

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D61/97

Profits tax – profit derived from sale of property – whether assessable to profits tax.

Panel: Robert Wei Wen Nam SC (chairman), Vernon F Moore and Michael Neale Somerville.

Date of hearing: 11 July 1997.

Date of decision: 30 September 1997.

The profits tax assessment of 1992/93 and 1993/94 concern the profits derived from the sale of two properties. The main grounds of appeal are that the taxpayer acquired the subject properties, not with the intention of disposing of them at a profit, but as long-term investments for the purpose of providing accommodation for her two children, that the subject properties were capital assets, that their acquisition and disposal did not constitute an adventure in the nature of trade and that profits derived from their disposal are capital gains and are not subject to profits tax. The Board found that the taxpayer was a credible witness and a person of means and that she had no history of trading. The Board found that the surrounding circumstances consistent with the taxpayer's stated intention.

Held:

The taxpayer acquired the subject properties as long-term investments for the purpose of providing accommodation for her daughter and her son. The circumstances of her children prompted her to give practical assistance. In the end the circumstances of her children did not materialize as anticipated. The subject flats were not needed and were sold. The circumstances disclose no characteristics of a trade or of an adventure in the nature of trade.

Appeal allowed.

Cases referred to:

Simmons v CIR 53 TC 461 at 491-2

All Best Wishes Ltd v CIR 3 HKTC 750

Cunliffe v Goodman [1950] 2 KB 237 at 253

K A Lancaster for the Commissioner of Inland Revenue.

Neil Thomson for the taxpayer.

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Decision:

Nature of appeal

1. This is an appeal by an individual (the Taxpayer) against the profits tax assessments raised on her for the years of assessment 1992/93 and 1993/94 as revised by the determination of the Commissioner of Inland Revenue dated 16 September 1996. She contends that the profits derived from the sale of two properties (the Subject Properties) are capital gains and therefore not assessable to profits tax.

Facts not in dispute

2. The particulars of the Taxpayer's acquisition and disposal of the Subject Properties are as follows:

| Property | Date of acquisition (assignment) | Purchase Cost \$ | Date of Disposal | Sale proceeds \$ |
|-------------------------|---|----------------------------|-------------------------|----------------------------|
| Garden A, District B | | | | |
| Flat C | 3-10-1991 | 7,990,000 | 19-11-1992 | 10,600,000 |
| Flat D | 30-9-1991 | 8,250,000 | 26-7-1993 | 14,380,000 |

The Taxpayer entered into agreements for sale and purchase dated 26 September 1991 and 21 September 1991 to purchase Flat C and Flat D respectively after the issuance of the occupation permit.

3. The acquisitions of the Subject Properties were financed by the following mortgage loans:

| | Amount of Loan \$ | Repayment Terms |
|--------|-----------------------------|---|
| Flat C | 6,392,000 | 144 monthly instalments each of \$79,183 |
| Flat D | 6,160,000 | 180 monthly instalments each of \$68,092 |

The Taxpayer was able to finance the repayments.

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4. The assessor considered that the profits derived by the Taxpayer from the sale of the Subject Properties were trading profits. On 8 June 1995, he raised profits tax assessment for the year of assessment 1992/93 and 1993/94 on the Taxpayer as follows:

| Year of Assessment 1992/93 | \$ |
|-----------------------------------|----------------|
| Estimated Assessable Profits | 2,080,500 |
| Tax Payable thereon | <u>312,075</u> |
| Year of Assessment 1993/94 | |
| Estimated Assessable Profits | 5,265,000 |
| Tax Payable thereon | <u>789,750</u> |

5. On 7 July 1995, the Taxpayer lodged an objection against the assessments by filing a letter of objection which is to the following effect:

5.1 She was writing to object formally to the assessments.

5.2 A friend gave her a brochure for the Garden A apartments. She viewed them and liked the layout, the view and the facilities offered. It occurred to her that she should buy one because properties on Road E do not come up very often. It would be convenient for her daughter and her family to live in it. Her grandchildren visited her daily. Her son-in-law was about to leave government service and they would no longer have a government apartment to live in. Having bought Flat D, a friend advised her that it would be unfair if she did not also buy one for her son who was planning to return to Hong Kong from Country F to work. After some careful consideration, she decided to buy another one, that is, Flat C. She had to make quick decisions on both apartments as they were in great demand. Besides, she was planning a trip to Country F and did not have time to consult her children in detail about the apartments.

