the sole permitted use of the land. Use for any other activity could result in forfeiture. What was the real estate position at the time? The market was in a slump. Nobody would want to develop whilst there was a slump on. They would like to maximise the profits. They could get an interim income from farming. Accordingly, because of the zoning, that does not prove that the land was held for investment. The farm made no profit. That seems to show that the land was not held for investment because it could not have been farmed enthusiastically. If the farm was in a bad way why did Mr C not do something about it? His evidence was inconsistent with the representations made to the Revenue; because of the absence of income it is arguable that the farm was not farmed for the first nine months it was not farmed until after April 1978. The possible scenario was that farming was the only available use and that that should be done until a change of user was approved. It was then established that the farm could not be operated profitably whereby the decision to close it down was made at which time the Taxpayer pursued redevelopment intentions with alacrity.
- 5.7.2 The witness had mentioned K Farm Ltd and L Ltd as evidence of his expertise as a farmer. However, if one looks at the documents one would see that K Farm Ltd was incorporated just over three months prior to the incorporation of the Taxpayer, and L Ltd had been incorporated almost eighteen months later. What could Mr C's experience be when one farm was incorporated only a few months before the one in Hong Kong. There was no evidence as to when K Farm Ltd commenced business. It could have been some time after the acquisition of the land. Further, how was L Ltd relevant? If this was to support Mr C's allegation that he was an experienced farmer it would tend to show that he did not have the experience. In that case he would not have the expertise to make a balanced judgement as to the viability of the farm, for example, look at its accounts which he did not. Additionally, the Board has no evidence of the extent to which farming in Malaysia and Hong Kong differ. There was no evidence that any experience in Malaysia was of relevance in Hong Kong.
- 5.7.3 The representative stated that when he referred to the Taxpayer ceasing business he was not implying that at that stage there was a change of intention as the Revenue did not accept that there had ever been an intention to invest. The Commissioner's view was that the farming activity which was carried out by the Taxpayer does not show that the Taxpayer necessarily acquired the land for investment purposes. In view of the losses sustained during the short term it was in business it is more compatible with a policy of endeavouring to make the best use of the land until the intention to develop could proceed.

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5.8 Acquisition was for development for resale.

5.8.1 The Commissioner's view was that the Taxpayer had all along acquired the property for development would be confirmed by the following:

5.8.1.1 There had been numerous applications for the permitted user to be changed to enable a development to take place. Directors of H Ltd were approached by the Taxpayer to negotiate the re-zoning of the land. Mr F and Mr G were friends of Mr D. The general authority was signed by Mr C. H Ltd is an association to buy and sell residences for the members of the association. It was submitted that the authorization given to H Ltd was to facilitate the application by demonstrating the potential for market for sales of redevelopment in due course.

5.8.1.2 The report:

The Board had been referred to passages in the report which make it self-evident that there was an intention to sell. The witness had stated that it was not a serious report: it was merely 'testing the water', refer Mr C's second affirmation. It was said that whole passages had been lifted wholesale from M report. It was submitted that the report was designed to show that the Taxpayer wished to get the project approved as opposed to 'testing the water'. The report was sent to the Government. If a change of user had been approved the Taxpayer would have had to have proceeded. There would have been a premium to pay and a scheduled time within which the project was to be completed.

5.8.1.3 The fact that the application was serious is demonstrated from paragraph 6 in Mr C's first affirmation in which Mr C had said:

'Having regard to other private development projects in nearby locations, the reasons advanced by the district office were not convincing and the matter was again resuscitated on 4 June 1979, and on 8 August 1979, the district officer [I Place] replied by saying that he was seeking comments from other Government departments. On 4 June 1980, the plaintiffs commissioned planning consultants to make a further submission to the district officer who, on 21 July 1980, replied that "there is at present no planning proposal to permit urban development in the general area in which your clients' (the plaintiff's) lands are situated. The appropriate use is still considered to be agricultural.'"

5.8.1.4 The suggestion that there was no intention for the Taxpayer to follow a development though was not the Taxpayer's case with the Revenue. It was stated that no architects had been engaged or financial arrangements made.

