Case No. D70/02

Profits tax – whether the sale of a property was trading in nature – it was crucial to ascertain the intention of the appellant at the time of acquisition of the property – the stated intention of the appellant was not decisive – actual intention had to be determined objectively – burden of proof on the appellant – definition of 'trade' – incumbent on the appellant to substantiate his contention – sections 2, 14(1) and 68(4) of the Inland Revenue Ordinance ('IRO').

Panel: Kenneth Kwok Hing Wai SC (chairman), James Julius Bertram and Douglas C Oxley.

Date of hearing: 4 June 2002.
Date of decision: 22 October 2002.

The appellant, a private limited company incorporated in Hong Kong, appealed against the determination of the Commissioner of Inland Revenue whereby the profits tax assessment for the year of assessment 1998/99 showing assessable profits of $38,759,409 with tax payable thereon of $6,201,505 was confirmed.

The appellant itself had three directors, who were also shareholders, namely Shareholder1, Shareholder2 and Shareholder3, each holding equal shares in it. The appellant claimed that the provision for diminution in the value of certain properties should be allowed as a deduction in computing its assessable profits.

The facts appear sufficiently in the following judgment.

Held:

1. Section 68(4) of the IRO provides that the onus of proving that the assessment appealed against is excessive or incorrect is on the appellant.

2. Section 2 defines 'trade' as including 'every trade and manufacture, and every adventure and concern in the nature of trade'.

3. Section 14(1) excludes profits arising from the sale of capital assets.

4. The Board reminded itself of what Sir Nicholas Browne-Wilkinson VC said in Marson v Morton [1986] 1 WLR 1343 at pages 1347 to 1349 and [1986] STC

463 at pages 470 to 471; what Lord Wilberforce authoritatively stated in Simmons v IRC [1980] 1 WLR 1196 at page 1199 and (1980) 53 Tax Cases 461 at pages 491 to 492; and the statement of the law by Orr LJ at pages 488 and 489 of the report in Tax Cases, which was approved by Lord Wilberforce as a generally correct statement (WLR at page 1202 and Tax Cases at page 495).

5. The Board also reminded itself of what Mortimer J, as he then was, said in All Best Wishes Limited v CIR (1992) 3 HKTC 750 at pages 770 and 771.

6. Shareholder1, Shareholder2 and Shareholder3 testified to the effect that the intention at the time of acquisition of Property A and Property B and at the time of acquisition of Property C was to acquire the properties for short term speculation. The Board accepted their testimony on this point and found in favour of the appellant on this factual issue. The Board also found that when they realized that they could not sell any of the three properties in the short term at a profit, they decided to and did live in the houses until such time as the properties could be sold at prices acceptable to them.

7. If the three properties had not been acquired as trading assets, they could only have been used as residence since they were residential houses. There was no suggestion by the respondent or the appellant that any of them was acquired for rental income. It made little or no sense to leave them vacant for an indefinite period of time. Effectively, the Board was left with their being acquired for the residence of the directors-shareholders.

8. Shareholder1, Shareholder2 and Shareholder3 were and had been equal shareholders and the Board would have expected a house of about the same purchase price for each of them to live in. But there was a significant difference in that the purchase price of Property C ($25,000,000) was about 32% cheaper than the purchase price of each of the other two houses ($36,640,000). This factor weighed against acquisition of the three houses as capital assets. There was no reason why equal shareholders should have unequal quarters.

9. Another unequal treatment for equal shareholders was that the appellant contracted to acquire only two houses on 5 March 1998. It was some nine months later that the appellant contracted to acquire the third house, Property C, on 5 December 1998. The Revenue conceded that according to the financial statements of the appellant, the appellant could afford in March 1998 to buy three houses at the project where Property A and Property B were situated had the appellant so wished. The Board saw no reason why one of the three equal shareholders should have been left out for nine months. This was another factor weighing against acquisition as capital assets.

10. Records of electricity consumption in Properties A, B and C were an objective fact against the respondent's case of capital assets. This was because:

    (a) The assignment of Property A was dated 9 June 1998. The consumption of electricity had been insignificant until the reading in February 1999 which recorded consumption of 718 units of electricity. If Property A had been acquired for the residence of one of the shareholders, it was improbable for Property A to have been left vacant and without any decoration work for about six months from 9 June 1998 to December 1998.

    (b) The assignment of Property B was also dated 9 June 1998. The consumption of electricity had been insignificant until the reading in June 1999 which recorded consumption of 419 units of electricity. If Property B had been acquired for the residence of one of the shareholders, it was improbable for Property B to have been left vacant and without any decoration work for about ten months from 9 June 1998 to April 1999.

