Case No. D63/01

Profits tax – property – whether investment or trade.

Panel: Ronny Wong Fook Hum SC (chairman), Samuel Chan Yin Sum and David Lam Tai Wai.

Date of hearing: 24 May 2001.
Date of decision: 6 August 2001.

The taxpayers bought and sold a number of properties. One of the properties (the property) was sold with loss. The taxpayers claimed that the property was part of their trading stock and thus the loss being trading loss and deductible.

Held:

The Board accepted that the property was financed in part by overdraft facilities. Furthermore, the taxpayers bought another property after they bought the property. Though they let the property out, it was for lessening their interest burden. The Board found that the property was bought for trading purpose.

Appeal allowed.

Cases referred to:

Lionel Simmons Properties Ltd v Commissioner of Inland Revenue 53 TC 461
All Best Wishes Ltd v Commissioner of Inland Revenue 3 HKTC 750

Yeung Siu Fai for the Commissioner of Inland Revenue.
Taxpayers in person.

Decision:

Background

1. The Taxpayers ('Mr A' and 'Mrs A') are husband and wife. At all material times, Mr A was a building service engineer employed by the Government whilst Mrs A was employed by Organization B as an assistant finance manager. Their earnings during the relevant years were as follow:

Year ended	Mr A	Mrs A	Total
	$	$	$
31-3-1997	843,854	505,039	1,348,893
31-3-1998	959,471	564,768	1,524,239
31-3-1999	1,030,029	625,511	1,655,540

2. In August 1990, Mr and Mrs A purchased a flat at Housing Estate C ('Property 1') and used the same as their residence.

3. By an agreement for sale and purchase dated 20 November 1995, Mr and Mrs A purchased as joint tenants another flat at Housing Estate C ('Property 2') for $3,650,000. The purchase was financed by a mortgage loan extended by Bank D.

4. Shortly before the purchase of Property 2, Mr and Mrs A sold Property 1.

5. By a provisional agreement for sale and purchase dated 21 May 1996, Mr and Mrs A purchased a flat at Housing Estate E ('Property 3') for $4,750,000. The purchase was supported by:

(a) an overdraft of $450,000 extended by Bank F which was repayable on demand; and

(b) a loan of $3,325,000 extended by Bank G under its home investment plan. The loan was repayable by 252 monthly instalments of $29,412.32.

6. By a tenancy agreement dated 17 October 1996, the Taxpayers let Property 3 out to a tenant for two years at a monthly rental of $22,000. The tenancy was terminable ten months after the inception of the tenancy by two months' notice. The option was not exercised but the amount of rental was reduced in February 1998 to $18,500 per month.

7. By a provisional agreement dated 3 March 1997, Mr and Mrs A purchased a flat at Housing Estate H ('Property 4') for $4,360,000. This purchase was supported by a $3,052,000 loan extended by Bank I repayable by 240 monthly instalments of $27,953.

8. Company J was a joint venture company between the couple and one Ms K. In June 1997, Company J purchased a flat at Housing Estate L ('Property 5'). Company J sold Property 5 in August 1997. It is common ground that Property 5 was purchased and sold in the course of Company J's property trading business.

9. In October 1997, Company J purchased a flat at Housing Estate M ('Property 6'). Company J sold Property 6 by a provisional agreement for sale and purchase dated 1 January 1999. It is also common ground that such purchase and sale were effected in the course of Company J's property trading activities.

10. By an agreement for sale and purchase dated 12 March 1998, Mr and Mrs A sold Property 2 for $4,880,000. The family moved to live in a third flat at Housing Estate C ('Property 7') which they purchased by an agreement for sale and purchase dated 4 November 1998 for $3,500,000. This purchase was financed by a loan of $2,450,000 extended by Bank N.

11. At about the same time, Mr and Mrs A sold Property 3 for $3,830,000 by a provisional agreement for sale and purchase dated 30 October 1998. In response to the assessor's enquiry, Mr and Mrs A stated in May and July 1999 that:

(a) 'Trading' was the intended or actual usage of Property 3.