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However, if the Government had agreed the Taxpayer would have had to go ahead with consultants.

- 5.8.1.5 An intention to retain for investment is not satisfied by a declaration of intention. The Board was referred to D11/80, IRBRD, vol 2, 374 at page 379 in which it was said:

‘“Intention” connotes an ability to carry into effect. It is idle to speak of “intention” if the person so intending did not have the means to bring it about or had made no arrangement or taken any steps to enable such intention to be implemented.’

When Mr C gave evidence as to what would have had happened if approval had been forthcoming his answer was unclear but he did indicate that if he had no funds he would sell. He acknowledged that the approval to a change of user would have enhanced the value of the property. The desire to obtain the change of user was evident from the fact that this was pursued vigorously: in all seven applications were made.

- 5.8.1.6 The Taxpayer’s representative had suggested that when the land was leased for parking the Taxpayer had abandoned any intention to develop. And that if the Revenue were correct in saying that the original intention was to acquire a trading asset that intention was changed by the grant of the tenancy agreement. However it was submitted that the fact was that even after the tenancy agreement was created applications for change of user continued to be made. Mr C had said that XYZ was familiar with Mr D. But that did not change the position. The first letter from XYZ was written after the term of the tenancy agreement commenced. Mr C had said that he had no knowledge of three further letters dated 26 July 1980, 21 January 1981, and 13 August 1981, this last letter having been written two months before the land was resumed. If the Board accept Mr C’s evidence that the Taxpayer, as opposed to Mr C, did not know of these three letters the Board has to consider why XYZ would endorse the letters ‘cc client’ or write of his own volition when he must be deemed to have known of the serious consequences for the Taxpayer if the consent had been forthcoming.

- 5.9 Leasing out the land did not change the company’s intention.

- 5.9.1 This was evident from the fact that applications continued to be made up to two months before resumption.

- 5.9.2 Making the best use of the land whilst development permission is sought does not change the nature of the land if that is its true nature. Such was not consistent with the intention to redevelop. What supports the proposition that the intention was not changed are the applications for the change of user which

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were made after the grant of the tenancy agreement and up to two months before the resumption.

- 5.10 One could speculate whether the company would have held the land for leasing if it did win its litigation against Government. Higher profits would flow from the development and a businessman would be expected to maximise its profits. Mr D had emigrated to Australia whereby there was nobody locally to look after the land and whereby it was equally likely that the Taxpayer would want to sell. The Taxpayer's representative had stated in his submission that rent under the tenancy agreement would recoup the capital investment in the short time and that if there had not been a resumption the Taxpayer would have continued to let. There was no evidence as to that. It was mere speculation by Counsel. There would have been higher profits from a development, which would have been of high class housing, whereas the profits from rental were insignificant compared with the profits that could have been made from the sale of units in the redevelopment.
- 5.11 The litigation had been on the basis that the user restriction was illegal. Had the Taxpayer won there was no reason to suppose it would not have developed the property. There was no evidence that it had any other intention.
- 5.12 The Board was then referred to JJ's letter of 12 August 1986 and the accompanying document. It was pointed out that this was created before the compensation had been agreed and the potential for taxation on the compensation considered, it was more likely to be true than what was now being said.
- 5.13 The representative for the Taxpayer had stated that the Commissioner had erred in his findings and it thereby followed that his determination was incorrect. The representative stated that whether or not the Commissioner's determination is not correct is not the issue: the issue for the Board to decide is whether the assessment is correct.
- 5.14 The land was a current asset.
- 5.14.1 It was submitted that the evidence showed that the company purchased the land with the intention to develop it for resale whereby the land was a current asset. The Taxpayer had claimed the land was shown all along as a fixed asset in its accounts and that this had a special significance. For reasons already advocated the classification of an asset could be indicative of an intention at the time of acquisition but it was not conclusive and had to be viewed in the light of surrounding circumstances. The courts have long held that it is not conclusive and this has been recognized by the Board on various occasions.

