

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D65/95

**Profits tax** – sale of property of private company – intention at time of acquisition – ‘director’s quarter’ – declaration – whether intention genuine, realistic and realisable.

Panel: Denis Chang Khen Lee QC (chairman), Felix Chow Fu Kee and Ambrose Lau Hon Chuen.

Dates of hearing: 23, 24 and 25 May 1995.

Date of decision: 29 September 1995.

The taxpayer was a private company and sold one of its properties at a profit. As per the minutes of directors’ meeting, the property was acquired for use as ‘director’s quarter’. The Revenue argued that little weight should be placed on such self-serving documents.

Held:

The Board had to ascertain the intention of the taxpayer at the time of acquisition as a question of fact to be determined ‘upon the whole of the evidence’. Subjective intention had to be tested against objective facts; mere declarations of intention – particularly those of a self-serving nature – are of limited value since actions speak louder than words.

**Appeal allowed.**

Cases referred to:

Lionel Simmons Properties Ltd v CIR 53 TC 461  
All Best Wishes Ltd v CIR 3 HKTC 750

Tse Yuk Yip for the Commissioner of Inland Revenue.  
Lau Kam Cheuk for Messrs S Y Leung & Co for the taxpayer.

**Decision:**

1. The Taxpayer is Company A. The issue on this appeal is whether the surplus resulting from the sale by the Taxpayer of the property known as ‘Property B’ is chargeable to profits tax under section 14 of the Inland Revenue Ordinance (IRO).

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2. The onus of proving that the assessment appealed against is excessive or incorrect is on the Taxpayer. The Board must ascertain the intention of the Taxpayer in relation to Property B at the time of acquisition. As Lord Wilberforce puts it in Lionel Simmons Properties Ltd v CIR 53 TC 461 at page 491:

*‘Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of 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?...’*

3. Whether there was at the time of acquisition a genuine, realistic and realisable intention on the part of the Taxpayer to hold Property B as a capital asset is a question of fact to be determined ‘upon the whole of the evidence’. Subjective intention has to be tested against objective facts; mere declarations of intention – particularly those of a self-serving nature – are of limited value since actions often speak louder than words: see Mortimer J in All Best Wishes Ltd v CIR 3 HKTC 750 at page 771.

### **FACTS NOT IN DISPUTE**

4. The following facts are not in dispute:

- (1) The Taxpayer was incorporated as a private company in Hong Kong on 5 November 1985 and commenced business in March 1986. Its nature of business has been described in its profits tax returns up to the year of assessment 1990/91 as ‘commission agent’ and from the return for the year of assessment 1991/92 onwards it has been described as ‘commission agent and property investment.’
- (2) Since the commencement of business, the Taxpayer’s issued and paid-up share capital has remained at \$10,000 and its directors have been Mr C and his wife Madam D.
- (3) The Taxpayer is the registered owners of Property E. The Taxpayer has held Property E since it was acquired on 13 July 1987 at a consideration of \$700,000.
- (4) On 21 October 1991 there was assigned to the Taxpayer at a consideration of \$2,840,000 Property B. The Taxpayer for the purpose of financing the acquisition obtained from Bank F an increase of its general overdraft facility from \$1,000,000 to \$1,500,000 and a fixed loan of \$1,300,000. The bank loan was repayable by 83 monthly instalments of \$15,470 each.
- (5) By a provisional agreement for sale and purchase dated 13 November 1991 the Taxpayer agreed to sell Property B at a consideration of \$3,480,000 inclusive of furniture, fixtures and fittings. A formal agreement for sale and purchase

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was entered into on 20 November 1991 and the assignment deed was executed on 2 December 1991. The Taxpayer sold Property B through Company G, a property agent, to whom the Taxpayer paid a commission of \$32,000.

- (6) In its accounts for the year ended 31 March 1992, the Taxpayer disclosed that there was a gain on the disposal of Property B in the amount of \$468,259. The Taxpayer did not offer this amount for assessment. Included in the supporting schedule was a note that Property B was 'acquired as proposed director's quarter'.
- (7) In a letter dated 24 February 1993 the Taxpayer's representatives, ('the Representatives') furnished to the assessor a copy of the minutes of directors' meeting held on 16 September 1991 which stated inter alia that Property B would be acquired for use as 'director's quarter' (sic) and explained the reasons for the disposal of Property B as follows:

'The director Mr C intended to move into the new quarters with his brother, and the existing quarters may be sold out. Afterwards, his brother changed mind, because the building was rather noisy as it faced Road H especially in the night. Mr C had no choice but to dispose it and continued to reside at the existing quarter.'

