Case No. D8/88

Appeals – mistake by tax representative alleged – need for evidence.

Profits tax – sale of land – whether trading gains or realization of capital – evidential matters: statement of intention – s 14 of the Inland Revenue Ordinance.

Profits tax – sale of trading stock – compulsory acquisition – whether resumption proceeds could be assessable – s 14 of the Inland Revenue Ordinance.

Panel: Charles A Ching QC (chairman), C G Large and Wilfred C W Lee.

Dates of hearing: 20 and 21 May 1987.
Date of decision: 2 May 1988.

The taxpayer company had an authorized share capital of $1,000. It purchased three lots of land in the New Territories for over $4,000,000. The purchase price was funded as to 41% by bank loans at relatively high interest rates, and the balance by interest-free shareholders' loans. The land was agricultural, and produced no income. No steps were taken to examine the feasibility of developing the land.

Directors' resolutions stated that the land was acquired as a long-term investment. However, profits on disposition were shown in the taxpayer's accounts as trading profits. The taxpayer claimed that this had been a mistake.

Some of the land was compulsorily acquired by the government.

The Commissioner assessed the taxpayer to profits tax on profits from the disposition of the land. The taxpayer appealed.

Held:

The profits were assessable.

(a) It is not sufficient for a taxpayer to allege that there had been a mistake made in the preparation of its accounts, without substantiating such allegation with evidence.

(b) A statement of intention carries little weight unless the means of putting that intention into practice existed. Here, the feasibility of development was

never explored and it was unlikely that the taxpayer could have afforded to develop the land.

(c) If land is trading stock, the compulsory acquisition of that land by the government, or other involuntary disposition, gives rise to assessable profits.

Appeal dismissed.

Cases referred to:

CIR v Newcastle Breweries Ltd (1927) 12 TC 927
Green v J Gliksten & Son Ltd (1929) 14 TC 364
Land Revenue Appeal No 2 of 1985
Public Trustee v CIR (NZ) (1961) 8 AITR 297

Pauline Fan for the Commissioner of Inland Revenue.
Andrew Lee Lun of Gregory K S Tsang & Co for the taxpayer.

Decision:

The Taxpayer was incorporated in May 1980 with an authorised capital of 1,000 shares of $1 each. Two subscriber shares were issued upon incorporation. On 3 June 1980, those shares were assigned to Mr A and on the same day a further 998 shares were allotted as follows:

(1)	Mr A	248
(2)	Mr B	250
(3)	Mr C	250
(4)	Mr D	250
		998

The authorised and issued capital has remained at 1,000 shares throughout. The shareholders were the directors.

The Taxpayer purchased land in the New Territories on three occasions, particulars of which are as follows:

Land	Date	Consideration
A	16-6-81	$2,073,822
B	14-11-80	$1,472,707

C	18-7-80	$ 838,100
		$4,384,629

There was a directors' resolution in relation to each purchase that the land should be purchased 'for long-term investment'. The land was all agricultural.

The purchases were funded partly from loans from the shareholders. Mr A, who was the only witness called, told us and we accept that the balance of the purchase money (about 41%) was raised by bank overdraft and bank loans because the shareholders at the time did not have sufficient money. The loans from the shareholders were interest free. Interest was paid to the bank and for a short while was at a rate of over 20% per annum. On average, the interest rate was 12 to 13% per annum.

Land B, which consisted of 17,849 square feet, was resumed by the Government under a notice dated February 1981. As compensation the Taxpayer received $794,280.50 and Letters B entitlements for 8,924.5 square feet of land. The Letters B were sold in the year ending 31 March 1983 for $655,950.

Land A consisted of 100,500 square feet. On 2 March 1981, the Government gave notice to resume 3,740 square feet of it. The Taxpayer received compensation of $166,430 and a Letters B entitlement for 1,870 square feet of land. The Taxpayer still has those Letters B. On 20 January 1984, the Government gave notice of resumption of a further 83,950 square feet of Land A. The Taxpayer received $3,828,120 in compensation. That sum was shown in the Taxpayer's accounts as being trading profit and was offered for assessment.

The Taxpayer was assessed to profits tax for the year 1983/84 and it is against that assessment that it appeals.

