

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D61/88

Case No. D62/88

Profits tax – sale of premises – whether losses were of a trading or capital nature – distinction between objective and subjective tests for determining taxpayer's original intention – s 14 of the Inland Revenue Ordinance.

Profits tax – sale of premises – whether losses were of a trading or capital nature – evidential matters: failure to register business and file profits tax returns, large mortgage commitment, lack of written agreement between taxpayers, purchase during property boom and lack of intention to reside in premises – s 14 of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Winston Lo Yau Lai and David Wu Chung Shing.

Date of hearing: 28 September 1988.

Date of decision: 29 December 1988.

In December 1980, the taxpayers purchased premises which were then under development for \$769,950, intending to make a quick profit when the value of the premises increased. At that time, property prices were rising strongly. However, before the sale was completed, the property market sharply declined.

The taxpayers were reluctant to sell the premises and lose their money. They therefore borrowed mortgage funds from a finance company over a twelve year term. Loan repayments were initially calculated at \$10,886 per month which represented more than one-half of the taxpayers' gross salaries.

Following substantial increases in interest rates, the term of the loan was increased, at one time to 21 years. In March 1982, the taxpayers rented out the premises for \$4,300 per month in order to help them meet their mortgage commitments. In October 1985, after a rise in property values, the taxpayers sold the premises at a loss of \$307,261. The taxpayers sought to have this loss deducted from their other income.

During the period they derived rent from the premises, the taxpayers were assessed to property tax and not profits tax. They did not file profits tax returns nor a business registration application.

The IRD denied a deduction to the taxpayers for their losses. The taxpayers appealed.

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Held:

The taxpayers had engaged in an adventure in the nature of trade and the losses were therefore deductible.

- (a) The question to be determined is the intention of the taxpayers at the time they purchased the premises. This is determined by reference to both subjective and objective factors.
- (b) On the facts, the taxpayers subjectively intended to purchase the premises as a venture in the nature of trade.
- (c) The objective facts were consistent with this subjective intention. Of particular relevance were the facts that the mortgage payments were large in relation to the taxpayers' salaries; that there was no formal agreement between the taxpayers, which one would expect in the case of a long-term capital investment; that the taxpayers never intended to reside in the premises; and that the taxpayers had purchased the premises in a period of general property speculation.
- (d) On balance, the facts that the taxpayers did not register their business and did not file profits tax returns, and had stated in their returns that they did not carry on a business, were not sufficient to overcome the objective factors which supported the taxpayers' case.

Appeal allowed.

D J Gaskin for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

This is one of two similar appeals. The Taxpayer, Mr X, appeared on behalf of himself and appealed against a refusal by the Commissioner to allow him to deduct by way of personal assessment alleged losses of a trading nature against his assessable salary.

The facts were as follows:

1. The Taxpayer and a colleague of his decided to purchase as tenants-in-common a flat under construction ('the property') for \$769,950. They had no intention of residing in the property. On 21 December 1980, they paid an initial deposit of \$5,000. They entered into a formal sale and purchase agreement on 9

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January 1981 when they paid a further deposit of \$71,995. They made two further payments of \$38,497.50 each.

2. A temporary occupation permit for the property was issued on 25 June 1981. In September 1981, the Taxpayer and his colleague completed the sale and purchase and the property was assigned to them. To pay the balance of the purchase price, the Taxpayer and his colleague mortgaged the property and obtained a loan of \$615,960 from a finance company ('the mortgages'). This loan was repayable by equal monthly instalments of \$10,886 each. Initially, there were 144 monthly payments spread over 12 years.
3. As the dollar amount of the instalment payments was fixed, the number of instalments which had to be made varied from time to time according to the rate of interest charged by the mortgagee. In November 1981, there appears to have been a very substantial jump in the interest rate charged by the mortgagee and the date of the final mortgage instalment jumped from September 1993 up to August 2002, which meant that the loan instead of being cleared in 12 years would take some 21 years to be repaid. Thereafter, the interest rate and the period for repayment fluctuated but were never as high or as long as in November 1981.
4. The property remained vacant until 31 March 1982 when the Taxpayer and his colleague let it for a period of five years at a monthly rental of \$4,300 inclusive of management fees of \$245.
5. On 17 October 1985, the Taxpayer and his colleague sold the property for a consideration of \$645,000. After taking into account the interest paid to the mortgagee and other expenses relating to the property, the Taxpayer and his colleague claimed to have suffered a loss of \$307,261 on the transaction.
6. Throughout the period from the date of acquisition of the property up to the date of its sale, the Taxpayer and his colleague did not file any profits tax returns in respect of the property. Instead, the property was assessable to property tax. The Taxpayer claimed personal assessment so that his liability to property tax was taken into account when his taxable income was assessed by way of personal assessment. The Taxpayer included in his personal assessment tax return that portion of the interest payable in respect of the property which was for his account. The net result would appear to be that, during the years in question, the Taxpayer either did not pay property tax or any property tax paid was fully off-set and refunded in the course of his being personally assessed.

At the hearing of the appeal, both the Taxpayer and his colleague gave evidence and were cross-examined by the representative for the Commissioner.

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We found both the Taxpayer and his colleague to be frank and truthful witnesses. The Taxpayer said that he and his colleague had decided to enter into a venture in the nature of trade when they decided to purchase the property. They did so expecting the value of the property to increase. They intended the speculation to be of short duration and they planned to sell the property before or when it was completed. The Taxpayer and his colleague were offered an immediate profit of \$10,000 shortly after they agreed to purchase the property, but they considered this to be insufficient and decided to wait for a higher profit. The Taxpayer said that unfortunately the property market had declined and he and his colleague had found themselves facing a substantial loss. As they had invested most of their savings, they did not wish to lose money and decided to wait for the market to improve. When the property had been completed, it was necessary to complete the purchase and for this reason they arranged for the mortgage loan. They did not envisage that the period of the mortgage would jump from 12 years to 21 years. When entering into the original venture, they had not anticipated that it would be necessary for them to make monthly payments which would represent more than half of their then current gross salaries. As they could not afford to pay the mortgage instalments and there was no prospect of selling the property at an acceptable price, they were forced to let out the property. In due course, as soon as property conditions improved, the Taxpayer and his colleague sold the property in 1985 even though it was still below their original purchase price.