    (c) The assignment of Property C was dated 5 February 1999. The consumption of electricity had been insignificant until the reading in August 1999 which recorded consumption of 657 units of electricity. If Property C had been acquired for the residence of one of the shareholders, it was improbable for Property C to have been left vacant and without any decoration work for about four months from 5 February 1999 to June 1999.

11. Shareholder1 was the shareholder who lived in Property C. The provisional agreement to acquire Property C was dated 5 December 1998. Prior to that, by a formal agreement dated 8 October 1998, Shareholder1 and another person contracted to buy another house at the same project as Property C. If the intention had been to acquire quarters for Shareholder1, it would have been more probable for one of the following two scenarios to have occurred:

    (a) The appellant would have been the contracting party, in place of Shareholder1 and another, to acquire the other house [possibly with one more house, since the other house was smaller than Property C and Property C was some 32% cheaper than Property A or Property B]. On this scenario, the appellant would not have contracted to acquire Property C.

    (b) The appellant would have contracted on about 8 October 1998, instead of 5 December 1998, to acquire Property C.

12. Shareholder3 was the shareholder who lived in Property B which was assigned to the appellant on 9 June 1998. The case of acquisition of Property B as director's quarters was inconsistent with the fact that in August 1998, Shareholder3 moved into a flat in the New Territories. He should have moved into Property B instead.

13. For reasons given above, the appellant had discharged the onus of proving that the assessment appealed against was excessive and incorrect.

14. The Board allowed the appeal and reduced the assessment appealed against to show assessable profits of $6,475,010 with tax payable thereon of $1,036,001.

Appeal allowed.

Cases referred to:

D11/80, IRBRD, vol 1, 374
Simmons (as liquidator of Lionel Simmons Properties Ltd) v Inland Revenue Commissioners [1980] 1 WLR 1196
All Best Wishes Limited v CIR 3 HKTC 750
Marson v Morton and Others 59 TC 381

Tsui Siu Fong for the Commissioner of Inland Revenue.
Daniel Kwok Wing Wah of Messrs Cheng, Kwok & Chang, Certified Public Accountants, for the taxpayer.

Decision:

1. This is an appeal against the determination of the Commissioner of Inland Revenue dated 8 February 2002 whereby the profits tax assessment for the year of assessment 1998/99 under charge number 1-1109369-99-7, dated 27 November 2000, showing assessable profits of $38,759,409 with tax payable thereon of $6,201,505 was confirmed.

The agreed facts

2. The following facts in the ' Facts upon which the determination was arrived at' in the determination are agreed and we find them as facts.

3. The Appellant has objected to the profits tax assessment for the year of assessment 1998/99 raised on it. The Appellant claimed that the provision for diminution in the value of certain properties should be allowed as a deduction in computing its assessable profits.

4. The Appellant is a private limited company incorporated in Hong Kong on 25 May 1990. At all relevant times, its authorised and paid up share capital was $1,500,000, divided into 1,500,000 shares of $1 each. The Appellant has since incorporation been carrying on a business of garments manufacturing and trading. The Appellant has three directors and shareholders, namely Shareholder1, Shareholder2 and Shareholder3, each holding 500,000 shares in it.

5. By two preliminary agreements both dated 5 March 1998, the Appellant purchased two three-storey houses at the same project (comprising G/F, 1/F, 2/F, roof and a car port), Property A and Property B, each at a consideration of $36,640,000. The gross floor area of the two properties was 3,523 square feet each.

6. To finance the purchase of Property A and Property B, the Appellant on 4 May 1998 took out a bank loan of US$4,514,963.88 (equivalent to HK$35,000,000) (' Loan 1') which was repayable by 84 monthly instalments of US$53,749.57 each. Property A and Property B were assigned to the Appellant on 9 June 1998.

7. By a provisional agreement dated 5 December 1998, the Appellant purchased a house, Property C, at a consideration of $25,000,000.

8. To finance the purchase of Property C, the Appellant on 22 January 1999 took out a bank loan of $5,000,000 (' Loan 2') which was repayable by 120 monthly instalments of $64,016 each. Property C was assigned to the Appellant on 5 February 1999.

9. On 9 March 1999, the Appellant made a partial repayment on Loan 1 in the amount of US$2,000,000 (equivalent to HK$15,504,000) leaving a balance of US$2,031,217.75. The monthly instalment was thereby reduced to US$27,083.