- (8) The assessor did not agree that the profit derived from the sale of Property B was a capital gain and on 22 March 1993 the assessor raised on the Taxpayer the following profits tax assessment for the year of assessment 1991/92:

	\$
Profits per return	18,907
<b>Add:</b> Profit on disposal of Property	<u>468,259</u>
Assessable Profits	487,166 =====
Tax Payable thereon	80,382 =====

- (9) The Taxpayer through the Representatives, lodged an objection against the year of assessment 1991/92 in the following terms:

'Our clients are aggrieved by your assessment, as they carry on agency business. The property was acquired for director's new residence, and we are directed to lodge objection against the assessment for the year of

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assessment 1991/92 on the ground that the capital gain from disposal was considered as a trading gain. Our clients did not carry on the business of property dealing since incorporation.'

- (10) In correspondence with the assessor the Representatives stated, inter alia: '(Property B) was maintained in good living conditions. Our clients preferred it because it demanded minimum decoration work and was ready for occupation. Our clients only changed the steel window to aluminium window and carried out the house clearing by themselves.'
- (11) Apart from Property E and Property B the Taxpayer has not acquired any other properties.

5. Even a single isolated transaction can, depending on the circumstances, be a trading venture or an adventure in the nature of trade. The Revenue in the present case relies, among other things, on the relatively short period of time between acquisition and re-sale as one of the so-called 'badges of trade'. This is certainly an important factor to be taken into account although it is by no means conclusive of the matter. It is necessary to look closely at the whole of the evidence, including the circumstances giving rise to the re-sale, to determine whether the property in question was indeed as alleged by the Taxpayer a capital asset.

6. Oral testimony was given on behalf of the Taxpayer by Mr C. Mr I also gave evidence: he is Mr C's first cousin (referred to in the Representatives' correspondence as Mr C's brother'). Mr I was born on 6 May 1954 and is some seven years younger than Mr C.

### **SOME BACKGROUND FACTS**

7. Mr C and his wife Madam D are and were at all material times the only shareholders and directors of the Taxpayer. They have a 17-year old son. Neither the wife nor the son lives in Hong Kong, having emigrated to Canada some years back.

8. In fact the last time the wife stayed in Hong Kong for more than just a few days was in July 1991. She came back for the summer holidays on 1 July 1991 and left Hong Kong for Canada on 22 August 1991. Since then she has been back in Hong Kong only once, and that was towards the end of 1992, when she stayed for a few days over Christmas.

9. Apart from being a director of the Taxpayer Mr C is engaged in the garment manufacturing business and was at all material times and is a frequent traveller, spending much of his time outside Hong Kong on business trips and on visits to his family in Canada. While in Hong Kong he lives in Property E and has been doing so since the Taxpayer acquired Property E some eight years ago on 13 July 1987 for use as directors' quarters.

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10. Property E has two bedrooms and a gross floor area of about 1,100 square feet. It is and was at all material times also used as the business address of the Taxpayer. Mr C, however, is and was a director of other companies and during the year 1991/92 his usual place of work – when he was not travelling – was at Place J.

11. Mr I is not and has never been a director or a shareholder of the Taxpayer and does not and has never held any position in the company. He is a director of a company engaged in China trade and was at the time of the Taxpayer's acquisition of Property B engaged in the electronic business. He office was then in Place K.

12. According to their marriage certificate Mr I's occupation was that of an engineer and his wife that of a teacher. However at the time of acquisition of Property B his wife, Madam L, was working for an Austrian trading company in Hong Kong. Her office was in Place M. The couple was then living with their school-age daughter in a rented flat (Property N) paying some \$8,000 per month by way of rent.

### **EVIDENCE: SALIENT POINTS**

13. The evidence presented comprised, apart from some documentary evidence, the oral testimony of Mr C and Mr I. We summarise below the salient points which have emerged from the evidence given (without repeating, except for emphasis, the points already covered by the agreed facts or the background facts set out in paragraphs 7-12 above):

- (1) In about August 1991 Mr I, after consulting his own wife, had discussions with his cousin Mr C about acquiring a property for the purpose of their joint residence. Mr I's wife at the time expressed no objection to the idea.
- (2) Mr I's 2-year tenancy of Property N was due to expire in early March 1992 (with an option to renew). He could renew the tenancy or look for alternative accommodation. He chose the latter. He believed that his landlord would be willing to accept an early surrender if he should decide to move out before term date.
- (3) Mr I's first proposal to his cousin was that they should jointly purchase a flat on a 50/50 basis. Mr C did not agree but went along with Mr I's second proposal that the Taxpayer be used to purchase a suitable flat of some 2,000 square feet in area for their joint occupation.
- (4) The understanding reached was that Mr C would be primarily responsible for procuring the necessary finance. It was envisaged that Mr I would join the Taxpayer and inject a capital contribution of \$500,000 to \$1,000,000 to develop the Taxpayer's business and that he would become a shareholder of 50% of the company's share capital and that Property E would later be sold and the proceeds applied towards repayment of loan.