5.3 After completion of the purchase, she showed her daughter the apartment she could have. However, she was not very keen on it. Her plans had changed as her husband would be remaining for the time being in government service and they did not need the apartment. After that she tried to let Flat C but could not find a tenant. Most people wanted to buy and not to rent the apartment. In the winter of 1992 she had an offer to buy Flat C and she accepted thus lessening her financial burden.

5.4 In June 1993 her son Dr G came back to Hong Kong to discuss his contract with University H – contract to work at Hospital I, District J. She showed him Flat D. He liked it but said it was too far from District J and it would be inconvenient to travel daily to work. He would like somewhere in District J or District K. After that she put Flat D on the market to let or to sell. A buyer quickly made an offer and it was sold.

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6. In reply to the assessor's enquiries and by a letter dated 3 November 1995 and addressed to the assessor, O Ltd, the then representative of the Taxpayer (the representative), made further representations concerning the acquisition and sale of the Subject Properties which read as follows:

6.1 'Flat D was thought to be suitable for her daughter and son-in-law (Mr P) who were in Hong Kong living in government quarters. The son-in-law was known by our client to be planning to leave government service. Our client kept the property vacant for them but the daughter did not like it even though she did not see it until after her husband was persuaded by the government to stay in service for a further year. She then disposed of the property when she was able to in June 1993.'

6.2 'Flat C was intended for our client's doctor son who was then in Country F but intended to move to Hong Kong. He eventually came to Hong Kong and was employed in Hospital I in District J and he also decided the property intended for him was not suitable in the circumstances being too far removed from his place of employment. The property was disposed of in November 1992.'

6.3 'Our client who is a person of sufficient means to finance these property arrangements was anyway unable to rent the properties at what she considered was a fair rental and preferred to keep them vacant.'

7. The Taxpayer confirmed that the net profits derived from the sale of the Subject Properties are as follows:

| | |
|--------|-------------|
| Flat C | \$1,375,641 |
| Flat D | \$4,533,294 |

8. Madam Q and Mr P, the Taxpayer's daughter and son-in-law, in a letter dated 12 March 1996, and addressed to the Inland Revenue Department, stated as follows:

'Mr P is a diplomat of Country F and was seconded to the Hong Kong Government in 1988. This secondment was expected to last for four years until April 1992. At the end of this secondment P would normally have been posted back to Country F by the Country F foreign office. However, as E had been working in the Solicitors' Firm L since 1984 and had become a partner of the firm in April 1991, we were concerned to try to stay in Hong Kong longer. The Taxpayer was aware of this and also that if P left the foreign office and the Hong Kong Government, we would no longer be able to continue living in the accommodation provided for our use in District M by the Hong Kong Government. The Taxpayer told Madam Q that she was buying an apartment at Garden A with the intention that we could live there if we had to move out of our then accommodation. In the event, P's secondment was extended for a

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further year until April 1993. In April 1993 SB left the employ of the Hong Kong Government and went on unpaid leave from the foreign office.

Although the Taxpayer had bought an apartment in Garden A for our use, we did not in the end live there. This was for a number of reasons. On a close inspection of the Garden A apartment we did not particularly like it and we were becoming increasingly tired of living in the District M area. Further, the Taxpayer was not able to offer us the apartment rent free. Also, we were optimistic about owning property in Hong Kong as an investment and found a property to buy ourselves in Road N ... We lived in Road N after moving out of the Government provided apartment in District M until the summer of 1995 ...'