10. On 22 March 2000, the Appellant fully repaid Loan 1.

11. (a) In its profits tax return for the year of assessment 1998/99, the Appellant described the nature of its business as ' Manufacturing and trading garments' and returned assessable profits of $6,475,010. In arriving at the assessable profits, the Appellant deducted, inter alia, the following:

(i) specific provision for unrealised loss of properties of $31,280,000 as shown below:

Property	**Cost**	**Net realizable value**	**Total**

	$	$	$
A and B	73,280,000	42,000,000	31,280,000
C	25,000,000	25,000,000	-
	98,280,000	67,000,000	31,280,000

(ii) legal and professional fees totaling $267,299 in relation to the purchase of Properties A, B and C;

(iii) stamp duty totaling $2,702,700 in relation to the purchase of Properties A, B and C.

(b) In the Appellant's financial accounts for the year ended 31 March 1999 which were approved by its board of directors on 15 November 1999, Properties A, B and C were classified as 'Current Assets'. The properties were continually so classified in the Appellant's subsequent accounts for the years ended 31 March 2000 and 2001.

12. In response to the assessor's enquiries in relation to the purchase of Properties A and B, the Appellant, through Messrs Cheng, Kwok & Chang ('the Representatives'), put forth the following assertions:

(a) 'The original intention of acquisition is short term dealing. Because of the downturn of the property market, no sales took place. No documentary evidence can be provided.'

(b) 'No feasibility study had been conducted. Please bear in mind this is not a long term investment project like the building of a large power station. It is not unusual for small companies with limited management resources to engage in short term dealing without a feasibility study. Only Government departments and semi-government organisations and really large corporations can afford the resources and expertise to engage in feasibility study regardless of the size and nature of the project.'

(c) 'The properties were left vacant during the period of ownership to March 31, 1999. It is because [the Appellant] prepare to sell the properties in the hope that the property market would rebound at any time.'

(d) 'The directors constantly checked prices with property agents by telephone and by reference to data and advertisements relating to the relevant properties published in newspapers. No formal offer for sale was made as market prices were far below [the Appellant's] expectations.'

(e) ' The properties have not formally been placed on the market for sale, as such sale could result in very significant losses to [the Appellant] and the sales proceeds are unlikely sufficient to fully repay the bank loans secured on the properties.'

(f) The Appellant had made oral agreement with a named property agency company to solicit purchasers for Properties A, B and C.

13. In correspondence with the assessor, the Representatives supplied the following information and documents:

(a) On 4 June 1998, the Appellant's directors held a meeting resolving to acquire Properties A and B. A copy of the minutes of directors' meeting was supplied.

(b) Except the two loans, that is, Loan 1 and Loan 2, that had been taken out, the Appellant financed the purchase of Properties A, B and C by internal funds.

(c) Properties A, B and C had been left vacant until Shareholder3, Shareholder2 and Shareholder1 moved into them in December 1999, October 1999 and April 2000 respectively. The properties were provided by the Appellant to them as directors' quarters.

(d) The estimated realizable values of Properties A and B [paragraph 11(a)(i)] were based on valuations conducted by a named company, the Valuer, in September 1999. The Valuer's valuation on the open market values of the two properties as at 31 March 1999 was $21,000,000 each. Copies of the valuation reports were supplied.

(e) Properties A and B had not formally been placed in the property market for sale.

14. The Representatives also put forward the following arguments to support the Appellant's claim that Properties A, B and C were acquired for trading purpose:

' In conclusion the speculative properties deals were ill conceived. There was no feasibility study carried out. [The Appellant] did not really need the properties. The return on investment is hopelessly low if they lease out the properties. The directors do not really deserve to have such luxurious quarters. It was difficult to obtain bank finance and the interest rate was high. The hard reality is that [the Appellant] was stuck with these properties.'

15. The assessor did not accept that Properties A, B and C were acquired as the Appellant's trading stocks. On 27 November 2000, he raised on the Appellant the following profits tax assessment for the year of assessment 1998/99:

	$	$
Profits per return [paragraph 11(a)]		6,475,010
Add: Specific provision for unrealised loss of Properties A and B [paragraph 11(a)(i)]	31,280,000	
Legal and professional fees [paragraph 11(a)(ii)]	267,299	
Stamp duty [paragraph 11(a)(iii)]	2,702,700	34,249,999
		40,725,009
Less: Commercial building allowance on Properties A , B and C		1,965,600
Assessable profits		38,759,409
Tax payable thereon		6,201,505

16. The Representatives, on behalf of the Appellant, objected against the above assessment in the following terms:

> ' ... the specific provision for unrealized loss of properties made ... was revenue in nature and therefore should have been allowed as a deductible expense ...
>
> It is not disputed that [the Appellant] had made a very unfortunate commercial decision in deciding to venture into the property dealing business when circumstances in the market indicated that property prices would be in decline. However, it was [the Appellant's] belief that the market had over-reacted in guessing the Government's true intention for the property market, and that a substantial rebound was imminent, especially in the luxurious residential sector. It appears that the loss is now disallowed solely because [the Appellant] made a wrong commercial decision ...'