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- 5.14.2 It was submitted that a probable explanation of the facts was that the Taxpayer had some spare cash and wanted to enter the Hong Kong property market. 1974 presented an opportunity to invest when the market was at its lowest for some time. A local resident, Mr D, was acquainted with the Hong Kong property market and the fact that a change of user of agricultural land in an area close to a new town was a possibility. After purchase of the land the Taxpayer wanted to pick the right opportunity to develop. In the meantime the Taxpayer wanted to obtain some income. The land could only be used for farming and some farming was carried out. In 1977 the property market began to pick up and the Taxpayer decided to make applications to change the user to enable it to develop the land. The application was rejected again and again but the Taxpayer persisted. The Taxpayer was presented with the opportunity to obtain substantial rental income whilst pursuing its primary objective of developing the land. The Taxpayer's applications continued up to two months before resumption of the land and for several months after the tenancy agreement had been granted.
- 5.14.3 The Taxpayer's approach to the development of the land may have been speculative but it had been recognized by the Supreme Court in CIR v Sincere Insurance Investment Company Ltd 1 HKTC 602, that, given the special conditions in Hong Kong where land is constantly in short supply, land is as much an object of speculation as any other type of investment, refer page 625.
- 5.14.4 The fact that the land was compulsorily required does not affect its assessability if it was a current asset. The Board was referred to D5/88 at page 145 and D8/88 at page 162. If the current asset when purchased is disposed of at a profit the profit is assessable. What is necessary is to establish that it is a current asset.
- 5.15 Carrying on the business:
- 5.15.1 The final point in issue is whether the company continued to trade after the resumption of the land.
- 5.15.2 The Board was referred to American Leaf Blending v Director General and the Board was also referred to the cessation provisions of the Ordinance. It was submitted that taxation is about technicalities.
- 5.15.3 The Taxpayer's memorandum provided power to surrender. The litigation was to protect its assets, which must have to be part of its business, and after the court case the negotiation of compensation had to be part of its business. The interest element forms part and parcel of the compensation. The Board was referred to D20/75.

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- 5.15.4 The Taxpayer still owned land in 1987/88 and the filing of its profits tax returns equated to acknowledgement that the Taxpayer was still in business.

6. REPLY OF THE TAXPAYER

6.1 The Authorities

6.1.1 Miller v Ministry of Pensions

The Board's attention was drawn to the two sentences immediately following the passage relied on by the Revenue, which amplified the burden in a civil case reading:

‘That degree is well settled. It must carry a reasonable degree of probability, but not so high as is required in a criminal case. If the evidence is such that the tribunal can say: “We think it more probable than not,” the burden is discharged, but, if the probabilities are equal, it is not.’

6.1.2 Marson v Morton

The Board's attention was drawn to the passage at page 472 at letter E reading:

‘The legal principle of course cannot change with the passage of time: but life does. Since the arrival of inflation and high rates of tax on income new approaches to investment have emerged putting the emphasis in investment on the making of capital profit at the expense of income yield. For example, the purchase of short-dated stocks giving a capital yield on redemption but no income has become common place. Similarly, split level investment trusts have been invented which produce capital profits on one type of share and income on another. Again, institutions now purchase works of art by way of investment. In my judgment those are plainly not trading deals; yet no income is produced from them. I can see no reason why land should be any different and the mere fact that land is not income-producing should not be decisive or even virtually decisive on the question whether it was bought as an investment.’

6.1.3 D11/80:

The Board's attention was drawn to the passage at page 378 reading:

‘When an owner of land exploits it by the development and construction of a multi-storey building and in the course of construction or shortly thereafter he sells units in the building, the

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inference that would be drawn in that the building was not erected for retention as an investment but for the purpose of resale. If the owner's case is that he intended to retain the property as a long term investment but supervening events outside his control forced him to dispose of the property, then before such a claim can succeed he must satisfy the Board that it was his intention to keep it as an investment or capital asset.'

The representative commented that the five years lease entered into by the Taxpayer denoted his intention to retain the land as an investment. The Board should ask itself did the Taxpayer do enough to 'develop and sell'.

6.1.4 American Leaf Blending Co Sdn Bhd v Director General of Inland Revenue

The question the Board should ask itself was the land put to gainful use whereby a business was carried on. The profits on farming was assessable as was the profits from letting. The intent to develop was not a gainful use.