The Commissioner's representative cross-examined the Taxpayer (inter alia) regarding the fact that the Taxpayer had not registered the venture as a business and had not filed profits tax returns but instead had filed property tax returns.

In his submission, the Commissioner's representative rightly submitted that, for the loss suffered by the Taxpayer to be allowed, it must be shown that it arose from an 'adventure in the nature of trade'. He submitted that each case must be decided on its own peculiar facts and the question is a matter of fact. The question to be decided is what was the intention of the Taxpayer at the time of the acquisition of the property. For convenience, we quote with approval from the submission made by the Commissioner's representative as follows:

'In ascertaining the true intention, it is necessary to consider two tests. Firstly one must look at the subjective intention of the Taxpayer and try to ascertain what was the intention. The second test is then to look at all of the facts objectively and see whether, on the objective construction of the facts, the answer is the same. Obviously, the answer should always be the same and one test should support the other. However, the second "objectivity" test is required because it may be difficult or impossible to establish the intention from a subjective test; clearly self-serving statements by the Taxpayers on their own are of limited value, and I would submit that, if these are the only indicators available for a "subjective" testing, then the Board must place far greater weight on the objective facts of the case. However, it is clear that the Board must attempt to determine the "true" intention.'

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This is a very apt and accurate summary of what the Board must do. The Board must find the true intention of the Taxpayer at the time when the property was purchased. To ascertain this intention, it is necessary to look at the facts both subjectively and objectively. Obviously, the answer to both the subjective and objective tests should be the same. If the answer is different, then it is necessary to consider why the answers are different and which is more truthful or accurate in all of the circumstances.

In the present case we have no hesitation in deciding that it was the Taxpayer's intention at the time when he acquired the property to do so as a venture in the nature of trade. We accept the evidence given by the Taxpayer and also find that it is consistent with the objective approach.

We have had many cases coming before the Board of Review where the Commissioner has sought to tax a gain which has arisen on the sale of a property. If on the facts before us the Taxpayer had made a profit and the Commissioner had sought to assess it to tax, we would have had no hesitation in deciding that the profit was taxable. The fact that in this case a loss has resulted and the Taxpayer has the skill and knowledge to seek to off-set his loss against his other taxable income is not material.

The Commissioner's representative argued strongly that the intention of the Taxpayer could be found or inferred from the fact that the Taxpayer was an assessor with the Inland Revenue Department who had great skill and knowledge relating to taxation matters. He pointed out that the Taxpayer, with his knowledge, should have obtained a business registration certificate and should have filed profit tax returns. He pointed out that, had profits tax returns been filed, the Taxpayer would have enjoyed tax benefits because he would have been able to off-set his business expenses against his other income. The Commissioner's representative also pointed out that the Taxpayer had made false statements to the Commissioner in providing information with regard to the property and also when the Taxpayer had stated in his personal assessment particulars that he carried on no trade or business.

Whilst these submissions on behalf of the Commissioner clearly carry significant weight, they are not sufficient to overcome the other objective facts which support what the Taxpayer said. It is most unlikely that any person with the education and intelligence of the Taxpayer would have entered into this transaction as a long-term capital investment. There are many facts to support this.

The Taxpayer's monthly salary when he decided to purchase the property was below \$10,000 and his half-share of the monthly instalments amounted to more than half of his monthly salary. When the property was let, the monthly rental was below the interest payable on the mortgage.

If the Taxpayer and his colleague had really intended to make a joint capital investment which would last for at least 12 years (the initial period of the instalment loan), then one would expect to see a formal agreement between the Taxpayer and his colleague.

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In fact, they appear to have had just a simple verbal agreement that they would pay half of the costs and share half the property. The fact that there was no formal agreement is indicative of a short-term relationship and not a long-term capital investment.

Neither the Taxpayer nor his colleague had any intention of ever residing in the property.

Prior to the Taxpayer deciding to enter into this transaction with his colleague, property prices had been rising strongly in Hong Kong and many private individuals were speculating in property transactions. Shortly after the acquisition, the property market declined and did not recover for some years. It was just beginning to recover at the time when the Taxpayer and his colleague decided to sell the property.

All of these objective factors point towards the intention that this was a short-term investment and not a long-term capital investment.

We have taken due note of the fact that the Taxpayer either intentionally or incidentally would have appeared to have kept his options open so far as taxation was concerned by not registering his venture in the nature of trade as a business. However, we do not feel that his failure to obtain a business registration certificate and to file profits tax returns is sufficient to negate all of the other facts.

For the reasons given, we find as a matter of fact that it was the true intention of the Taxpayer to enter into a venture in the nature of trade. Accordingly, we allow this appeal. As it is not practical or possible for us to make the appropriate financial adjustments to the personal assessment of the Taxpayer for 1985/86, we refer the assessment appealed against back to the Commissioner with an order that it be reduced or amended as appropriate to make due allowance for the loss suffered by the Taxpayer.

As the only assessment before us is the personal assessment for the year 1985/86, it is neither appropriate nor within our powers to make other orders or directions. It would however appear that the assessments made in previous years may also have been incorrect and that the Taxpayer may have made incorrect returns and statements. It is for the Commissioner to look into previous years and make such decisions as he may consider appropriate in all of the circumstances.