17. In response to the assessor's enquiries as to why the Appellant decided to venture into the property market in 1998, the Representatives explained as follows:

> ' At the time of the purchase of [Properties A and B], the property market has already dropped significantly (by about 14%) whilst the Hang Seng Index has rebounded to above 12,000 points after the diving to about 9,000 points in January 1998 ... Apart from the drastic fall of the property markets following the breakdown of the negotiations on Hong Kong's political future in 1982/83, the fall in property prices for the period up to March 1998 has never been more than 15% per annum ...

> With the removal of Hong Kong's political uncertainty after the change in sovereignty, and the successful stabilisation of the Hong Kong currency and the stock marke (*sic*) after October 1997, [the Appellant's] directors formed the view that property prices had come to the bottom and therefore it was the right time to go into the market for some quick profit. It was their belief that the luxurious residential sector would lead the rebound. Armed with the good profits that [the Appellant] made in 1997/98 (HK$17 million after tax) they plunged into the property market.
>
> It has never been their intention to hold the properties long term. It just did not make any commercial sense to tie up HK$98 million in residential properties which are not essential for the running of [the Appellant's] businesses, bearing in mind that as at March 31, 1999 [the Appellant's] fixed assets comprising principally plant and machinery were only HK$62M, and total assets were only HK$180M. The net shareholders' funds were only HK$59 million.'

The appeal hearing

18. The objection failed and by letter dated 4 March 2002, the Appellant, through the Representatives, gave notice of appeal on the following ground:

> ' The specific provision of HK$31,280,000 for unrealised loss of properties classified as current assets and related legal fees of HK$267,299 and Stamp duty of HK$2,702,700 are revenue in nature and should therefore be treated as tax deductible expenses in the year of Assessment 1998/99.'

19. At the hearing of the appeal, the Appellant was represented by Mr Daniel Kwok Wing-wah of the Representatives and the Respondent was represented by Ms Tsui Siu-fong, senior assessor.

20. Mr Daniel Kwok Wing-wah called Shareholder2, Shareholder3, Shareholder1 and another person to give evidence.

21. No witness was called by Ms Tsui Siu-fong.

22. Mr Daniel Kwok Wing-wah cited Board of Review case D11/80, IRBRD, vol 1, 374.

23. Ms Tsui Siu-fong cited:

(a) Simmons (as liquidator of Lionel Simmons Properties Ltd) v Inland Revenue Commissioners [1980] 1 WLR 1196,

(b) All Best Wishes Limited v CIR 3 HKTC 750,

(c) Marson v Morton and Others 59 TC 381.

Our decision

24. Section 68(4) of the IRO provides that the onus of proving that the assessment appealed against is excessive or incorrect is on the appellant. Section 2 defines 'trade' as including 'every trade and manufacture, and every adventure and concern in the nature of trade'. Section 14(1) excludes profits arising from the sale of capital assets.

25. We remind ourselves of what Sir Nicholas Browne-Wilkinson VC said in Marson v Morton [1986] 1 WLR 1343 at pages 1347 to 1349 and [1986] STC 463 at pages 470 to 471; what Lord Wilberforce authoritatively stated in Simmons v IRC [1980] 1 WLR 1196 at page 1199 and (1980) 53 Tax Cases 461 at pages 491 to 492; and the statement of the law by Orr LJ at pages 488 and 489 of the report in Tax Cases, which was approved by Lord Wilberforce as a generally correct statement (WLR at page 1202 and Tax Cases at page 495).

26. We also remind ourselves of what Mortimer J, as he then was, said in All Best Wishes Limited v CIR (1992) 3 HKTC 750 at page 770 and page 771.

27. Shareholder2, Shareholder3 and Shareholder1 testified to the effect that the intention at the time of acquisition of Property A and Property B and at the time of acquisition of Property C was to acquire the properties for short term speculation. For reasons which we shall give below, we accept their testimony on this point and find in favour of the Appellant on this factual issue. We also find that when they realised that they could not sell any of the three properties in the short term at a profit, they decided to and did live in the houses until such time as the properties could be sold at prices acceptable to them.

28. If the three properties had not been acquired as trading assets, they could only have been used as residence since they were residential houses. There was no suggestion by the Respondent or the Appellant that any of them was acquired for rental income. It made little or no sense to leave them vacant for an indefinite period of time. Effectively, we are left with their being acquired for the residence of the directors-shareholders.