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- (5) Mr I was given the task of finding a suitable flat. He located Property B which was of some 2,000 square feet. The flat was in a building some 30 years old. Vacant possession was available on completion of purchase. Mr I informed his cousin of what he had found and together they visited the flat.
- (6) They both thought the price was quite low for a flat of that size and quickly decided that the flat should be purchased for the purpose they had agreed upon. Mr C told his wife of his plans. His wife had no objection.
- (7) A provisional agreement dated 7 September 1991 for the purchase of Property B was signed by Mr I. At the time the Taxpayer had not yet finalised the financing arrangements with Bank F. The initial deposit of \$100,000 was paid by way of a cheque from Mr I who decided to put down his wife's name in the provisional agreement as purchaser pending finalisation by the Taxpayer of the bank loan.
- (8) The Taxpayer did secure the bank loan. Under the bank's facility letter dated 3 October 1991 the Taxpayer's general overdraft facility was increased from \$1,000,000 to \$1,500,000 and in addition thereto a new loan of \$1,300,000 was made available by the bank on condition that additional security was provided. Such additional security was to include a legal charge on Property B. Property E was already charged to the bank for the overdraft facility. The bank also required a personal guarantee from Mr C and his wife.
- (9) On 21 October 1991 Madam L executed a nomination in favour of the Taxpayer to enable the Taxpayer to take up the assignment of Property B in its name. The transaction was completed on the same day with the aid of the financing provided under the facility letter, the Taxpayer becoming the mortgagor of the property as required by the bank.
- (10) After receiving the keys to Property B Mr I began to get ready the flat for occupation. It was agreed between him and Mr C that he and his wife should occupy the master-bedroom and their daughter the second bedroom. Mr C chose the third bedroom.
- (11) All the bedrooms had steel window frames except one which was fitted with aluminium window frames. Mr I engaged a contractor to replace the steel frames with aluminium frames at the cost of just over \$10,000. The written quotation supplied to Mr I was dated 26 October 1991 but prefabrication work had started off-site a little earlier, with one-site installation starting in the beginning of November 1991.
- (12) As a result of his visits to Property B at different times of the day (including evenings) Mr I discovered that the place was very noisy contrary to his earlier expectations. The noise pollution was particularly bad at night. Mr I's wife

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was particularly sensitive to noise. Mr I also discovered that there was a slight parking problem but it was noise pollution that was perceived to be critical.

- (13) On about 1 or 2 November 1991 new aluminium window frames were installed to the master bedroom. It was around this time that Mr I, after informing Mr C about the noise pollution problem, decided that he should not in all the circumstances ask his family to move into Property B but that the flat should be sold. Mr C was content to go along with Mr I's decision.
- (14) The provisional agreement dated 13 November 1991 signed by Mr I on behalf of the Taxpayer for the sale of Property B was entered into **after** the aluminium window frames had been installed to the master bedroom but **before** all the steel windows in one of the two other bedrooms had been property replaced.
- (15) There was a mismatch of one of the window panels which had to be rectified and which delayed the completion of works. This was reflected in a clause in the provisional agreement dated 13 November 1991 which in effect provided that the vendor had agreed to **complete** the proper installation of the aluminium windows of the bedroom nearest the front door.
- (16) Following the sale of Property B which was completed on 2 December 1991 Mr I was repaid all the monies which he had advanced, totalling almost \$200,000, in connection with the purchase. This included the sum of \$100,000 advanced by him in respect of the initial deposit.
- (17) Mr I subsequently succeeded in finding a suitable flat for himself and his family. This was Property O. Property O, which had a car park, was 1,450 square feet in size which was appreciably larger than the rented Property N but substantially smaller than Property B.
- (18) On 14 January 1992 Mr I purchased the Property O for \$3,420,000 in the joint names of himself and his wife. The purchase was financed from their savings and by means of a \$2,300,000 bank loan. The assignment took place on 18 February 1992 and he and his family moved into the flat in March 1992 upon the expiry of the tenancy of Property N.
- (19) Since the sale of Property B Mr I has not pursued his flat-sharing or joint investment arrangements with his cousin. It transpired that although his wife did not express any objection to his flat-sharing proposals when he first raised the matter with her he subsequently began to sense that she was not really too happy with the idea.