9. The representative provided the following information in respect of Mr G, the Taxpayer's son:

- (a) Mr G was employed jointly by Hospital I and University H as a lecturer. He was first employed in October 1993.
- (b) The properties owned by Mr G were used as follows:

| | Date of Purchase | Date of Sale | Usage | Period |
|-----------------------|-------------------------|---------------------|------------------|--|
| Flat O, District V | 18-7-1985 | 5-7-1993 | rental vacant | 18-7-1985 to 31-8-1991 1-9-1991 to 5-7-1993 |
| Flat P, Road W | 3-7-1992 | - | rental | 3-7-1992 to present |
| Flat Q, District K | 9-8-1993 | - | own residence | 9-8-1993 to present |

10. The assessor considered that the assessments should be revised as follows:

Year of Assessment 1992/93

| | |
|---------------------|----------------|
| | \$ |
| Assessable Profits | 1,375,641 |
| Tax Payable thereon | <u>206,346</u> |

Year of Assessment 1993/94

| | |
|--------------------|-----------|
| | \$ |
| Assessable Profits | 4,533,294 |

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Tax Payable thereon

679,994

11. By her determination dated 16 September 1996 the Commissioner of Inland Revenue determined the objection against the Taxpayer and revised the assessments as shown in paragraph 10 above.

Grounds of appeal

12. The Taxpayer appeals against the assessments as revised. The main grounds of appeal are that the Taxpayer acquired the Subject Properties, not with the intention of disposing of them at a profit, but as long-term investments for the purpose of providing accommodation for her two children, that the Subject Properties were capital assets, that their acquisition and disposal did not constitute an adventure in the nature of trade and that profits derived from their disposal are capital gains and are not subject to profits tax.

Onus of proof

13. The onus of proving that the assessments appealed against are excessive or incorrect is on the Taxpayer (see section 68(4) of the IRO).

Relevant legal principles

14. The legal principles that are applied include the following:

14.1 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? Often it is necessary to ask further questions: a permanent investment may be sold in order to acquire another investment thought to be more satisfactory; that does not involve an operation of trade, whether the first investment is sold at a profit or at a loss ... What ... is not possible is for an asset to be both trading stock and permanent investment at the same time, nor to possess an indeterminate status – neither trading stock nor permanent asset. It must be one or other ... (per Lord Wilberforce in Simmons v CIR 53 TC 461 at 491-2).

14.2 Frustration of a plan for investment, which compels realisation, even if foreseen as a possibility, surely cannot give rise to an intention to trade (Ibid at 494).

14.3 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. 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

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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 (per Mortimer J in All Best Wishes Limited v CIR 3 HKTC 750 at 771).

Parties and representatives

15. The hearing of this appeal took place on 11 July 1997. Mr Neil Thomson appeared for the Taxpayer on the instructions of Mr R, Solicitor and Mr S, tax consultant, of T Limited, a management services company, whereas Mr KA Lancaster, senior assessor, appeared for the Commissioner of Inland Revenue.

Evidence

16. The Taxpayer gave evidence for herself. No other witness was called. The Taxpayer's evidence in chief comprised a typed statement clarified by viva voce evidence. The following is a summary of her evidence.

In chief

16.1 She lives in Road E, Hong Kong. She has two children, a son Dr G who is now aged 36 and a daughter Mrs Q who is now aged 38. Her son is now employed at Hospital I in District J. Her daughter now lives with her husband in Country F. Both her children were born and brought up in Hong Kong.

16.2 She bought her present home in 1960 after the death of her husband. She built her other house on an adjacent site in Road U about 30 years ago and the rental from this house provides her with income. She has refused many offers for the sale of this property, because she wanted it for long-term investment. A hundred million dollars has been offered for it and she would still not wish to sell.

16.3 In September 1991 she bought the two flats in question.

16.4 Her daughter was a solicitor with Solicitors' Firm L. She was married to Mr P who is a diplomat of Country F and at that time he had been seconded to the Hong Kong Government. He had been appointed in 1988 and in the normal course of events this secondment would have lasted until April 1992. They lived with their two children in a flat in District M provided by the Hong Kong Government. As part of his employment he was entitled to take up to two years unpaid leave and he had planned to take this leave when his secondment to the Hong Kong Government expired for the purpose of writing a book. She did not formally discuss the question of accommodation with him but she knew that they would have to find somewhere to live.

16.5 Her son had then qualified as a doctor and was working in Country F. He would come to Hong Kong frequently when he could obtain leave from his employers. He had indicated to her that he intended to come to Hong Kong to practise which he eventually did. She wanted to encourage him in this intention.

