

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D9/00

Profits Tax – sale of property – intention at the time of acquisition – self-serving statements – one-off transaction – indicative of an acquisition for trading purpose – burden of proof.

Panel: Anna Chow Suk Han (chairman), Colin Cohen and Christopher Henry Sherrin.

Date of hearing: 16 February 2000.

Date of decision: 12 May 2000.

The taxpayer was incorporated as a private company in Hong Kong. By an agreement for sale and purchase dated 11 March 1993, the taxpayer agreed to purchase Property 1 which was then under construction, from the developer. By a provisional agreement dated 8 March 1994, the taxpayer agreed to sell Property 1 to Company E. In March 1994 the taxpayer entered into a cancellation agreement with the developer so that the developer could sell Property 1 to Company E direct. After the occupation permit was issued, the developer assigned Property 1 to Company E.

In the profits tax return for the year of assessment 1993/94 together with the accounts and a proposed tax computation, the taxpayer reported that a profit was derived from the sale of Property 1, but it did not offer the profit for assessment. The assessor considered that the purchase and sale of Property 1 by the taxpayer amounted to an adventure in the nature of trade.

The taxpayer asserted that Property 1 was acquired as long term investment for rental purposes. As the taxpayer foresaw the rental return from individual buildings would come down, it changed its property investment strategy and decided to sell Property 1.

Held :

1. The Board found that the taxpayer's stated intention as borne out by the objects expressed in the taxpayer's memorandum and articles of association, the declarations in its profits tax returns, the minutes of the board's meeting on 2 March 1993 and the classification of Property 1 in its audited financial statement are all self-serving statements, and especially some of them are prepared after the sale of Property 1. They are of limited value and have to be tested against the objective facts and surrounding circumstances of the case (All Best Wishes Limited v CIR 3 HKTC 750 applied).

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2. An one-off transaction is capable of constituting an adventure in the nature of trade. The task is to ascertain the intention of the taxpayer at the time when Property 1 was purchased and not its intention relating to the other properties. Of course, in determining the taxpayer's actual intention in relation to Property 1, the Board would also bear in mind the status of the three other properties and whether the circumstances under which they are held by the taxpayer should affect the Board's ascertainment of the actual intention of the taxpayer.
3. The Board found that the taxpayer sold the Subject Property shortly before it was ready for occupation and the taxpayer had never put it to its intended use. This factor is against the taxpayer's claim and is an indicator of an acquisition for trading purpose.
4. Having heard the evidence, the Board found that the taxpayer's action was at odds with its professed reasons for the sale of Property 1. The burden of proof is on the taxpayer. The Board found that the taxpayer has failed to discharge the burden placed upon it to prove that Property 1 was acquired for rental purposes.

Appeal dismissed.

Case referred to:

All Best Wishes Limited v CIR 3 HKTC 750

Wong Ki Fong for the Commissioner of Inland Revenue.

Andrew Li Chung Kwong of Messrs Chu and Chu for the taxpayer.

Decision:

The appeal

1. This is an appeal by the Taxpayer against the determination made by the Commissioner of Inland Revenue on 24 September 1999 in respect of the profits tax assessments raised on the Taxpayer for the year of assessment 1993/94 relating to the gain derived from the sale of the property in District A ('Property 1').

The facts not in dispute

2. The Taxpayer was incorporated as a private company on 5 May 1992 in Hong Kong

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under the name of Company B which was changed to its present name by a special resolution passed on 25 September 1992.

3. At all relevant times, the Taxpayer's authorized and paid-up capital remained at \$10,000 and the directors were Mr C and Ms D.

4. By an agreement for sale and purchase dated 11 March 1993, the Taxpayer agreed to purchase Property 1 from the developer at a consideration of \$3,491,000. Property 1 was then under construction.

5. By a provisional agreement dated 8 March 1994, the Taxpayer agreed to sell Property 1 to Company E at a consideration of \$4,994,260. In March 1994 the Taxpayer entered into a cancellation agreement with the developer so that the developer could sell Property 1 to Company E direct. After the occupation permit was issued on 25 May 1994, the developer assigned Property 1 to Company E on 7 July 1994.

6. The Taxpayer filed the profits tax return for the year of assessment 1993/94 together with the accounts and a proposed tax computation. In the accounts, the Taxpayer reported that a profit of \$1,503,260 was derived from the sale of Property 1, but it did not offer the profit for assessment.

7. The assessor considered that the purchase and sale of Property 1 by the Taxpayer amounted to an adventure in the nature of trade. He raised the following profits tax assessment for the year of assessment 1993/94 on the Taxpayer:

	\$
Loss per return	922,408
<u>Less</u> : Profits on sale of Property 1	<u>1,503,260</u>
Assessable profits	<u>580,852</u>
Tax payable thereon	<u>101,649</u>

The Taxpayer's contention

8. The Taxpayer asserted that Property 1 was acquired by it as a long term investment. As it foresaw the rental return from industrial buildings would come down, it changed its property investment strategy and decided to sell Property 1.

