

INLAND REVENUE BOARD OF REVIEW DECISIONS

**Case No. D54/01**

**Profits tax** – properties – whether for redevelopment.

Panel: Anna Chow Suk Han (chairman), Peter R Griffiths and Winnie Kong Lai Wan.

Date of hearing: 19 December 2000.

Date of decision: 20 July 2001.

The taxpayer claimed that the properties in question were originally acquired for redevelopment and thus being a long term investment. He was only forced to sell them, despite at profits, when the redevelopment fell through.

**Held:**

The taxpayer failed to prove that the properties were not acquired as trading assets.

**Appeal dismissed.**

Cases referred to:

Lionel Simmons Properties Ltd v CIR 53 TC 461

All Best Wishes Limited v CIR 3 HKTC 750

D54/98, IRBRD, vol 13, 314

D11/80, IRBRD, vol 1, 374

CIR v The Scottish Automobile and General Insurance Company Limited 16 TC 381

Extramoney v CIR 4 HKTC 394

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Ng Yuk Chun for the Commissioner of Inland Revenue.

Au Ping Lam of Messrs P L Au & Co for the taxpayer.

### Decision:

### The appeal

1. Company A (‘ the Taxpayer’ ) has objected to the profits tax assessment for the year of assessment 1994/95 raised on it. The Taxpayer claims that the gains which it derived from the sale of certain properties should be capital profits not chargeable to profits tax. The Taxpayer is appealing against the determination of 29 June 2000.

### The background facts

2. The Taxpayer was incorporated as a private company in Hong Kong on 3 November 1976. According to the annual returns filed with the Company Registry, the Taxpayer’s shareholders and directors at all relevant times were as follows:

Shareholders	Directors
Mr B	Mr C
Mr C	Mr D
	Madam E

3. The Taxpayer acquired the properties at Sites 1 to 3 and at 1/F to 5/F and roof of Site 4, Road F (‘ the Subject Properties’ ) on the following dates:

Road F	Date of sale and purchase agreement	Date of assignment	Consideration \$
Sites 1 and 2	22-5-1992	22-6-1992	55,500,000
G/F and cockloft Site 3		31-3-1993	16,000,000
1/F Site 3		28-5-1993	2,600,000
2/F Site 3		5-7-1993	4,300,000
3/F Site 3		19-11-1993	3,500,000
4/F Site 3		27-7-1993	3,000,000
5/F and roof Site 3	7-4-1993	6-10-1993	4,300,000
1/F Site 4	30-6-1993	28-10-1993	3,400,000
2/F Site 4	11-6-1993	10-12-1993	3,700,000
3/F Site 4		28-5-1993	2,650,000

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4/F Site 4		31-7-1993	3,580,000
5/F and roof Site 4	18-6-1993	15-12-1993	<u>3,670,000</u>
			<u><u>106,200,000</u></u>

The Subject Properties were acquired with vacant possession except for G/F of Sites 1, 2 and 3 and 4/F of Site 4 which were acquired with existing tenants.

4. On 21 October 1994 the Taxpayer entered into a memorandum of sale and purchase to sell the Subject Properties at \$200,000,000. On 4 November 1994 the Taxpayer entered into a formal agreement for sale and purchase. The sale was completed on 23 December 1994 when the Subject Properties were assigned to the purchaser. The Taxpayer made a profit of \$83,877,070 on sale of these properties.

5. In its accounts for the year ended 31 March 1995 the Taxpayer showed:

- (a) the profits on sale of the 13 units in Housing Estate G as trading profits; and
- (b) the profits on sale of Unit 5 and a carparking space at Housing Estate H ('Unit 5') and the Subject Properties as 'gain on disposal of properties'.

In its proposed tax computation, the Taxpayer offered for assessment the profits on sale of the 13 units in Housing Estate G but not the profits on sale of Unit 5 and the Subject Properties.

