

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D48/98

Profits tax – acquisition of property – intention of purchaser at time of acquisition – burden of proof on purchaser – taxability of proceeds – section 16(1) Inland Revenue Ordinance.

Panel: Ronny Wong Fook Hum SC (chairman), Edward Chow Kam Wah and Ronald Tong Wui Tung.

Date of hearing: 21 March 1998.

Date of decision: 24 June 1998.

The taxpayer was a company. Mr and Mrs A were two of its directors. It was incorporated in 1979 with the sole purpose of “property investment and property dealing”. In 1981 and 1982, the taxpayer acquired various lots of land (Lots 1 and 2) in one district after the Government had announced that it was planning to build an airport in the district. The Lots were far away from town and had been left vacant. After the airport plans were subsequently dropped by the Government, the Lots became valueless.

In the taxpayer’s financial statements between 1983 and 1989, the Lots were classified as ‘current assets’ held for resale, and for the year ended 31 March 1989, the taxpayer was said to be dormant. In the taxpayer’s financial statement for year ended 31 March 1993, however, the Lots were classified as ‘fixed assets’. A note attached stated that “the taxpayer’s original intention for the acquisition of the Lots was for long-term investments. However, it had been wrongly classified as current assets in the previous years and thus is re-classified as fixed assets this year.”

On 15 April 1993, the taxpayer accepted an offer of HK\$8,509,881.60 as compensation by the Government in respect of resumption of part of Lot 1. This was paid on 28 September 1993.

The Board was required to decide:-

- (a) The taxability of the said HK\$8,509,881.60;
- (b) The deductibility of various expenses totaling HK\$58,556.

Held:

1. It was for the taxpayer to prove that the acquisition of the Lots was for a long term investment. A bare assertion was not decisive and must be viewed in the light of the conduct of the parties (Lionel Simmons Properties Ltd (in

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liquidation) v Commissioner of Inland Revenue 53 TC 461 and All Best Wishes Limited v CIR 3 HKTC 750, followed);

2. The evidence here pointed strongly against the taxpayer's assertions and the taxpayer failed to discharge its onus in proving that the property was acquired as a long term investment;
3. Section 16(1) of the IRO made it clear that each item of expense claimed must be looked at and analysed to find out what extent it was incurred to produce the profits. The taxpayer likewise failed to discharge its burden in demonstrating this to the Board.

Appeal dismissed.

Cases referred to:

Lionel Simmons Properties Ltd (In Liquidation) v CIR 53 TC 461
All Best Wishes Limited v CIR 3 HKTC 750
Chinachem Investment Co Ltd v CIR 2 HKTC 261

Ma Wai Fong for the Commissioner of Inland Revenue.
Taxpayer represented by its Ex-director.

Decision:

The Background

1. The Taxpayer is a company incorporated in Hong Kong on 4 December 1979. On 11 January 1980, Mr and Mrs A were appointed directors of the Taxpayer.
2. On 31 December 1980, the Taxpayer acquired Property B for \$960,000. The Taxpayer sold this property on 17 March 1981 for \$1,050,000. The profits on sale of this property was assessed to profits tax.
3. In the period ended 31 March 1981, the Taxpayer acquired various lots of land in Area C at District D ['Lots 1']. The Taxpayer acquired other lots in Area E at District D ['Lots 2'] in the period ended 31 March 1982. Both acquisitions were financed by advances from a director of the Taxpayer.
4. During an interview on 26 March 1985, Mrs A told the assessor that:

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- a. She and her husband heard that Government was planning to build an airport in District D. They therefore used the Taxpayer to purchase Lots 1 and Lots 2 with the view of making substantial profits.
 - b. Both Lots were far away from town and had been left vacant since acquisition.
 - c. The Lots became valueless as the Government had not proceeded with its plan to build an airport.
 - d. The Taxpayer was unable to sell the Lots.
5. The interview was followed by a letter dated 1 April 1985 [‘the April 1985 Letter’] in the hands of Mrs A on paper of a hotel in these terms:

‘Following my visit to your office, I want to confirm that [the Taxpayer] whose I am director is now having no activities at all. This company was set up in 1979 for purpose of real estate. We bought three farmer land located in District D thinking of a new airport to be build. Unhappily the project was cancelled. So these land are vacant and have no value for the time being so we receive no income at all. So I request from you the honour to cancel the penalty of \$600 ... I am not living in Hong Kong ... For the future you can always write me in Country F’.