6.2 Interest

This should be regarded as part of the compensation. Interest is to be distinguished from capital but it was interest which was earned from an activity other than a trading activity.

6.3 The Taxpayer's action

The Board has to decide whether what was done was enhancement of the capital value of a capital asset. If it was then there was no liability to tax.

6.4 The negotiations by JJ

These took place in August 1986, that is twelve years after the acquisition and the claim was made with respect to the Taxpayer's entitlement to compensation. A 'passing remark', namely a preamble to the claim, should not be afforded substance. It was an off-the-cuff comment and the paper itself was loosely worded. The Board should ask itself whether the expectation, in the light of subsequent acts, changed the nature of the assets.

7. REASONS FOR THE DECISION

7.1 The Taxpayer has appealed against an assessment which was upheld by the Commissioner. The onus is on the Taxpayer to establish that the assessment, as confirmed by the Commissioner, was incorrect. The duty of the Board is to endeavour to ascertain the facts and to apply the legislation to the facts as found. The reasoning of the assessor or of the Commissioner are irrelevant.

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The appeal is not against the reasons of either the assessor or the Commissioner. The appeal is against the validity of the assessment.

- 7.2 The appeal posed two questions:
- 7.2.1 Was the land a capital asset of the Taxpayer, whereby the compensation received after its resumption is not liable to tax? This is considered in sub-paragraph 7.4 below.
- 7.2.2 Whether the interest paid at the time the compensation was paid was a receipt from the 'carrying on of a trade ... or business in Hong Kong' within the meaning of section 15(1)(f) of the Ordinance? This is considered in sub-paragraph 7.3 below.
- 7.3 The nature of the interest:
- 7.3.1 The Board was not told why interest was paid and the agreement between the Taxpayer and the Government with respect to the interest, is silent as to this. The only inference the Board can draw is that had compensation been agreed within a reasonable period of the gazetting of the resumption notice the compensation would have been payable at that time as opposed to several years later, the delay being attributable to the litigation. However from the evidence the Board was obliged to conclude that, in fact, the land was resumed upon vacant possession being obtained by the Taxpayer whereby the Taxpayer's title to the resumed land ceased and determined some time in 1981 or 1982.
- 7.3.2 Under the provisions of section 15(1)(f) of the Ordinance to be taxable a receipt has to be derived from the carrying on of the trade of business.
- 7.3.3 There can be no doubt that from the commencement of its farming operations and thereafter from the commencement of the tenancy agreement the Taxpayer was carrying on a trade or business in Hong Kong. The fact that it accumulated losses during the farming period is irrelevant. Those losses were recovered when rental from the tenancy commenced to flow and profits continued to accrue until the land was surrendered to the Government pursuant to the resumption notice.
- 7.3.4 In the year of receipt of the compensation and interest, 1987/1988, the interest on the compensation was shown as income in the Taxpayer's profits and loss account and was offered for assessment in the proposed tax computation and, factually, it would appear the first occasion the issue as to the liability of this interest to tax was first raised when the grounds of appeal were lodged.
- 7.3.5 The grounds of appeal read:

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‘That the Commissioner erred in including in the assessment the amount of interest of \$5,212,399 paid by the Government on the compensation due representing interest which was received after the company had ceased to carry on any business which should not be taken as profit chargeable to profits tax.’

The Board does not accept the statement that the Commissioner erred. More correctly the ground of appeal ought to have been that the Taxpayer’s tax representatives had erred in including the interest, in which event the correct procedure for the Taxpayer would appear to be an application under section 70A for correction. However, the grounds of appeal do not allege that the interest was not itself taxable per se but that it is not taxable because it was received subsequent to the Taxpayer having ceased to carry on any business. Patently this argument is incapable of being substantiated: for so long as the Taxpayer had a claim outstanding against the Government for compensation for the resumption of the resumed land it must have been deemed to have been in business. As the quantum for claim for compensation was the subject matter of an agreement with the Government and as that agreement included the agreement as to compensation it follows that the company was in business, pursuing a valid object, at least until that agreement had been struck and that agreement completed by the payment by the Government of the compensation.