### EVALUATION & FINDINGS

14. Both Mr C and Mr I were subjected to detailed cross-examination. Despite some minor differences in detail or emphasis their evidence was in substantial agreement on

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the principal points. Their testimony, some of which was in response to questions from members of the Board, did succeed in giving a far fuller picture of the circumstances surrounding the acquisition and disposal of Property B than what was supplied to the assessor by the Taxpayer's representatives.

15. The Revenue quite rightly invited us to look at the objective facts and circumstances and the inherent probabilities when deciding the issues before us. Was it likely that these two families, who had never lived together before, would want to share a flat? If so why was there a change of mind? Why did they not attempt to get another flat for joint use? Why did they not implement their proposals for joint investment in the company? Had they the financial ability to carry out their alleged plans? etc.

16. In our judgment, however, there was in all the circumstances nothing inherently improbable about the alleged purpose of the acquisition, having regard in particular to the fact that Mr C's family had emigrated and he spent much of his time outside Hong Kong.

17. From the immigration records produced by the Revenue it is clear that Property B was acquired shortly after Mr C's wife left Hong Kong on 22 August 1991 practically for good. That was the last time – up to the date of the hearing – that she had ever spent her summer holidays in Hong Kong. She came to Hong Kong again in 1992 but that was only for a few days over Christmas.

18. The evidence shows that Mr C was willing to go along with his cousin's proposals because, among other things, it would be convenient for him to have somebody to look after him and a 'home' to go back to when he was not travelling abroad.

19. As regards financial ability we have little doubt that the alleged intent or purpose of acquisition of Property B was perfectly feasible. The Taxpayer owned a valuable asset in the form of Property E. It also had an income-earning capacity from its commission-agency business. Its overdraft facility which was increased from \$1,000,000 to \$1,500,000 was utilised to the extent of \$800,000, leaving \$700,000 available for draw-down in connection with the acquisition **plus** the new loan of \$1,300,000, making a total of \$2,000,000. Mr I advanced about \$200,000 and the balance of the money required for the purchase was provided by Mr C by way of shareholder's loans. The terms of repayment, with the bank loan spread out over 83 monthly instalments of \$15,470 each, were not onerous.

20. The very fact that Mr I and his wife were able jointly to purchase Property O at \$3,400,000 tends to support his evidence that he and his wife had sufficient savings from which he could make capital contributions to the Taxpayer company. He said he did not foresee any difficulty on the part of the Taxpayer or his cousin in meeting the Taxpayer's repayment obligations to the bank but that should it ever be necessary for him to chip in he would be willing and able to do so. His wife had a stable job with a salary in excess of \$20,000 per month.



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21. Mr I and his wife lived in Property O until 1994 – by which time its value had risen substantially – when they disposed of it at the price of \$5,600,000, re-purchasing a smaller flat in the same building on the 9/F where they have been residing ever since.

22. Mr I was understandably embarrassed to admit in the presence of his cousin that his change of plans was due in no small part to his respect for his wife’s sensibilities. Her sensitivity to noise pollution was chiefly responsible for his decision not to move into Property B; indeed noise pollution was the only reason he gave his cousin for his decision. He then quietly stopped pursuing the flat-sharing and related arrangements altogether when he realised that his wife despite her original indications was not too happy with the idea.

23. Mr C, for this part, was content to go along with his cousin’s change of plans. Since the whole idea of flat-sharing and related arrangements originated from Mr I in the first place it did not occur to Mr C to pursue the matter further if his cousin did not wish to do so. He was content, in his own words, to let the whole thing just ‘fade away’. He continued to live at Property E.

### CONCLUSION

24. Having seen and heard the witnesses and evaluated their testimony in the light of the whole of the evidence we are satisfied on balance that their evidence is basically reliable and worthy of credence. We find as facts the matters set out under paragraph 13 above as well as the matters referred to in paragraphs 19-23 in addition to the background facts.

25. We are satisfied on balance that Property B was not acquired by the Taxpayer with the intention of disposing of it at a profit but was acquired with the intention and for the purpose alleged to be held by the Taxpayer as a capital asset. In reaching this conclusion we have not relied on the statement of intention appearing in the purported minute of directors’ meeting of 16 September 1991 mentioned above. The Revenue rightly argued that little weight should be placed on such self-serving documents.

26. We are indebted to the Revenue’s representatives for the able and fair way they have argued this case. We venture to suggest that had the Taxpayer’s representatives supplied a fuller and more accurate picture to the assessor the present dispute might have been obviated.

27. On the facts we have found the appeal is allowed and we discharge the assessment.