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16.6 She had previously helped her son purchase a flat in District V in July 1985 as an investment. That flat was then let and the rent was sufficient to discharge the mortgage payments. She provided the initial deposits and paid the shortfall of any mortgage payments. She also made such an offer to her daughter but she did not want a flat in District V. Instead she gave her daughter a cash present so as to be fair.

16.7 In September 1991 a friend gave her a brochure announcing the sale of new flats of Garden A, District B. She was interested as flats in the Road E are rarely available. She went to see the flats. She liked the layout and the size. It seemed to her that a flat in the building would be very suitable for her daughter. Her grandchildren used to come to visit her almost everyday and it would be nearer to her home. She knew that her son-in-law was intending to take unpaid leave and would have to give up the flat in District M which meant that they would have to find alternative accommodation. On her daughter's income they could probably only afford a much smaller flat than the one they were living in. If they paid her not the market rental but whatever they could afford they could live in a larger flat than they would otherwise be able to. Her daughter had been brought up living in decent sized accommodation and she knew that her daughter would not like living in a small flat with her children. One alternative would be for her daughter, her husband and the two children to move in with her but it would cause some inconvenience to her and to them. As for the question of her daughter paying, not the market rental, but whatever they could afford, she was sure she raised it with her daughter. She was expecting her son to do the same. Although she could let them live rent-free, she did not want them to develop a habit of depending on her entirely.

16.8 She decided to buy the flat. Everything was done in a great rush because the sellers were eager to get out before the completion date which was due very soon. Her agent told her that if she did not decide, the vendor would take another buyer's offer. The sale was made by a confirmor who wanted a decision immediately. The sale and purchase agreement for the purchase of Flat D was signed on 21 September 1991.

16.9 She told her daughter what she had done. Her daughter said that she was too busy to come and visit the flat and she did not in fact inspect the flat until later. She paid the deposit from her own resources and also paid the monthly instalments.

16.10 She knew that her son intended to return to Hong Kong and she wanted to encourage him. Her friend said that it was unfair not to buy a flat for her son also. So she bought Flat C and the sale and purchase agreement for the purchase was signed on 26 September 1991. She paid the initial deposits and the monthly instalments. She was able to pay this from her own resources.

16.11 Her son-in-law's contract was extended until April 1993. She did not want to let the flats because they were intended for the use of her children and she could afford to pay the mortgage instalments.

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16.12 Her daughter eventually decided that she did not want to stay in the flat. She told the Taxpayer that they wanted to buy a house of their own and did not want to stay in District M. In November 1992 her daughter purchased a house in Road N, and, as the flat in Garden A was no longer required, she decided to sell one of them. She sold Flat C on 19 November 1992 as she wanted to keep the better property. Her daughter decided that she did not want the flat sometime in summer 1992. For three or four months she tried to let Flat D which commanded better rental because it was on a higher floor. She did not succeed in letting. There were very few enquiries and a casual offer about \$15,000 lower than she intended to get. She sold Flat C on 20 November and kept Flat D because Flat D was better, higher up and had a better view. It could see Kowloon while Flat C had no such view. Although she bought one for her daughter and one for her son, it was not fixed that he could only have Flat C, so when she had to sell one, she sold the lesser one and kept the better one. Her intention at that time was that Flat D was for her son.

16.13 Her son had been discussing returning to Hong Kong with Hospital I in District J. The flat in District V suddenly became vacant in 1991 but could not be rented. On her advice he decided to sell the flat which she had purchased for him in July 1985 and reinvest in a flat in Road W which the previous owner's employer agreed to lease back. She considered this to be a better investment than the flat in District V. The flat in Road W was purchased in July 1992 and after some difficulties the flat in District V was sold in July 1993.

16.14 By July 1993 her son had decided to join Hospital I in October 1993. He came to Hong Kong and she showed him the flat. He told her that he wanted to live close to the hospital. It was a long journey to make to the flat, particularly if he had to work late. The job at Hospital I did not provide accommodation but included a rent allowance which could be used to pay mortgage instalments. He found a house in District K which was suitable for his family. He bought the house in August 1993. She helped him arrange finance. As the remaining flat in Garden A was no longer required she sold it in July 1993 after having first tried to let it.