7.4 The nature of the asset:

The Board is obliged to endeavour to determine from the documentary and oral evidence submitted to it whether when the land was purchased it was purchased as an investment and whether that intention changed at any time during the Taxpayer’s ownership and whether any subsequent change of intent was also changed to the intent that at the time of resumption the resumed land was a capital asset as opposed to a trading asset of the Taxpayer.

7.5 The chronology of events is not complicated:

7.5.1 Two days after the incorporation of the Taxpayer, the directors resolved to negotiate to acquire the land. The purpose for which the acquisition was being made is not recorded on the minutes. However, the Taxpayer’s representative drew the Board’s attention to a site plan, refer paragraph 3.4.8 above, and it was pointed out that the negotiations for the acquisition of one lot, a lot which connected the bulk of the land to the main road, had to be negotiated without the vendors appreciating that it would link the body of the land to the main road hence the authorization to Mr D to negotiate.

7.5.2 The land was acquired on various dates in June and July 1974 and February 1976.

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- 7.5.3 The Taxpayer operated a farm on the land from acquisition until July of 1979 when the term granted by the tenancy agreement commenced.
- 7.5.4 From July 1977 the Taxpayer made three attempts at obtaining Government approval to a change of user. These attempts may be briefly summarized as follows:
- 7.5.4.1 That authorized from 19 July 1977 to the directors of H Ltd;
- 7.5.4.2 That initiated by the Taxpayer sometime from, at the latest, September 1977; and
- 7.5.4.3 That by XYZ from June 1980.
- 7.5.5 The resumption notice was gazetted later whereafter the Taxpayer unsuccessfully sought a series of declarations before the courts the effect, so far as the Taxpayer is concerned, being, if the litigation had been successful, a declaration that the Taxpayer owned the land free of any user restriction and free from any right on the part of the Government to resume.
- 7.5.6 Having failed in the litigation the Taxpayer appointed JJ to negotiate the compensation. In due course the compensation was agreed and the outcome recorded in an agreement dated 17 December 1987.
- 7.6 The chronology of events may be supplemented by certain facts which are apparent from the documents or from the evidence and information provided to the Board.
- 7.6.1 The decision to acquire the land: it is noted that the purpose for which the acquisition was being made is not recorded in the board minutes. However, the Taxpayer's representative drew the Board's attention to a site plan, and it was pointed out that the negotiations for the acquisition of one lot, a lot which connected the bulk of the land to the main road, had to be negotiated without the vendors appreciating that it would link the body of the land to the main road, hence the authorization to Mr D to negotiate.

The Board attaches considerable significance to this fact: it was told that the main body of the land had been used as a farm for generations and was well known. Presumably customers of the farm had over the years been able to access the farm without difficulty and the Board questions why it was necessary to acquire an additional piece of land to link the main body to the main road? The Board is satisfied that this is indicative that from day one the Taxpayer was looking to have vehicular access to the site from the main road a factor which is more indicative of the intention to redevelop the land than merely to farm it.

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7.6.2 The tenancy agreement: much emphasis was placed on the relative return from the tenancy agreement when compared to the original cost. The point was made before in Mr C's first affirmation that between the date of resumption and the falling in of the leases of the lots the Taxpayer would have received some \$23,000,000 in rental income. Reference is made in submissions to the tenancy agreement being a five years tenancy. However, when the option provision in the tenancy agreement is examined it is not a true option agreement. The relevant parts of the provision, which is clause 8 of the tenancy agreement reads as follows:

‘ If the tenant shall be desirous of taking a new tenancy of the said land after the expiration of the term hereby granted and ... shall deliver to the landlord notice in writing not less than two months before the expiration of the term hereby granted then the landlord shall at or before the expiration of the said term ... at the cost of the tenant grant to the tenant a new tenancy of the said land for a further term of two years ... BUT with the following additional clause namely that if either the landlord or the tenant shall at any time be desirous of determining this further term of two years and ... shall deliver to the other not less than three months' notice in writing ... then and in such case immediately after the expiration of the said period of three months the agreement for such further term shall cease ... ’

The Board regards the terms of this option clause as significant: after the initial three years' term of the tenancy the Taxpayer could obtain vacant possession of the land on three months' notice. If the Taxpayer was content to regard the rental income of the land as satisfactory, why would it not seek to maximize that return by granting a full period of renewal as oppose to having the right to determine the option period if events occurred which would make it prudent for the Taxpayer to determine that term. The Board considers this more indicative of an intention to have the ability to recover possession if a change of user was permitted and a redevelopment became feasible than with an intention to retain the land as a long term investment.