6. The assessor had since ascertained that Unit 5 had been acquired and used by the Taxpayer as director's quarters. He thus accepted that the profits arising from the sale of Unit 5 should be a capital gain. He, however, considered that the purchases and sales of, the Subject Properties were trading activities. He raised on the Taxpayer the following profits tax assessment for the year of assessment 1994/95:

	\$	\$
Loss per return		(5,188,543)
<u>Add:</u> Gain on sale of the Subject Properties	83,877,070	
Rebuilding allowances overclaimed	<u>1,227,400</u>	<u>85,104,470</u>
Assessable profits		79,915,927
<u>Less:</u> Set-off of loss brought forward		<u>4,631,048</u>
Net assessable profits		<u><u>75,284,879</u></u>
Tax payable thereon		<u><u>12,422,005</u></u>

**The Taxpayer's case**

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7. It is the Taxpayer's case that the Subject Properties were acquired by the Taxpayer for redevelopment to be held as a long term investment. The Taxpayer originally intended to acquire and redevelop Sites 1 to 4 of Road F of which the Subject Properties formed part, by erecting thereon a new commercial building for rental income but the Taxpayer was forced to sell the Subject Properties when it was unable to acquire G/F and cockloft, Site 4, Road F, Hong Kong ('the Remaining Unit').
8. The Taxpayer's representative urged the Board to accept its case for the following reasons.
9. The Taxpayer's directors' reports clearly stated that the Taxpayer's principal activities were investment in properties for rental income and trading of properties.
10. In the Taxpayer's balance sheets, investment properties were classified as fixed assets and trading properties as current assets and the Subject Properties were classified as fixed assets to be held as long term investment.
11. The Inland Revenue Department had originally accepted that the Subject Properties were long term investment properties by allowing the rebuilding allowances claimed.
12. It was minuted in a directors' meeting that the Subject Properties were acquired for redevelopment for rental purpose.
13. The Subject Properties were acquired by means of shareholder's interest free loans with no fixed dates for repayment. This supported the Taxpayer's stated intention of acquiring the Subject Properties for redevelopment as a long term investment. The Subject Properties were subsequently mortgaged to secure overdraft facilities to finance the purchase of trading properties and advances to related company but was not used to repay the shareholder's loans.
14. The Taxpayer had not declared any dividends but had re-invested all its gains from its investment properties in other investment properties.
15. The Taxpayer's history of property transactions showed that it had long term investment properties and trading properties.
16. The Subject Properties were sold because the Taxpayer could not purchase the Remaining Unit for redevelopment.
17. Considerable time and efforts had been spent by the Taxpayer on the proposed redevelopment. Time and efforts were spent on obtaining vacant possession of premises from the existing tenants; paying the existing tenants heavy compensation; obtaining counsel's opinion on the proposed redevelopment; instructing architect to prepare building plans; submitting building plans to

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the Building Authority for approval; demolishing the existing building; and after sale of the Subject Properties, re-investing in the property at Site 6 of Road I which was still being held by the Taxpayer for rental income.

18. The Taxpayer's loans were shareholders' loans. The Taxpayer was not obliged to pay interest nor make repayment of the loans at a fixed date. The Taxpayer was also not required to arrange any loans to finance the redevelopment project because its shareholders had sufficient fund for the purpose.

19. The Taxpayer was running a family business and was fully supported by its shareholders financially. All its decisions and plans needed not be properly minuted. Admittedly the budget by a firm of architects and engineers (' the Architect' ) of 18 December 1992 was not a contemporaneous record and was prepared only at the time when the Revenue requested for one. Nonetheless, the Taxpayer did have discussion with the Architect on the expected return and usable area of the proposed redevelopment.

20. The submission of the building plans to the Building Authority and the advertisement for sale of Sites 1 to 3 of Road F, in July 1994 were tactical moves on the part of the Taxpayer to mislead the owner of the Remaining Unit into thinking that the Taxpayer had given up its plan of redevelopment. They served as a message to the owner not to demand outrageous prices for the Remaining Unit. The Taxpayer had not at that time entirely given up the redevelopment plan.

