

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D60/93

Profits tax – sale of property – whether profit subject to profits tax.

Panel: Howard F G Hobson (chairman), Calvin Fung Chor Hang and David Ling Dai Wai.

Dates of hearing: 1 and 2 December 1993.

Date of decision: 23 February 1994.

The taxpayer purchased and sold the first property at a substantial profit within nine months. The taxpayer purchased and sold the second property also at a substantial profit within a period of six months. It was submitted that the two properties had been purchased as quarters for a company director and his sister. There were conflicts in the evidence given on behalf of the taxpayer.

Held:

On the evidence before it the Board was not satisfied with regard to the alleged intention of the taxpayer. The Board was not satisfied that the two properties were to be used as quarters for the directors.

Appeal dismissed.

Cases referred to:

Lionel Simmons Properties Ltd etc v CIR 53 TC 461
Shadford v H Fairweather & Co Ltd 43 TC 291
Iswera v CIR [1945] 1 WLR 663
D11/80, IRBRD, vol 1, 374

H Bale for the Commissioner of Inland Revenue.

Thomas Lai Sin Thong of Messrs Chan, Lai, Pang & Co for the taxpayer.

Decision:

This appeal is concerned with whether the surpluses on the sale by the company of two residential apartments (the taxpayer) were capital gains as claimed by the Taxpayer or trading profits as assessed by the Revenue. The undisputed facts are as follows:

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1. The Taxpayer was incorporated in Hong Kong as a private company in 1987.
2. No return for the year of assessment 1988/89 having been filed, an estimated assessment of \$30,000 was raised subsequent to which a first additional assessment of \$300,000 was raised. The Taxpayer objected to the latter and submitted a profits tax return showing assessable profits of \$59,680. The Taxpayer omitted profits totalling \$1,861,688 from the sale of Flat B and two car parking spaces at Place X ('Property I') and the sale of Flat A and a car parking space at Place X ('Property II') because it considered them to be capital gains.
3. Property I had been bought by the Taxpayer in June 1987, at a time that the Taxpayer was owned by Ms X, for \$3,360,000 and sold in March 1988 (that is about nine months later) for \$4,675,000 when the Taxpayer was then owned by Mr Y.
4. Property II had been bought, subject to a tenancy, in August 1988 (when the Taxpayer was owned by Mr Y) for \$3,600,000 and sold, subject to the same tenancy, in February 1989 (that is six months later) for \$4,370,000.
5. The net profit from the sale of Property I was \$1,340,733 and that from Property II was \$520,955.50, together totalling \$1,861,688.50.
6. In response to Revenue enquiries, the Taxpayer's tax representative gave the following information:
 - (a) Property I was acquired by the Taxpayer as directors' quarters and was sold because of the time wasted in travelling each day. After that sale the director concerned ('Mr Y') moved to a service apartment.
 - (b) After 'a few months', he missed the feeling of home and the superb view he had had at Property I. Consequently, Property II which was let to Bank A was bought with the intention that the director would occupy it when the tenancy expired.
 - (c) But later the Taxpayer found a more suitable property in Place Z ('Flat Z'). The Taxpayer thereupon sold Property II while still let to Bank A and lent the proceeds to a wholly owned subsidiary company - Company F - to buy Flat Z.
 - (d) Mr Y and his sister Ms Y, directors of the Taxpayer occupied:

Property I from January to April 1988;

Flat N from June 1988 to June 1989; and

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Flat O for July 1989; and

Flat Z from August 1989 to present.

This information was revised by the Taxpayer's tax representative in his final submission to the Board.

- (e) From the time Property I was bought in June 1987 until January 1988 the Taxpayer's former director, Ms X occupied this property.
- (f) Prior to moving into Property I, about January 1988, Mr Y and Ms Y lived with their mother in Flat V.
- (g) After Property I was sold and before residing at Flats N and O, that is during May and June 1988, Ms Y moved back with her mother and Mr Y stayed with a friend.

The Revenue also raised a second additional assessment but as that was subsequently withdrawn we need not deal with it.

TESTIMONY

At the hearing, Mr Y gave evidence on oath to the following effect:

1. He carried on business, as a sole proprietor under Company A and as an agent of Company B.
2. Ms X was also an agent in Company B and she owned the Taxpayer which she had used to buy Property I. She offered to sell him the Taxpayer for about \$1,000,000, there being a mortgage on Property I of about \$2,800,000. Mr Y purchase of the Taxpayer was completed in January 1988. He held 99 shares, Ms Y held 1 share and both of them were the directors.
3. During cross examination, it became apparent that the information at 6(d) and 6(e) as to the residences of Ms X, Mr Y and Ms Y was misleading. Regarding 6(e) the Revenue's representative produced Ms X returns for the years of assessment 1985/86, 1986/87 and 1987/88 which all show her address as being in Place T. On being confronted with these Mr Y said he thought Ms X had only stayed at Property I for a short period. Mr Y also passed the unsolicited comment that he did not think Ms X used the Taxpayer to carry on her business as an agent. Granted that there is nothing innately wrong with any company providing its directors with accommodation but to do so when the company has no income certainly calls for an explanation. In his 1986/87 profits tax return dated 15 October 1987 (that is after the company acquired Property I) Mr Y had given his address in Place R ('Flat R') which he acknowledged he owned

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(at the same time that the Taxpayer owned Property I) until he sold it in March 1988. Despite that sale he gave it as his address in the 1988/89 return dated 22 January 1990, not Flat Z as stated at 6(d). Moreover in the Taxpayer's employer's return dated 17 July 1990, Mr Y's residence is given as Flat R which return, (signed by Mr Y) states that the Taxpayer provided no quarters for him between 1 April 1989 to 31 March 1990 that is after Property II sold but after Company F bought Flat Z. The annual return for the Taxpayer made up to 28 December 1990 showed Mr Y's address again as at Flat R not Flat Z. Ms Y's salaries tax return dated 30 May 1988 showed her residence as at Flat V not Property I and her return dated 31 July 1989 also referred to Flat V but not Flat O.