A point taken by the Taxpayer but later abandoned was that, since the land had been compulsorily resumed, what had happened was not a sale and was not a trading activity. Having regard to the provisions of section 14 of the Inland Revenue Ordinance, we find that the point is irrelevant. If the land was purchased as a trading rather than as a capital asset, it matters not whether its disposition was voluntary or involuntary: see Green v J Gliksten & Son Ltd (1929) 14 TC 364, CIR v Newcastle Breweries Ltd (1927) 12 TC 927 and contrast the different wording of the legislation in Public Trustee v CIR (NZ) (1961) 8 AITR 297. The sole question is whether the land was purchased as a trading asset or as a capital asset.

Mr A told us that, as natives of the New Territories, the shareholders of the Taxpayer considered it better to hold land than cash. The intention was to pass on the land to their descendants. If Government allowed the land to be developed, the Taxpayer would do so for rental income. In any event, the land was to be held as a long term investment. He knew of the Government's policy to resume land in the New Territories but did not know

how and when any land would be resumed. We accept that he did not know how and when or if the land would be resumed, but we do not accept the rest of his evidence.

The manner in which the Taxpayer dealt with the land in its books cannot of itself be decisive. Nonetheless it may be indicative of the intention with which it was purchased. We do not think it greatly assists to say that the land was purchased 'for long term investment'. On the other hand, the accounts of the Taxpayer brought in the surpluses of the amounts of compensation received as revenue. By a letter dated 29 November 1984, the Taxpayer's accountants informed the Commissioner that

> 'the ... company has made a mistake in its accounts for the year ended 31 March 1984 and in its Profits Tax Return for Final Assessment 1983/84 and Provisional Payment 1984/85 by treating the surrender of a piece of land to the Hong Kong Government as an ordinary sale. So the trading profits of the Company is overstated by the surplus from surrendering that piece of land to the Government.'

They asked that the mistake be rectified under section 70A. No further explanation was given to us. We agree with the statement of the Chairman in another case to be found set out at page 8 of the judgment of Macdougall J in Inland Revenue Appeal No 2 of 1985, that:

> 'If a taxpayer wishes to challenge the accuracy of its own audited statements and tax declarations made by a director, it is not sufficient merely to say that ... a mistake was made ... Evidence to substantiate the mistake must be given in the strongest terms.'

No such evidence and no explanation was given to us as to how the mistake came to be made even though the accountants appeared before us as the Taxpayer's representatives.

We found the stated intention of the Taxpayer to be extraordinary. This was a small company with only $1,000 issued capital. No steps were ever taken to increase the authorised capital and therefore the possible issued capital. Yet it entered into purchases of land to the extent of well over $4,000,000. It relied partly on interest-free loans from the shareholders but, because these shareholders did not have sufficient money at the time, assistance from a bank was necessary and large amounts of interest had to be paid. That interest was $390,255, $195,678 and $360,833 for the three years ending 31 March 1984. Meanwhile the land produced no income other than the compensation received and the shareholders were losing interest on their loans to the Taxpayer. It is not apparent how these loans were to be paid off, for the company had no other business. It is remarkable that the minutes of the directors' meetings at which the purchases were authorised contained nothing about the way in which the purchases were to be funded.

It is trite to say that an intention cannot be said to have been held unless the means of putting that intention into practice existed. The land was agricultural land. No enquiries were made as to whether or not it could be converted into building land either

before or after the purchases. No investigations or plans were made as to the possible cost of development and no thought was given to the return that could be expected. We were given details of the income of Mr A and of Mr B but as to the other two shareholders we were only told that Mr C was a partner of X Company and Mr D was a shareholder and director of Y Company.

Having regard to the fact that banking facilities were necessary for the initial purchases because the shareholders did not have sufficient money at the time, and having regard to the fact that the Taxpayer continued to be indebted to the bank with substantial interest being paid, we are not satisfied that the shareholders could have come up with the development costs whatever they may have been. We were given no evidence that any facilities from banks for the purposes of development could have been obtained or, if they could be, on what terms. At the same time Mr A in evidence stated that it would be impossible to hold the bare land permanently so that there must be development. But he also said that at the time of acquisition he did not know if the land had building potential. Finally he said that the Taxpayer would go on holding the land if it could afford the bank interest but that if it could not the land would be sold.

It was for the Taxpayer to persuade us that its intention in buying the land was to buy a capital asset. We did not accept the only evidence put before us. We therefore dismiss this appeal.