21. Even though the Taxpayer was financially capable of meeting the asking price for the Remaining Unit, as a shrewd property investor, it decided to abandon the proposed project, sell the Subject Properties and turn to other investment choices, once the expected return could not be achieved by reason of a higher purchase price.

22. The sale proceeds of the Subject Properties were re-invested in Housing Estate J and Site 6 of Road I.

23. We were urged to consider some well established legal principles in this area which were said to support the Taxpayer's case.

### **The Respondent's case**

24. It is the Respondent's case that the Subject Properties were acquired by the Taxpayer with the intention of trading for profits and hence the profits derived by the Taxpayer from the subsequent sale of the Subject Properties were properly assessed to profits tax. The Respondent presented this Board with a detailed written submission and we were referred to the legal principles as hereinafter mentioned.

### **The evidence**

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25. The Taxpayer called Madam E, a director of the Taxpayer to give evidence on its behalf. Madam E gave evidence at the hearing to the following effects.

26. She was one of the directors and the secretary of the Taxpayer. She oversaw the daily operations, took care of the personnel matters and also the buying and selling of properties. When there was a redevelopment project, she would contact architects for matters such as submission of building plans, organizing meetings with shareholders and making reports to them.

27. She had worked for the Taxpayer for over 30 years. Her boss was Mr C, the other director and also a shareholder of the Taxpayer. He held the shares in trust for a Mr K, a Thai national, residing in Thailand. Mr C and Mr K knew each other for over 30 years. They trusted each other. She was in direct contact with Mr C in her daily operations. She would occasionally contact Mr K by phone and would see him if he visited Hong Kong. It was her understanding that she only needed to report to Mr C.

28. She explained to the Board that the purchase price of the Subject Properties came from the proceeds of sale of a property at Road L owned by a related company of the Taxpayer, named 'Company M'. Company M purchased and redeveloped the property at Road L and rented it to the Hong Kong Government as nursing quarters for some ten years. The property at Road L was bought at the price of \$20,000,000 and was afterwards sold for \$132,000,000. Company M made a profit of \$130,000,000. Besides holding that amount of cash, Mr K was also holding a lot of shares, for example, Bank N shares, as long term investments. Mr K, although a foreign investor, retained the proceeds of sale from the investment within Hong Kong and sought to acquire new properties, thus leading her and Mr C to acquire the Subject Properties.

29. She and Mr C had a site inspection at Road F and were impressed by the activities there. After a few meetings, they decided to proceed with the acquisition. Sites 1 and 2 of Road F were easily acquired from one single owner at the price of \$55,500,000. As the remaining units of the Subject Properties were separately owned, the acquisition was not so easy. They instructed agents to deal with those purchases. G/F of Site 3, Road F was purchased at the price of \$16,000,000, while the upper units were at roughly a few million dollars each. After acquiring the whole of Site 3, they started on Site 4.

30. The initial asking price of the Remaining Unit was only \$8,000,000. It progressed to \$15,000,000 and then to \$30,000,000. Since they experienced difficulties in their negotiations with the owner of the Remaining Unit, they used another company and instructed a different firm of solicitors to purchase the upper units, 1/F to 5/F. After they acquired the upper units of Site 4, they still encountered difficulties in reaching an agreement with the owner of the Remaining Unit. They were a bit disheartened and began looking for other properties to purchase. However, at the same time they had not entirely given up the proposed purchase of the Remaining Unit.

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31. In connection with the proposed redevelopment, she instructed an architect to prepare building plans for Sites 1 and 2 and after Site 3 was acquired, to prepare further building plans for Sites 1, 2 and 3 and later a demolition plan.

32. Madam E explained that they decided to sell the Subject Properties because the owner of the Remaining Unit was being difficult and had no idea how much she wanted for the property. However, she stressed, more importantly, whether the Board would believe it or not, because after they had rejected a cheque from the purchaser of the Subject Properties, two men whom she believed to belong to triad society, came to their office and threatened them to sell and not to 'play games'. For this reason, Mr C came to the view that they had no alternative but to sell the Subject Properties.