9. The Taxpayer claimed that the Taxpayer was a property investment company and not a property trading company. It found support from the objects of its memorandum and articles of association, in particular, those set out in clauses 3(7) and (8), the declarations in the profits tax

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returns that the nature of its business was investment in properties for rental purpose, and also the fact that the Taxpayer was still holding three out of the five properties acquired by it for rental purposes.

10. The Taxpayer placed reliance on the following factors to prove its stated intention that Property 1 was acquired for rental income.

11. The Taxpayer's board resolution on 2 March 1993 stated, inter alia, that the Taxpayer 'do acquire the property for the purpose of letting out in order to earn rental income.'

12. Property 1 was classified as an investment property in the audited financial statements for the year ended 31 March 1994.

13. The sale proceeds from Property 1 was reinvested in three other properties which had been letted out for rental income. They were:

1. Property 2,
District F
2. Property 3,
Building G, District H
3. Property 4
Building G, District H

Property 2 was sold on 2 June 1997 subject to the existing tenancy.

14. The Taxpayer changed its investment plan and decided to sell Property 1 when it assessed and came to the view that the rental return from industrial buildings would come down. We were referred to an extract of a report from 'Property Review 1998' prepared by the Rating and Valuation Department. However, the Taxpayer claimed that the decision to sell was the result of its director's forecast of an unfavourable future rental market and not because of the lowering market rent in a particular year.

15. As to the Respondent's (the Revenue's) challenge of the Taxpayer's failure to make a long term financial arrangement for the purchase of Property 1, the Taxpayer claimed that when the agreement to purchase was entered into, Property 1 was under construction. Thus, only deposits were required to be paid and arrangement for a mortgage loan was not necessary until completion of Property 1. In any event, the Taxpayer asserted that the directors could certainly provide the necessary finance to complete the purchase as they did subsequently in the acquisition of the other properties.

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16. The Taxpayer claimed the fact that the other properties of the Taxpayer were being held as long term investment, should help to prove its stated intention that Property 1 was acquired as long term investment. It argued that although Property 3 and Property 4 were not used by its related companies and were let out to some third parties, the nature of these properties remained the same. They were capital assets and not trading stock. The letting out of these properties was consistent with its long range plan. The fact that they were let out and not sold by the Taxpayer demonstrated the Taxpayer's intention of holding them as capital assets.

The Respondent's (the Revenue's) contention

17. The Respondent argued that the objects in the Taxpayer's memorandum and articles of association did not preclude the Taxpayer from being a property trading company. Furthermore, the objects in clauses 3(7) and (8) of the memorandum and articles of association were so wide that the Taxpayer could also carry on the business of property trading.

18. The Respondent asserted that the Taxpayer's declarations in its profits tax returns were self-serving statements. More so, they were made after the sale of Property 1. Their values were therefore minimal. The Respondent argued that the description 'rental income and consultancy income' could cover income from both property investment and property trading business. Properties could be let out pending an opportune moment for resale. Hence, the self-serving statement in the board's resolution at most had only neutral effect on the Taxpayer's claim. Furthermore, the audited financial statements for the year ended 31 March 1994 were also self-serving statements and were also made after the sale of Property 1.

19. We were reminded that we should only concern ourselves with Property 1 and not with the other four properties subsequently acquired by the Taxpayer. The fact that they were capital assets or trading stock, was irrelevant to the present appeal. Furthermore, how the sale proceeds of Property 1 were utilized by the Taxpayer, should have no effect on the Board's ascertainment of the Taxpayer's intention for the purpose of this appeal.

20. On the Taxpayer's assertion that the sale proceeds of Property 1 were reinvested in the three properties, Property 2, Property 3 and Property 4, the Respondent argued that once the cash inflow of Property 1 was received, it would be mixed with other funds of the Taxpayer. It would therefore be difficult to ascertain how it was applied to the three properties.

21. The Respondent highlighted the rental index at the time of the sale of Property 1 at 130 which was higher than that at the time of acquisition of Property 1 in 1993 at 129 and even higher than that for 1992 at 117.

22. In assessing the rental market condition of industrial buildings, the Taxpayer only relied on the 'feeling' of its director, Mr C and not proper advice from professional bodies. The Respondent asserted that this was a pointer that the Taxpayer's claim of acquiring Property 1 as a

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capital investment, was not a genuine one.

23. The Taxpayer's alleged lack of confidence in the rental market of industrial buildings was contradicted by its purchase of Property 3 and Property 4.

Our findings and reasons

24. *'The intention of the taxpayer, at the time of acquisition, and at the time when he is holding the assets 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 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.'* (per Mortimer J in All Best Wishes Limited v CIR 3 HKTC 750 at 771).

25. The Taxpayer claimed that Property 1, the subject matter of this appeal, was acquired for rental purposes. It claimed that its stated intention was borne out by the objects expressed in the Taxpayer's memorandum and articles of association, the declarations in its profits tax returns, the minutes of the board's meeting on 2 March 1993 and the classification of Property 1 in its audited financial statement. These are all self-serving statements, and especially some of them were prepared after the sale of Property 1. They are of limited value and have to be tested against the objective facts and surrounding circumstances of the case.