7.6.3 Applications for change of user

If the Taxpayer were to be believed the report was no more than a 'testing of the water'. As it was rejected why then did the Taxpayer continue its applications and, additionally, authorized XYZ to pursue the application?

7.6.4 The litigation

The principal effect, so far as the Taxpayer was concerned, of being successful in the litigation would have been declarations to the effect that the land was held by the Taxpayer free of any purported restriction on the user imposed in

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the crown lease, on the basis that that restriction was a contravention of the convention and the resumption notice would have been declared invalid. The consequences: the Taxpayer would have continued to own the land and could have undertaken redevelopment without obtaining a change of user and, accordingly, without having to pay a premium for that, and without having the restrictions normally imposed upon the successful applicant for a change of user.

7.7 Other relevant information

The audited accounts of the Taxpayer include the land as a fixed asset. However, the evidence from the witness was not that this classification was adopted after thought or discussion with ABC, the Taxpayer's then auditors and tax representatives. The tenor of his evidence was that he wanted a company and left secretarial and other matters to ABC. Accordingly, the Board feels fully entitled to attach no significance howsoever to this classification of the land in the Taxpayer's audited accounts.

7.8 Conflicts in evidence

The Board was provided with the first affirmation and, in due course, the Board also received a copy of the second affirmation.

7.8.1 The second affirmation contains the following paragraphs which the Board fees obliged to quote 'in full'.

‘By later 1977, after about three years running the farm, [the Taxpayer] was still not making a success of the agricultural business. As a businessman I considered it proper to explore other possible use of the land, either by running a different kind of business or put the land to a different use which would enhance its value.’

Paragraph 17 reads:

‘I decided to apply to the Government for permission to change the user of the land to permit residential development. As far as [the Taxpayer] is concerned, the application was more in the nature in an enquiry, something like testing the temperature of water before dipping in. It was done simply by correspondence with the district lands office.’

Paragraph 18 reads:

‘However, to make the application more convincing, I decided to have a formal development plan report prepared and submit it with the application to the district lands office. At the time there was a civil

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engineering project in Malaysia known as the [M project] [location mentioned]. I had a copy of the [M development report] and I used it as a basis for preparing a development plan report for [the Taxpayer's land (refer paragraph 3.4.18 above)]. I also called the document "development plan report" which I now understand as an unusual title for a modification application in Hong Kong. I prepared the development plan report for [the Taxpayer's land] myself and actually copied various paragraphs word for word from [M report] into [the development plan report].'

7.8.2 The first affirmation contains the following paragraphs:

- ' 5. The plaintiff would not have instituted these proceedings but for the unfair treatment which it had received at the hands of the Hong Kong Government, the history of which I will now relate.

6. In 1977, the plaintiff submitted a proposal for the development of the said land into a housing estate. The said lands were, and are, closely situated to [P Road] where several development projects had been approved only three hundred metres away and stretching to a distance of one kilometre towards the east of the said lands. Although the said lands were not within the urban layout area of [I Place] new town, it was considered by the plaintiff that because of the proximity of other approved projects, the proposed project of the plaintiff would usefully complement such other approved development projects in the vicinity and in [I Place] new town. The plaintiff's proposed development had been carefully planned to cater for the entrepreneurial and managerial class which would have to reside near to [I Place] new town which had been planned as an industrial city. Included in the proposal were elements which would give [I Place] new town a kind of residential development which had been carried out successfully in other countries, notably the Philippines, Singapore, Malaysia, Indonesia as well as Europe and the United States. In May 1978, the proposals, having been circulated to other Government departments, were turned down. There was an appeal by the plaintiffs in June 1978 which was again refused in December 1978. At a meeting with [Mr Q], estate surveyor, held in April 1979 at the district office, [I Place], I was informed by [Mr Q] that the development proposed by the plaintiff was unacceptable because the district office considered that the area was not adequately supplied with water and other basic amenities

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such as electricity, drainage, access to and from main road etc. Having regard to other private development projects in nearby locations, the reasons advanced by the district office were not convincing and the matter was again unsusitated on 4 June 1979, and on 8 August 1979, the district officer [I Place] replied by saying that he was seeking comments from other Government departments.