33. She further explained that the Taxpayer usually classified those properties held for a short period and not rented out as 'trading stocks' while other properties, like the Subject Properties, which were for redevelopment, as 'fixed assets'. She also explained that the Subject Properties were mortgaged to banks to obtain loans and overdrafts which were used partly to finance their trading activities and partly as loans to their related companies.

34. Madam E was cross-examined at length. She explained that the rate of the expected return for the proposed redevelopment of the Subject Properties was calculated by way of dividing the estimated annual rental by the total estimate cost of the development which included the purchase price, the construction cost, the architect fees, the solicitors' fees and the stamp duty, etc. She confirmed that 9% per annum would be regarded as a satisfactory rate of return for the project. Their fall-back plan was to develop Site 1 to Site 3, if Site 4 could not be acquired. They did not proceed with this plan because it was not cost-effective. She further explained that the major obstacles which they would have to face in developing only Site 1 to Site 3 were the common staircase shared by Site 3 and Site 4 and the potential liabilities which it would generate. She explained that the advertisement which they put up for sale of Site 1 to Site 3 was used as a warning to the owner of the Remaining Unit that they would proceed to develop Site 1 to Site 3 without Site 4.

35. As to the project estimate of 18 December 1992 submitted to the Revenue, Madam E explained that, at the time they did not have it but upon the request by the Revenue, the project estimate was prepared for submission to the Revenue. They only had simple calculations on pieces of paper which they no longer retained. She disclosed that the project estimate was in fact prepared by her and not the architect. The architect refused to prepare one because their file was closed. She did not mean to be deceitful. Had it been so, she would have signed the letter. As it was, the letter was not signed. She did not think it was an important document. She thought it was only for record purpose. She admitted that she had made a mistake by using the actual land cost in the estimate and such actual land cost was not available as at 18 December 1992.

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36. Upon questioning on the short term loans obtained from banks on the mortgage of the Subject Properties, she denied that it was used for repayment of the shareholder's loans. She said that it was used to finance the purchase prices of the units in Housing Estate G. She explained that although there were withdrawals of fund by Mr K, there were also injections of fund by him. The total amount injected was greater than that withdrawn.

37. On the decision to sell the Subject Properties, she said that the last offer they made to the owner of the Remaining Unit was \$30,000,000. However, she believed that even if they were to offer \$40,000,000, the owner would not have accepted their offer. She also believed that if not for the triad background of the purchaser, the owner would not have sold the Remaining Unit to the purchaser. She confirmed that the Subject Properties and the Remaining Unit were sold to the same person named 'Mr O' and the purchase price of the Remaining Unit was \$46,000,000. She explained that she did not inform their representatives of the visit by the triad members because they did not report the matter to the police and they had no documentary proof of the incident.

### **The relevant legislation**

38. Section 14(1)

*' Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment ...on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) ...'*

39. Section 68(4)

*' The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.'*

### **The legal principles**

40. Intention at the time of purchase is crucial

It is a well-established legal principle that in determining whether a property is a capital asset or a trading asset, one has to ascertain the intention of the purchaser of the property at the time of acquisition. If the property was purchased with the intention of disposing of it at a profit, it was a trading asset. If the property was acquired as a permanent investment, it was a capital asset. This principle is enunciated in the House of Lords judgement in Lionel Simmons Properties Ltd v CIR 53 TC 461 where Lord Wilberforce said at page 491 (R2-page 31):



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*‘ One must ask, first, what the Commissioners were required or entitled to find. Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment?’*

41. Subjective intention is to be tested by objective facts and circumstances

A self-serving statement by a person is of limited value until it has been tested against the objective facts. See the following judgement from All Best Wishes Limited v CIR 3 HKTC 750 as quoted in D54/98, IRBRD, vol 13, 314 at page 321(R2-page 46):