26. The Taxpayer also asserted that up to now it had not involved in property trading transactions. Apart from Property 1 and Property 2 which were sold, it was currently holding three other properties for rental purposes. Property 2 was also at one time rented out and was sold subject to the existing tenancy. It is a well established legal principle that an one-off transaction is capable of constituting an adventure in the nature of trade. This appeal concerns Property 1 only. The fact that the Taxpayer's three other properties are letted out, is not determinative of the purpose for which Property 1 was acquired. Our task is to ascertain the intention of the Taxpayer at the time when Property 1 was purchased and not its intention relating to the other properties. Of course, in determining the Taxpayer's actual intention in relation to Property 1, we would also bear in mind the status of the three other properties and whether the circumstances under which they are held by the Taxpayer should affect our ascertainment of the actual intention of the Taxpayer for the purpose of this appeal.

27. The Taxpayer claimed that Property 1 was acquired for rental purposes. Nonetheless, the Taxpayer sold it shortly before it was ready for occupation and the Taxpayer had never put it to its intended use. This factor is against the Taxpayer's claim. It is indicative of an acquisition for

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trading purpose. Unless the resale of Property 1 can be satisfactorily explained away by the Taxpayer, the Taxpayer has failed to discharge the burden of proof placed upon it by section 68(4) of the Inland Revenue Ordinance.

28. We now examine closely the reasons advanced by the Taxpayer for the resale of Property 1. The Taxpayer explained that its decision to sell was caused by the Taxpayer's change in property investment strategy. Mr C, a director and shareholder of the Taxpayer, gave evidence that after entering into the agreement to purchase Property 1, he observed that in the manufacturing industry, there was developing a trend of relocating factories from Hong Kong to China. He thus believed that the demand for industrial premises would decrease and the rental yield of factory premises would come down. That being the case, the Taxpayer took the decision to sell Property 1 and re-invested the proceeds of sale in three other properties, namely Property 2, Property 3 and Property 4. Property 2 is a residential property which remained vacant for a period of time after it was acquired. It was eventually let out and was sold on 2 June 1997 subject to the existing tenancy. Property 3 and Property 4 are industrial premises. They were under construction when agreements for sale and purchase were entered into and completion of the purchase took place in April 1996. The two units were purchased in May 1994 soon after Property 1 was sold on 8 March 1994. Mr C claimed that the two industrial units were intended for self use in the future expansion of his other companies. An impressive list of no less than ten companies in which Mr C had significant interests during the years of assessment 1994/95 to 1995/96, was submitted to this Board, for reference.

29. Mr C claimed that Property 3 and Property 4 were chosen because they were in Building G and Building G was next to Building I where his companies, Company J, Company K and four other companies were located. He intended to expand the garment accessories business of Company K and reserved these units for its use or those of his other related companies, at a rent. The premises at Building I were occupied by Company J as a factory with manufacturing machines and equipment and also godown, workshop, design room and office. Mr C claimed that the location of the two properties was good and convenient for the purpose of relocating his other companies and for his participation and management of the companies. Upon being cross-examined by the Respondent on the Taxpayer's professed need of the two properties for Company K's expansion, Mr C stressed that the two properties were not necessarily just reserved for use by Company K but also for use by his other companies as he was involved in many different kinds of business. Furthermore, he needed good premises for display of goods to his international clients. 'Company K is not the only company that may possibly occupy Property 3 and Property 4.' Emphasis was also placed on this point by Mr Lee in his submission.

30. Completion of the two properties took place on 22 April 1996 and they were respectively let out on 1 July 1996 and 1 August 1996. The Taxpayer claimed that they were not put to its intended use because Company K never grew to the expected scale of operation. The two properties were therefore let out. However, the Taxpayer's claim was challenged by the Respondent because there was evidence that Company K's assessable profits increased in the relevant years. The Taxpayer submitted that despite the increases in revenue, the company did not

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reach a level of operation which would require an office for its use. We recall Mr C' s evidence on the reason for the purchase of the two industrial properties. They were intended for use by Company K or Mr C' s other companies. Even if we are to accept that the properties were not needed by Company K, what about the many other related companies mentioned earlier on? Did none of them have any use of the two properties? No evidence was adduced in this regard.

31. If, indeed, the two properties could not be used by Company K or any of the Taxpayer' s related companies, we find it odd that the Taxpayer should choose to rent them out. We find it inconsistent that on the other hand the Taxpayer claimed that it had no confidence in investment in industrial premises due to the softening of the rental market and on the other hand, it retained the two properties for rental purposes after discovering that none of its related companies had any use of them. If indeed the Taxpayer saw that there was no future in the rental market of industrial premises and sold Property 1, why did it not sell these properties as it did to Property 1 as soon as it found that they were not required for use by its related companies? Thus, we do not accept that the reason for the sale of Property 1 as alleged by the Taxpayer was a genuine one.

32. The Taxpayer' s action was at odds with its professed reasons for the sale of Property 1. The burden of proof is on the Taxpayer. We find that the Taxpayer has failed to discharge the burden placed upon it to prove that Property 1 was acquired for rental purposes. The appeal is accordingly dismissed and the determination confirmed.