Mr Y could offer no plausible explanations for the inconsistencies concerning addresses, other than to comment that they were mistakes resulting from copying previous year's returns.

Mr Y was a little uncertain about the relationship of his sole proprietorship business and the Taxpayer; we believe however that the latter acted as a service company for Mr Y's business as an agent and accept that the provision of quarters by service companies is a common method of taking advantage of the tax provisions concerning housing for employees.

Mr Y told us that the reason for selling Property I was the bad fung shui whereas Property II did not.

SUBMISSION BY THE COMPANY

In the Taxpayer's representative's submissions made to the Commissioner of Inland Revenue the reason given for selling Property I was the time wasted travelling from Place Y to Company B. The Deputy Commissioner was unimpressed with that reason because it was inconsistent with the purchase of the substitute Property II also located in the same place. Until the Taxpayer's tax representative's opening address the matter of fung shui had not been mooted. It was suggested to us that the fung shui factor was the main reason for the sale and that the persuasiveness of the estate agent (whom Mr Y had engaged to find a flat to enable him to move back to Place X) to the effect that the sitting tenancy would soon end led the Taxpayer into believing that Property II represented a bargain. Furthermore Property II was only sold when a replacement, namely Flat Z, had been earmarked. Then when Property II was sold the surplus monies were lent to Company F to buy Flat Z, upon which over one million dollars was spent on decorations.

Our attention was drawn to the fact that after Mr Y acquired the Taxpayer he caused the Taxpayer to redeem the existing mortgage on Property I and take out a new mortgage with another bank and in the application for that mortgage it is stated that the property is to serve as Mr Y's residence. Both Property I and II were shown as fixed assets in the accounts of the Taxpayer.

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At the end of his submission the Taxpayer's representative presented a revised version of 6(d). Although that may have set the record straight it did not cancel the inconsistencies to which we have referred at 3.

SUBMISSIONS BY THE REVENUE

The Revenue's representative referred us to the following cases:

Lionel Simmons Properties Ltd etc v CIR 53 TC 461

Shadford v H Fairweather & Co Ltd 43 TC 291

Iswera v CIR [1965] 1 WLR 663

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We have first to decide what was the Taxpayer's intention when it purchased Property I, testing the declared intention against the surrounding and subsequent facts as found by us on the basis of material and testimony before us (Lionel Simmons case).

The Revenue's representative then made the following points:

There was no direct evidence in support of the contention that Ms X occupied Property I as her residence, indeed in her various returns she consistently, both during and after selling her shares in the Taxpayer, gave an address in Place T as her residence.

As to the badges of trade the subject matter (Property I was a new property in a rising property market) was not income producing and probably was not occupied and the short period of ownership coupled with the frequency of property sales (that is two in the period June 1987 and February 1989) are all consistent with trading. Moreover the finances of the Taxpayer cast doubt on the Taxpayer's ability to hold Property I as a long term investment.

The fact that an asset is shown in the accounts as a fixed asset is not conclusive (Shadford's case).

As regards Property II, when purchased Bank A's tenancy had 18 months to run. That factor tends to be inconsistent with acquisition as a director's quarters. Next the price was slightly higher than Property I so if the Taxpayer did manage to get possession it was doubtful if the Taxpayer had the income to support the mortgage payments.

CONCLUSION

In general we are persuaded by the Revenue's representative's arguments. Specifically however in the fact of (a) the information contained in Ms X's returns, (b) Mr Y's comment that he believed she did not use the Taxpayer for her business as an agent and

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(c) the absence of any direct contradictory evidence from Ms X and (d) the absence of any reference to furnishings owned by the Taxpayer we find as a matter of fact that Ms X never occupied Property I and that she never intended it to be used as quarters for the Taxpayer's directors.

That conclusion alone is probably sufficient to dispose of this appeal because the Taxpayer's intention at the time of purchase - in the absence of any suggestion of a subsequent change of intention - is the critical test. However for the sake of completeness we should mention that we think Mr Y's explanation for the supposed inconsistency in residential addresses, namely mistakes arising from copying previous years' returns, is just too weak having regard to the number of inconsistencies. We also noted that no telephone accounts, removal invoices, or even letters addressed to Mr Y or the Taxpayer at Property I or anything else which could have indicated actual occupation were offered in evidence. We therefore do not believe in Mr Y's testimony and find as a matter of fact that neither Mr Y nor Ms Y actually occupied Property I and that Property and Property II were acquired with a view to sale as soon as a suitable profit could be secured.

Accordingly this appeal is dismissed.