6. The earliest financial statement of the Taxpayer is for the period between 4 December 1979 to 31 March 1981. It was prepared by the directors of the Taxpayer on or about 9 February 1988. The principal business of the Taxpayer was stated to be in the field ‘of property investment and property dealing’. Its current assets included ‘stocks’ at \$731,263.75. According to its auditors, ‘stock of leasehold land held for resale are stated at cost’. This financial statement was submitted to the Commissioner who decided on 16 March 1988 to permit the Taxpayer to set off the amount of loss computed on the basis of this financial statement against the gain of the Taxpayer arising from its disposal of properties.

7. Six other financial statements of the Taxpayer for each of the accounting years between 31 March 1983 and 31 March 1988 were prepared on 29 November 1988. ‘Property investment and property dealing’ were stated as the ‘principal activities’ of the Taxpayer in each of those years. These financial statements, together with the one referred to in paragraph 6 above, were all prepared by Messrs Chan, Lai, Pang & Co.

8. Messrs Chan, Lai, Pang & Co also prepared the financial statement of the Taxpayer for the year ended 31 March 1989. The Taxpayer was said to be ‘dormant’ during the year. Lots 1 and Lots 2 were still classified as ‘current assets’ held for resale.

9. Messrs Chan & Chan became the Taxpayer’s auditor for the years ended 31 March 1990 to 31 March 1992. The financial statements of the Taxpayer for those years followed the same pattern as the ones prepared by Messrs Chan, Lai, Pang & Co.

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10. On 15 April 1993, the Taxpayer accepted an offer of compensation made by the Government in respect of resumption of part of Lots 1. \$8,509,881.6 was paid to the Taxpayer pursuant to an agreement dated 28 September 1993.

11. The financial statement of the Taxpayer for the year ended 31 March 1993 was audited by Messrs Paul M P Chan & Co on 25 October 1993. According to this financial statement, the Taxpayer 'was dormant since March 1982'. The two Lots were classified as 'fixed assets'. Note 2 to that financial statement explained that 'The land had been acquired for more than ten years. The company's original intention for the acquisition was for long-term investments. However, it had been wrongly classified as current assets in the previous years and thus is re-classified as fixed assets this year.' The report of the auditor further referred to a special resolution passed on 4 June 1993 for the voluntary winding up of the Taxpayer.

12. By a debit note dated 21 November 1996, Messrs G debited Mr A a sum of \$5,000 in respect of a study on the development potential of what remains of Lots 1 not resumed by the Government.

13. Mr and Mrs A were regular visitors to Hong Kong. Bills issued by two hotels in Hong Kong were placed before us. Those bills, dating from 1984, covered room charges; pool lunch and numerous long distance calls. In respect of the year 1993, the Taxpayer had further adduced evidence in the form of receipts issued by various restaurants in Hong Kong.

14. We have to decide two issues:

- a. The taxability of the sum of \$8,128,673 paid by the Government for resumption of part of Lots 1.
- b. The deductibility of various expenses for the period between 1 April 1982 to 31 March 1993 totalling \$58,556.

The evidence before us

15. Mrs A was authorised by the provisional liquidators of the Taxpayer to represent the Taxpayer's interests before us.

16. Mrs A gave the following sworn testimony:

- a. She and her husband left Country H in 1981 to work with a Mr I in Hong Kong. Mr I was ten heavily involved in District D.
- b. Mr A spent six months in Hong Kong living in a hotel. Mrs A joined her husband subsequently 'but I never get resident permit here. No, because no need as we don't want to settle here'.

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- c. Mr I suggested to the couple that they should purchase some land in District D. At that juncture there was some rumour of an airport in District D but other locations like District J was also mentioned.
- d. The Lots were acquired through Mr I's connections with the farmers in District D. She did not visit any of the Lots prior to their purchase. She only learned in 1986/87 that the Lots were scattered lots.
- e. 'We bought the land for a long-term investment to keep it in asset'.
- f. Their plans were changed by Mrs Thatcher's China visit in 1982. Mr A moved to Country K working for a chemical company whilst Mrs A acted as legal advisor for her clients in Country K.
- g. Apart from the one disposal referred to in paragraph 2 above, the Taxpayer had 'no activities, no transactions and no organisation'.
- h. In relation to the April 1985 Letter: 'I just write briefly and it is due to the circumstances.' The letter was written for 'a penalty purpose'. To Mrs A, the letter is of no importance.
- i. The classification of the Lots as 'current assets' in the early financial statements of the Taxpayer 'was just a mistake'. 'That means nothing for me'.
- j. The Taxpayer had never made any application to the Government to change the agricultural usage of the Lots.
- k. She maintains the Taxpayer's claim for deduction of various expenses. She described that as a 'subsidiary' claim. She accepts that the hotel bills and the restaurant receipts that she placed before us had never been tendered by her to the Taxpayer's auditors for their consideration.