16.15 She did not buy the flats in Garden A with the intention of re-selling them at a profit. She bought them for the purpose of providing accommodation for her son and daughter.

In cross-examination

16.16 Before she bought the apartment, her daughter and son-in-law had told her that he would not be staying on with the Country F government. Her daughter wanted to stay along with her job in Solicitors' Firm L. Her husband always knew he had to be sent back to Country F one day but while her daughter was working here, he agreed she should carry on with her job because she was doing a very good job here and had interest in her work, chance of becoming a partner, which she did.

16.17 Her daughter eventually bought a town house in Road N. That was after she had bought the flat, after her son-in-law had got an extension. A partner of Solicitors' Firm

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L told her daughter that if one stayed in Hong Kong, one must own one's own property. Previously to that, her daughter and son-in-law had said they did not want to own any property in Hong Kong, otherwise she would not, need not have come in to help them.

16.18 They did not specially ask her to buy any property for them. She was a disappointed mother. She was a single parent from a very early stage, and has taken everything onto her shoulder.

16.19 She had purchased property for her son as a graduation present. She did not give her daughter a graduation present when she graduated. Her daughter was living in Country X and she phoned her to say that she had decided to buy an apartment for her son in District V, and would like to do the same for her. Her daughter said no, no, thank you, not District V. So in lieu she gave her a cash present which bought her a diamond necklace and some watches.

16.20 Her daughter was aware that she was buying the flat. She said nothing. She did not commit herself either way. Later on when she viewed the flat, she said she did not like it; she had got fed up with District M getting so crowded.

16.21 The decision had to be made on day one. The question was either she missed the two flats or she had them so she could let them live there.

16.22 She agreed when it was put to her that she was not concerned when the children decided not to live there, because she felt she could rent them out.

16.23 One of the reasons why she decided to buy was because flats did not come up very often in that area. Less chance of buying them if her children were not going to live in them because there would be no urgency then. She might have decided to buy for rental if she had been attracted.

16.24 She roughly had some indication from her daughter's friend who owned an apartment in that block. He said he knew someone letting the apartment on the 15th floor for \$55,000. That was why she thought the \$50,000 or so mentioned by people for her flat was ridiculously low.

16.25 It could be that she told her agent that either of the two flats could be let, but she should be letting Flat D which would fetch higher rent. She only needed one flat for her son.

16.26 She did not employ anybody specific such as having a contract, but she had various agents phoning her wanting to know if she would sell. Her answer was she was not selling but please find her a tenant. She did not have a contract with any one agent. Right after completion, agents were ringing her, 'You can sell it, we can get you a profit.' She said, 'No, I did not buy for a profit, I bought for my children.' Before her daughter decided she did not want the flat, she could not even let. She did not have to go to the agents because they were constantly ringing her. She waited for two months to rent, almost every other day they rang her, asking do you want to sell, do you want to sell.

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Findings and reasons

17. The Taxpayer gave her testimony in a straightforward and unhesitating manner. Having heard her and viewed the circumstances of the case, we have no hesitation in saying that she is a credible witness and we accept the truth of her evidence summarised above.

18. The Taxpayer is a person of means but has no history of trading. She bought her present home in Road E in 1960 and built her other house on an adjacent site about thirty years ago. A hundred million dollars has been offered for it and she still would not wish to sell (see paragraph 16.2 above).

19. In September 1991 she bought the Subject Properties Flat D and Flat C. She paid the deposits and monthly instalments from her own resources (see paragraphs 16.9 and 16.10 above).

20. With regard to Flat D, apart from the fact that the building was near to her home in Road E, which would be convenient as her grandchildren visited her almost everyday, she knew that her son-in-law was intending to take unpaid leave and would have to give up the flat in District M which meant that they would have to find alternative accommodation. On her daughter's income they could probably only afford a much smaller flat than the one they were living in. If they paid her not the market rental but whatever they could afford they could live in a larger flat than they would otherwise be able to. She raised with her daughter the question of paying only whatever she could afford. She was expecting her son to do the same with regard to the other flat. Although she could let her children live rent-free, she did not want them to develop a habit of depending on her entirely (see paragraph 16.7 above).