29. Shareholder1, Shareholder2 and Shareholder3 are and have been equal shareholders and we would have expected a house of about the same purchase price for each of them to live in. But there is a significant difference in that the purchase price of Property C ($25,000,000) is about 32% cheaper than the purchase price of each of the other two houses ($36,640,000). This factor weighs against acquisition of the three houses as capital assets. There is no reason why equal shareholders should have unequal quarters.

30. Another unequal treatment for equal shareholders is that the Appellant contracted to acquire only two houses on 5 March 1998. It was some nine months later that the Appellant contracted to acquire the third house, Property C, on 5 December 1998. Ms Tsui Siu-fong conceded that according to the financial statements of the Appellant, the Appellant could afford in March 1998 to buy three houses at the project where Property A and Property B were situated had the Appellant so wished. We see no reason why one of the three equal shareholders should have been left out for nine months. This is another factor weighing against acquisition as capital assets.

31. We do not know why Mr Daniel Kwok Wing-wah did not agree ' Fact (18)' in the determination which stated an objective fact against the Respondent's case of capital assets. ' Fact (18)' stated that:

> ' According to the records of CLP Power Hong Kong Limited, there have been electricity consumption in Properties A, B and C since December 1998, October 1998 and August 1999 respectively. Copies of the relevant electricity consumption records are at Appendix E.'

32. According to the electricity company, the electricity consumption at the three houses was as follows:

Reading month	**Units consumed at Property A**	**Units consumed at Property B**	**Units consumed at Property C**
9-6-1998	*Acquisition assignment*	*Acquisition assignment*	-
18-6-1998	*Account effective date*	*Account effective date*	-
8-1998	6	4	-
10-1998	0	38	-
12-1998	41	95	-
2-1999	718	1	-
5-2-1999	-	-	*Acquisition assignment*
4-1999	1310	1	-
12-4-1999	-	-	*Account effective date*
6-1999	2241	419	4
8-1999	1137	665	657
10-1999	3367	970	963
12-1999	2001	1869	1424
2-2000	2566	3324	6634

4-2000	2272	2519	9778
6-2000	3559	4651	5889
8-2000	4550	5624	5627
10-2000	4229	3929	5024
12-2000	2278	2581	3080
2-2001	2621	2688	4872
4-2001	2472	2897	3140
6-2001	3682	3512	2698

33. The assignment of Property A was dated 9 June 1998. The consumption of electricity had been insignificant until the reading in February 1999 which recorded consumption of 718 units of electricity. If Property A had been acquired for the residence of one of the shareholders, it is improbable for Property A to have been left vacant and without any decoration work for about six months from 9 June 1998 to December 1998.

34. The assignment of Property B was also dated 9 June 1998. The consumption of electricity had been insignificant until the reading in June 1999 which recorded consumption of 419 units of electricity. If Property B had been acquired for the residence of one of the shareholders, it is improbable for Property B to have been left vacant and without any decoration work for about ten months from 9 June 1998 to April 1999.

35. The assignment of Property C was dated 5 February 1999. The consumption of electricity had been insignificant until the reading in August 1999 which recorded consumption of 657 units of electricity. If Property C had been acquired for the residence of one of the shareholders, it is improbable for Property C to have been left vacant and without any decoration work for about four months from 5 February 1999 to June 1999.

36. Shareholder1 was the shareholder who lived in Property C. The provisional agreement to acquire Property C was dated 5 December 1998. By a formal agreement dated 8 October 1998, Shareholder1 and another person contracted to buy another house at the same project as Property C. If the intention had been to acquire quarters for Shareholder1, it would have been more probable for one of the following two scenarios to have occurred:

(a) The Appellant would have been the contracting party, in place of Shareholder1 and another, to acquire the other house [possibly with one more house, since the other house was smaller than Property C and Property C was some 32% cheaper than Property A or Property B]. On this scenario, the Appellant would not have contracted to acquire Property C.

(b) The Appellant would have contracted on about 8 October 1998, instead of 5 December 1998, to acquire Property C.

37. Shareholder3 was the shareholder who lived in Property B which was assigned to the Appellant on 9 June 1998. The case of acquisition of Property B as director's quarters is inconsistent with the fact that in August 1998, Shareholder3 moved into a flat in the New Territories. He should have moved into Property B instead.

38. For reasons given above, the Appellant has discharged the onus of proving that the assessment appealed against is excessive and incorrect.

Disposition

39. We allow the appeal and reduce the assessment appealed against to show assessable profits of $6,475,010 with tax payable thereon of $1,036,001.