(b) They sold Property 3 in order 'to cut loss' as they 'can't afford mortgage payment.'

(c) They sustained a loss of $1,636,743.51 in relation to this property.

12. In about May 1999, Mr and Mrs A purchased a flat at Housing Estate O ('Property 8') as their family residence. They sold Property 7 for $4,180,000.

13. By a provisional agreement for sale and purchase dated 27 November 1999, Mr A purchased a fourth flat at Housing Estate C ('Property 9') for $2,120,000. The purchase was subject to a then subsisting tenancy over Property 9. It is not disputed between the parties that Mr A purchased this flat for trading purposes.

14. By an agreement for sale and purchase dated 25 September 2000, Mr and Mrs A sold Property 4 for $2,282,000.

15. There are two issues before us. The first relates to an application by Mr and Mrs A for extension of time in relation to their notice of appeal. They explained that their delay was attributable to the birth of their child on 2 December 2000. Their domestic helper was of little assistance and Mrs A took time to recuperate. We are of the view that the delay is understandable. We extend time in their favour.

16. The second issue relates to the fiscal status of Property 3. This flat was purchased on 21 May 1996 for $4,750,000 and sold on 30 October 1998 for $3,830,000. Mr and Mrs A sustained a loss of $1,636,743.51 in the process. The Revenue says that Property 3 was capital in nature and any loss could not be allowed as trading loss. Mr and Mrs A contend that Property 3 was part of their trading stock. In correspondence with the Revenue, they further maintained that:

(a) ‘ Most of the fund in purchasing the property was supported by a bank overdraft ($600,000) facility and mortgage arrangement ($3,325,000). A short-term loan was arranged because we anticipated that the property as a trading stock could be sold out for a profit within a short period of time. This is a common business arrangement.’

(b) ‘ The property/stock...was purchased in May 1996...could not be sold out as we expected before October 1996. In October 1996, we decided to rent out the property with an understanding that demand for property attached with rent contract is also welcomed to our potential customers in the property estate (the most popular estate in Hong Kong). We at the same time had continuously put our property on the sales lists of the property agencies. Renting out the property is a business arrangement to reduce the high interest cost of the business...’

(c) ‘ ...renting out the property...was considered as a short-term and temporary arrangement to help to release our financial burden. We did not anticipate that we need to hold the property for long. However, our expectation did not come true and we needed to source additional financial assistance. You may aware [*sic*] that we had just purchased another property for residential purpose in March 1996. It was not possible for us to support the financial burden of two properties for a long term.’

(d) ‘ ...we had terminated the first rental contract with our tenant and immediately sold it out within three weeks. This shows our intention not using the flat “mainly used for letting purposes”.’

(e) ‘ [Property 3]...was the first trading stock of our property trading business. ...a number of property were purchased in the subsequent months as our stocks. Similar to other business, most of the funds in the property trading business were financed by short-term loan from bank.’

(f) '...A number of improvement works have been carried out in the property to improve and enhance the marketability...'. The total expenditure in this connection amounted to $96,220.

Sworn testimony of Mr and Mrs A before us

17. Mr A told us that:

(a) Expenditure was incurred in renovating Property 3 with the view of enhancing its sale potential. Such expenditure was not incurred with the view of letting the flat out on a long term basis. The floor of Property 3 was totally worn out. He wanted to touch up the flat for a speedy resale. He could not, however, produce any document in support of the alleged expenditure of $96,220.

(b) He engaged various real estate agents to assist in disposing of Property 3. There were offers from interested purchasers but the offers did not match his expectation. Company P was amongst the agents that he engaged. He did approach Company P for supporting evidence but Company P refused to help.

(c) As a result of the economic downtrun in 1997, he could not dispose of Property 3 within a short time. His initial plan was frustrated and he decided to let the flat out.

(d) Housing Estate E is a well known haven for property speculators. The subsistence of a tenancy would not restrict the marketability of Property 3. He himself bought Properties 4 and 9 subject to tenancies.