On 4 June 1980, the plaintiffs commissioned planning consultants to make a further submission to the district officer who, on 21 July 1980, replied that “There is at present no planning proposal to permit urban development in the general area in which your client’s (the plaintiff’s) lands are situated. The appropriate use is still considered to be agricultural”.

...

13. Furthermore, the plaintiff is aggrieved by the resumption because it feels that the Government had taken unfair advantage of the situation, in that the Government had long known that the said lands, in the light of the development plans put forward by the plaintiff, had development potential but had kept back from allowing the plaintiff to develop the area on the ostensible grounds that there were insufficient facilities, such as electricity, water, drainage, access etc (see paragraph 6 above).’

7.8.3 Paragraphs 17 and 18 of the second affirmation put a completely different picture on the position as represented to the court in paragraph 6 of the first affirmation.

7.8.3.1 Before the court the witness’ evidence, refer paragraph 6 of the first affirmation, includes the following:

‘The plaintiff’s proposed development had been carefully planned to cater for the entrepreneurial and managerial class which would have to reside near to [I Place] new town ...’

7.8.3.2 Before the Board Mr C endeavoured to persuade the Board that the report was not really a serious report and in paragraph 18 of his second affirmation he used the words:

‘... to make the application more convincing.’

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The Board regards the contents of these two affirmations as being in direct conflict each with the other. Placed with this contradictory evidence the Board has no alternative but to say that it is unable to accept the explanations afforded by the witness as credible unless such are corroborated by contemporaneous documents.

- 7.8.4 The witness endeavoured to satisfy the Board that he had the expertise to assess the value of agricultural land by producing the memorandum and articles of association of two Malaysian companies, K Farm Ltd and L Ltd. The Revenue pointed out that K Farm Ltd was incorporated no more than some three months prior to the incorporation of Taxpayer, and L Ltd had been incorporated almost eighteen months later. The Board accepts the Revenue's submission that this evidence does not establish what it was adduced to establish. It may be that the witness had expertise but there was no evidence before the Board to establish this.
- 7.8.5 Overall the witness did not create a favourable impression with the Board. On many occasions he was unable to answer questions the excuse being that he had entrusted that aspect to third parties to handle and he, himself, was not aware of how they had dealt with it. Additionally, he sought to belittle the report which he had submitted to the Government suggesting that this was not a serious attempt at convincing the Government that was no more than an attempt to obtain some indication as to the Government's likely reaction. It would seem to the Board that this is not a plausible excuse. If a person wished to 'test the water' he would probably do no more than visit the district office and enquire as to what would be required of a person making the application and to endeavour to obtain some indication as to whether it was worthwhile expending any money on putting together any documentation in support. If there had been absolute lack of encouragement the matter would not be pursued. However, if there had been some encouragement then the matter could be pursued. Clearly the witness had visited the district office before submitting any documentation and, perhaps, the response was that a report should be submitted. Whichever, the Board does not accept the evidence that the Taxpayer was only a change of user.
- 7.8.6 The Board has reached the conclusion that the Taxpayer has failed to discharge the burden of proof on it. It has not satisfied the Board that the land was acquired as an investment or that it was held at any time by the Taxpayer as an investment, notwithstanding the statements in its audited accounts. The Board is satisfied that all along the intention of the Taxpayer was to endeavour to obtain a change of user and redevelop the land. It is also clear from the report that it was not the intention of the Taxpayer to obtain ownership of all of the land. This passage at page 12 of the report which indicates that sales were intended and, indeed, in the first affirmation the Taxpayer referred to a

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redevelopment for a category of individuals who would be more expected to purchase and rent their residences.

8. DECISION

For the reasons given the Taxpayer's appeal is dismissed.