20. She decided to buy Flat D. Everything was done in a great rush because the sellers were eager to get out before the completion date which was due very soon. The decision had to be taken on day one. Either she was going to miss the flat or she was to have it so she could let her daughter live there. The same applied to the other flat (see paragraphs 16.8 and 16.21 above). The sale and purchase agreement for the purchase of Flat D was signed on 21 September 1991. Her daughter knew about the purchase, but was too busy to view the flat until later. She did not commit herself either way (see paragraph 16.20).

21. The Taxpayer knew that her son intended to return to Hong Kong from Country F where he was working as a doctor. She wanted to encourage him in this intention and also to be fair to him, so she bought Flat C, and the sale and purchase agreement for the purchase was signed on 26 September 1991 (see paragraph 16.10 above).

22. The Taxpayer did not let out the flats because they were intended for the use of her children (see paragraph 16.11 above).

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23. Eventually in the summer of 1992, her daughter decided that she did not want to live in the flat. In November 1992 her daughter purchased a house in Road N. The Taxpayer only needed one flat for her son, so she sold Flat C on 19 November 1992 as she wanted to keep Flat D which was better, higher up and had a better view. Before the sale, she tried to let either of the flats, although she preferred to let Flat D which would fetch higher rent. She did not succeed in letting (see paragraphs 16.12, 16.25 and 5.3 above). In selling Flat C and keeping Flat D, she intended that Flat D should be for the use of her son (see paragraph 16.12 above).

24. By July 1993 her son had decided to join Hospital I in October 1993. He came to Hong Kong and she showed him the flat. He declined it because it was too far away from work. He found a house in District K which was suitable for his family. As Flat D was no longer required, she sold it in July 1993 after having tried to let it.

25. The Taxpayer stated that she did not buy the flats with the intention of re-selling them at a profit and that she bought them for the purpose of providing accommodation for her children (see paragraph 16.15 above). We find the surrounding circumstances of the case consistent with her stated intention.

26. We agree with Mr Thomson when he submitted the following in conclusion:

26.1 This was a purchase which she could afford. A point which is not challenged.

26.2 The circumstances of her children prompted her to give practical assistance.

26.3 In the end the circumstances of her children did not materialise as had been anticipated. The flats were not needed and were sold.

26.4 None of this discloses characteristics of a trade or of an adventure in the nature of trade.

27. We further find as follows:

27.1 The Taxpayer acquired the Subject Properties as long-term investments for the purpose of providing accommodation for her daughter and her son.

27.2 Her daughter declined Flat D as her accommodation and the relevant investment purpose was frustrated.

27.3 Flat D was considered by the Taxpayer a better investment than Flat C. The frustration of her daughter's investment resulted in the sale of Flat C so that Flat D was held for the purpose of providing accommodation for her son.

27.4 Her son declined Flat D as his accommodation and the investment purpose was again frustrated. The frustration resulted in Flat D being sold.

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28. There was some discussion as to whether the Taxpayer's intention at the time of acquisition was tentative, provisional and exploratory, in the sense of those words in Cunliffe v Goodman [1950] 2 KB 237 at 253. We are of the view that it was not. Unlike the landlord in that case who was reserving her decision until she got to a stage where she could decide whether to proceed with the project, the Taxpayer here simply made her decision and bought the Subject Properties for the use of her children. In our view, there was nothing tentative, provisional or exploratory about it. It is true that she met with frustration, but that is another matter.

29. The representative's letter in paragraph 6 above suggests that Flat D was intended for the daughter until it was sold, while Flat C was intended for the son until it was sold, leaving out any reference to the substitution of Flat D for Flat C as a residence for the use of her son. We accept Mr Thomson's submission that that was a mistake and should be disregarded. Mr Lancaster very properly did not seek to build any argument on that part of the letter.

30. It follows that this appeal succeeds and that the assessments in question (as revised) are hereby annulled.

31. It remains for us thank both Mr Thomson and Mr Lancaster for their able arguments.