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

42. Intention connotes the ability to carry it out into effect

The Board in D54/98 also endorsed the following often quoted statement in another Board of Review decision D11/80, IRBRD, vol 1, 374 (R2-pages 46 and 47):

*‘ 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 inference that would be drawn is 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... “Intention” connotes an ability to carry it 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 no steps to enable such intention to be implemented.’*

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43. Accounting classification and board minutes are not conclusive of the matter on intention

In the case of CIR v The Scottish Automobile and General Insurance Company Limited 16 TC 381, Lord Sands said the following at page 391 (R2-page 64) :

*‘ Reference was made to the manner in which this profit was treated in the accounts. It is well settled, however, that in Revenue cases one must look at the substance of the thing and not at the manner in which the account is stated.’*

44. This principle can also be found in the Board of Review decision D54/98 where the Board said at page 321 (R2-page 46):

*‘ It follows that the way in which a company keeps its accounts though admissible to show what, in the view of the company’s directors and auditors at that time was the intention of the company, is not conclusive evidence by any means. That evidence must be weighed against other evidence available; see for example, shadford v H Fairweather & Co Ltd [1966] 43 TC 291, at page 299 per Buckley J. If the financial statements of the company are by no means conclusive it must follow that board minutes are in no better position. One must look at all the circumstances to see if that self-declaration of intent is bore out by the facts.’*

45. Principle of estoppel not applicable in this case

As a matter of general principle, the Commissioner of Inland Revenue is usually not estopped from carrying out its statutory obligation. He cannot be prevented either by agreement or otherwise from discharging his duties under statute – see the statement made by Patrick Chan, J in Extramoney v CIR 4 HKTC 394 at page 423 (R2-page 96).

### **Our findings**

46. To determine whether a property is a capital asset or a trading asset, the intention of the purchaser at the time of the acquisition of the property is crucial. If the property was purchased with the intention of disposing of it at a profit, it was a trading asset. In case of dispute, the onus is on the taxpayer to prove that the property was not acquired as a trading asset.

47. In the present case, the Taxpayer’s representative urged the Board to accept that the Subject Properties were acquired by the Taxpayer for redevelopment as a long term investment for rental purpose. The representative claimed that the Taxpayer’s intention was supported by the fact that there were other properties held by the Taxpayer and its related companies as long term investment. Details of those properties were given to the Board for reference. While we accept

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that the Taxpayer were holding some properties as capital assets, the status of those properties is not determinative of the status of the Subject Properties. The test was the intention of the Taxpayer at the time when it acquired the Subject Properties.

48. The Representative also urged us to accept that the Taxpayer was financially capable of carrying out its stated intention into effect. Cash flow statements of the Taxpayer from the years of assessment 1992/93 to 1998/99 were produced, showing (1) an average of 19.34% building fund came from bank loans while 80.66% came from shareholders and related company and (2) 85.15% of fund came from shareholders and related companies to finance the purchase cost of the Taxpayer's properties. The representative asserted that this cash flow statement should be able to substantiate that there would be available fund from the shareholders to finance the proposed redevelopment and a long term loan from banks were not necessary. However, we do not consider that this cash flow statement can assist the Taxpayer's case. Even if we were to accept that Mr K, the beneficial owner of the Taxpayer, was a wealthy individual, it did not follow that he was willing or was capable of advancing the entire construction cost as when it was needed. No evidence to this effect was produced. However, there was evidence that even though Mr K injected fund into the Taxpayer's account from time to time, he also made frequent withdrawals of fund from the company.