(e) In evidence in chief, he stated that his financial position was stable when he purchased Property 3. In cross examination, he asserted that his financial position was tight when he embarked upon the purchase of Property 3 – his first trading venture. He confirmed his financial position in July 1996 as follows:

	$	$
Monthly average income at July 1996	112,000	
Add: Rental income from Property 3	22,000	
Total monthly income		134,000
Less: Mortgage payment for Property 3	33,000	
Mortgage payment for Property 2	27,000	
Interest cost on overdraft facilities of $45,000 from Bank F	2,000	
Monthly repayment of the $450,000		

overdraft from Bank F	37,500	
Taxation payment reserved	20,000	
Alleged total monthly expenditure		119,500
Balance of cash		14,500

When pressed, Mr A conceded that he did not repay Bank F at the rate of $37,500 per month. There is also no evidence of payment being reserved for taxation.

(f) He embarked upon four property ventures comprising of Properties 3, 4, 5 and 6 within a period of 18 months. He could not afford these properties totalling about $13,600,000. He was under severe financial pressure and had to make substantial borrowings from various financial institutions.

18. Mrs A told us that:

(a) They did spend $96,220 re-decorating Property 3. This amount was spent in wall-papers, bath tubs and kitchen cabinets.

(b) Property 4 was put on the market for sale immediately after its purchase.

The applicable principles

19. The statement of principle by Lord Wilberforce in Lionel Simmons Properties Ltd v Commissioner of Inland Revenue 53 TC 461 at page 491 is well known:

> *'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?'*

20. We have also reminded ourselves of the often quoted directive of Mortimer J in All Best Wishes Ltd v Commissioner of Inland Revenue 3 HKTC 750 at 771:

> *'The intention of the taxpayer, at the time of the 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.'

21. There is no dispute between the parties that we should adhere to these principles in reaching our decision.

Our decision

22. Mr Yeung for the Revenue challenged strenuously the computation put forward by Mr and Mr A as to their available cash after the purchase of Property 3. Whilst we accept that there is no evidence of actual reduction of the $450,000 overdraft from Bank F, we are of the view some weight must be given to the fact that the acquisition was financed in part by an overdraft in assessing the capacity of the couple to hold Property 3 on a long term basis. We are of the view that the financial resources of the couple would be stretched had they intended to acquire Property 3 as a long term investment. They had to maintain a family consisting of themselves, a child born on 30 August 1994 and the parents of Mrs A.

23. We regard the acquisition of Property 4 in March 1997 as throwing important light on the intention of the couple in relation to Property 3. On the Revenue's case, the couple's intention to hold Property 3 on a long term basis was crystallised in October 1996 when they let it out on a two year lease. They decided five months later to embark upon their first property trade. On the couple's case, Properties 3 and 4 were part of their trading stock. They embarked upon such trading activity in May 1996 which activity was continued in March 1997. Given the state of the property market before the hand-over and their financial resources as described in the preceding paragraph, we are of the view that the probability favours the view that the couple, like a large section of our community at that juncture, was trying to make speculative gains by mustering all their available resources.

24. Mrs A impressed us as an honest witness. Mr A's evidence was tampered by his passion but we accept his overall credibility. We find that renovations were done to improve the marketability of Property 3. They did give instruction to estate agents to sell that flat but the offer price did not reach their expectation. The 17 October 1996 tenancy was a short-term measure to lessen their interest burden. This is reinforced by the option to terminate in the tenancy agreement. We accept their evidence that the subsistence of the tenancy had little impact on the marketability of that flat.

25. We attach little weight to Mr Yeung's argument that Mr and Mrs A did not register a business at the time when they purchased Property 3. At no time did they register a property

dealing business. Yet it is accepted by the Revenue that they traded in a series of other properties without such registration.

26. In these circumstances, we are of the view that the couple have successfully discharged their onus in demonstrating that Property 3 was part of their trading stock. We allow their appeal and discharge the assessment.