The applicable principles

17. In Lionel Simmons Properties Ltd (In Liquidation) v Commissioner of Inland Revenue 53 TC 461, Lord Wilberforce at page 491 stated the principle thus:

'Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment?'

18. The decision in All Best Wishes Limited v CIR 3 HKTC 750 provides guidance in ascertainment of that intention. Mortimer J (as he then was) at page 771 stated that:

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'The intention of the taxpayer, at the time of acquisition, and at the time when he is holding the asset is undoubtedly of very great weight. And if the intention is on the evidence, genuinely held, realistic and realisable, and if the circumstances show that at the time of the acquisition of the asset, the taxpayer was investing in it, then I agree. But as it is a question of fact, no single test can produce the answer. In particular, the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of the evidence. Indeed, decisions upon a person's intention are commonplace in the law. It is probably the most litigated issue of all. It is trite to say that intention can only be judged by considering the whole of the surrounding circumstances, including things said and things done. Things said at the time, before and after, and things done at the time, before and after. Often it is rightly said that actions speak louder than words...'

Our decision

19. Mrs A asserted that it was the intention of the Taxpayer to acquire Lots 1 and Lots 2 as long term investment. Such bare assertion is not decisive and must be viewed in the light of the conduct of the parties as indicated by the decision in All Best Wishes Limited v CIR. The Taxpayer has not produced any contemporaneous minutes. No feasibility study was done at the time of the acquisition. There is no evidence which can be prayed in aid to support the assertion of Mrs A. The evidence is decidedly the other way and strongly suggests that we should view her assertion with extreme caution.

20. First, the early financial statements of the Taxpayer classified the Lots in question as 'current assets'. They were 'held for resale'. Those financial statements were approved by Mr and Mrs A. The Taxpayer's liability to profits tax was computed on the strength of those financial statements. We echo what this Board stated in the decision in Chinachem Investment Co Ltd v CIR 2 HKLC 261 at page 273

'If a taxpayer wishes to challenge the accuracy of its own audited statements and tax declarations made by a director it is not sufficient merely to say that either a mistake was made or that the accounts were kept in a particular form "for convenience". Evidence to substantiate the mistake must be given in the strongest terms. In this case no such evidence was given.'

If the Taxpayer be right, two firms of professional accountants would have committed the same mistake. We are not prepared to come to that conclusion given the tax benefits which the Taxpayer hitherto enjoyed as a result of such alleged 'mistake' and the fact that the so-called 'mistake' was not discovered until it was apparent that the Taxpayer would receive substantial compensation from the Government.

21. Secondly, the explanation which Mrs A gave to the April 1985 Letter does not generate confidence in the veracity of her evidence. No mention was made in the April 1985 Letter that the Lots in question were acquired by way of long term investment.

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Reading the letter as a whole, it is suggestive that the Taxpayer had embarked upon the purchase as a speculative venture in anticipation of a new airport in District D. Mrs A sought to dismiss the April 1985 Letter as no more than an insignificant attempt to avert a penalty. We do not see how the threat of penalty should prevent her from stating the truth.

22. The Lots were purchased shortly after Mr and Mrs A's arrival in Hong Kong. They did not have a settled intention to stay in Hong Kong. The acquisitions were in the context of rumours that the new airport would be located in District D. They did not inspect the Lots but simply relied on Mr I. They did not realise that the Lots were scattered about until well after the acquisitions. These surrounding circumstances refute in the strongest possible terms the bare statement of intention that Mrs A now wishes us to accept.

23. For these reasons, we find that the Taxpayer has wholly failed to discharge its onus and we reject its contention that Lots 1 and Lots 2 were acquired as long term investment.

24. In relation to the expenses claimed, the position is governed by section 16(1) of the Inland Revenue Ordinance which provides:

'In ascertaining the profits in respect of which a person is chargeable to tax ... for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax ...'

The words 'to the extent' make it clear that each item of expense claimed must be looked at and analysed to find out to what extent it was incurred to produce the profit.

25. Mrs A made no attempt in her evidence to link any of the item claimed to profit in respect of which the Taxpayer is liable to tax. The Taxpayer has likewise failed to discharge its burden in demonstrating that the expenses claimed were incurred in the production of assessable profits.

26. We dismiss the Taxpayer's appeal.