49. As to the other factors which the representative claimed should be determinative of the Taxpayer's intention, we have considered each of them carefully and hold the following views. The minutes of the Taxpayer's directors meeting, the classification of the Subject Properties, the audited financial statements are all self-serving statements and should be treated with caution. Rebuilding allowances were first granted in respect of the Subject Properties. However, this fact is no bar to the Revenue to raise the assessment in question. The Taxpayer subsequently acquired another property, Site 6 of Road I as a long term investment. Again, this fact is not determinative of the status of the Subject Properties. We also cannot find substance in the Representative's argument that since Mr K was a Thai national, if he had been trading, he would have remitted his profits out of Hong Kong and would not have re-invested the profits in Hong Kong. As to the absence of a contemporaneous feasibility study, the representative asserted that since the Taxpayer was a 'family company' or a 'one man company', a feasibility study was not necessary. Since the proposed project was of a sizeable scale and both directors Madam E and Mr C, were acting for Mr K, even if a detailed feasibility study was not necessary, we would have thought some written record would be necessary for Mr K's reference or information.

50. Payment of compensation to the tenants and demolition of the existing buildings could enhance the resale value of the properties. We do not treat those steps taken by the Taxpayer as a positive indication of its intention to redevelop the Subject Properties. As to the submission of building plans, we do not believe there was any genuine intention on the part of the Taxpayer to proceed with those plans. Completion of Sites 1 and 2 of Road F took place on 22 June 1992. The building plan for Sites 1 and 2 was submitted on 26 June 1992. It could not be a genuine intention on the part of the Taxpayer to use such a building plan, since it was only on 18 April 1992,

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the directors resolved to purchase Sites 1 to 4 of Road F for redevelopment. There is no evidence that the Taxpayer intended to give up at this juncture the redevelopment plan for Sites 1 to 4. The building plan for Sites 1, 2 and 3 was submitted on 13th July 1994. On 23 December 1993 a directors' meeting was held by the Taxpayer and it resolved that an alternate investment in Housing Estate J was to be purchased in view of the difficulties in acquiring the whole of Sites 1 to 4, Road F. On 1 July 1994, a directors' meeting was held and it was resolved to sell the Subject Properties. The architect in his letter to the Taxpayer of 13 July 1994 said that on 12 July 1994 instructions were given to him to submit the plans. Since it was only resolved on 1 July 1994 that the Subject Properties were to be sold, surely the building plans were not meant to be acted upon.

51. It is the Taxpayer's case that it was its intention to acquire Sites 1 to 4 of Road F for redevelopment but it had to give up the plan when it failed to acquire the Remaining Unit. However, for the first time it was revealed by Madam E during the hearing that, they decided to sell because when they rejected a cheque from a purchaser, they were paid a visit by two persons whom they believed to have triad connection. Madam E also believed that the owner of the Remaining Unit was only prepared to sell its unit because of the purchaser's triad background. The Taxpayer never gave this reason for sale of the Subject Properties to the assessor nor to its representative. We have doubts as to the genuineness of this claim. Even if the incident were true, we are of the view that the alleged anxiety which caused the sale was grossly exaggerated. The incident was not reported to the police nor was it mentioned to its representatives. Had the incident created such a serious concern to the Taxpayer, the Taxpayer should have at least remembered and mentioned it to the representatives. Thus, it could not be a genuine reason for the Taxpayer's sale of the Subject Properties. Furthermore, we do not accept Madam E's interpretation of the reason for the owner of the Remaining Unit to sell. The willingness of the owner of the Remaining Unit to sell its property to the purchaser is understandable and not surprising. As Madam E told the Board, the Taxpayer's last offer for the Remaining Unit was \$30,000,000. The Remaining Unit was sold to the purchaser for \$46,000,000. The price was far higher than that offered by the Taxpayer.

52. It transpired during cross-examination that not only the project estimate was not a contemporaneous record, neither was it prepared by the architect. It was prepared by Madam E herself, using the letterhead of the architect. This revelation reflects poorly on the credibility of the witness.

53. Having considered all the factors urged upon us by both sides and all the evidence before us, we do not find that the Taxpayer had discharged the burden on it to prove that the Subject Properties were acquired as a long term investment for redevelopment. Accordingly, we confirm the assessment and dismiss the appeal.