INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D97/01

Profits tax – disposal of properties – whether profits derived from the sale of the property assessable to profits tax – intention at the time of acquisition – whether quick disposition is inconsistent with the long term investment intention – onus of proof.

Panel: Audrey Eu Yuet Mee SC (chairman), Charles Graeme Large and Daniel Wan Yim Keung.

Date of hearing: 20 September 2001.
Date of decision: 7 November 2001.

The appellants bought a property and sold it about six months later. The appellants contended that the property was purchased for their own residence and the gain arose from the disposal of a capital asset and was not taxable. Even if it was, the appellants said that the additional expenses on renovation works should be allowed as deduction.

Considering all evidence before the Board, the Board was not prepared to find that the property was acquired as capital asset and for use as a matrimonial home. The Board was not persuaded that the assessment is erroneous.

Held:

1. Whether a property is a capital asset or trading stock depends on the intention at the time of acquisition. A mere declaration of intention is of limited value. It must be judged by considering the whole of the surrounding circumstances. Things said at the time, before and after, and things done at the time, before and after. The onus is upon the appellants to persuade the Board that the determination is erroneous.

2. It is easy to say that a property is intended for self use. However, a quick disposition as in this case is inconsistent with such intention. It is necessary to consider the reason given for the sale. The appellants failed to give a clear and credible account as to what transpired to prompt them to change their mind. The Board also found the appellants made an excessive claim in respect of renovation cost, bank charges and agency fee.

Appeal dismissed.

Tse Yue Keung for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

The appeal

1. The Appellants, Mr A and Ms B, appeal against the determination of the Commissioner of Inland Revenue dated 26 April 2001 in respect of the profits tax assessment raised against them in the year of assessment 1997/98 on the gain arising from the disposal of their property known as Property 1 in District C. The Appellants claim that the gain arose from the disposal of a capital asset and was not taxable.

The background

2. The following background matters are not in dispute.

3. The Appellants, husband and wife, were involved in the following property transactions during the material period.

Location of property	Owner	Purchase	Sale
Property 2 in District D	Mr A and Mr E	(1) 5-8-1991 (2) 20-8-1991 (3) $4,860,000	(1) 9-8-1996 (2) 29-11-1996 (3) $15,000,000
Property 3 in District F	The Taxpayers	(1) 26-4-1996 (2) -- (3) $5,900,000	(1) 8-6-1996 (2) 10-7-1996 (3) $6,380,000
Property 4 in District F	Mr A	(1) 20-9-1996 (2) 4-12-1996 (3) $6,900,000	(1) 16-12-1996 (2) 13-1-1997 (3) $8,380,000
Property 1 in District C	The Taxpayers	(1) 4-11-1996 (2) 12-12-1996 (3) $8,850,000	(1) 23-5-1997 (2) 25-6-1997 (3) $11,800,000
Property 5 in District G	The Taxpayers	(1) 23-12-1997	

(2) 24-2-1998
(3) $7,604,000

Notes:
(1) Date of agreement for sale and purchase
(2) Date of assignment
(3) Consideration

4. Mr A had paid the tax arising from the sale of Property 3. Whilst the Appellants initially objected to the tax assessment made by the assessor on the gain arising from the sale of Property 4, following the determination of the Commissioner of Inland Revenue upholding such assessment, no appeal has been brought against this part of the determination. The present appeal only concerns the gain arising from Property 1.

5. The Commissioner upheld the assessment by the assessor and determined the tax on Property 1 as follows.

Amounts as provided by Mr A:

	$	$
Selling proceeds		11,800,000
Purchase cost		8,850,000
Gross profit		2,950,000
Expenses (approximate figures) –		
Agency fee on purchase	88,000	
Agency fee on sale	110,000	
Legal fees on purchase	65,000	
Legal fees on sale	29,000	
Insurance	10,000	
Stamp duty	243,575	
Payment to bank (mortgage) including penalty, interest and appraisal fee	300,000	
Renovation	1,000,000	1,845,575
Net profit		1,104,425

Revised amounts as assessed:

	$
Profits per the Appellants' computation	1,104,425
Add: Expenses not incurred or overstated –	
Agency fee on sale not incurred as per provisional Agreement	110,000

Payment to bank overstated as per bank's information ($300,000 - $291,498)	8,502
Renovation	1,000,000
Assessable profits	2,222,927
Tax payable thereon (10% tax rebate deducted)	300,095

6. The Appellants bring the present appeal contending that Property 1 was purchased for their own residence. The gain was thus not subject to tax. Even if it is, they say that the following additional expenses should be allowed as deduction.

	$
Renovation/decoration expenses paid to Company H	320,300.00
A set of locks	1,800.00
Lever handles and latch	460.00
Display item	2,800.00
Food waste disposer	1,266.50
Garden equipment	4,036.00
Cutlery drawer and hanger	695.00
Renovation/decoration expenses paid to Company I	202,000.00
Total	533,357.50

The issues

7. There are thus two issues in this appeal:

(a) whether the gain arising from the disposal of Property 1 was subject to profits tax; and

(b) if so, the amount of the taxable profit in this case.

The hearing

8. Mr A did not appear at the hearing of the appeal. Ms B who attended stated that they have separated. They have reached agreement as to their respective rights and liabilities on the various properties and it was agreed that she should represent him in this appeal.

9. Apart from making one correction, Ms B confirmed what had been already stated in their correspondence with the Inland Revenue Department ('IRD'). This was further elaborated upon in her oral evidence. The written and oral evidence can be summarized as follows.

10. From about 1991, the parties resided in Property 2 with a domestic helper. It was about 1,700 to 1,800 square feet with three bedrooms and a servant's room. In 1993 or 1994, the Appellants contemplated moving but they did not find anything suitable. By 1996, they had lived in District D for about five years and wanted to move to a different area. Ms B said that, to be honest, she had not discussed with her husband what type of property they should acquire or in which area they would like to live. The price had to be reasonable and such that they could have some saving after sale of Property 2.

11. On 26 April 1996, the Appellants signed a sale and purchase agreement for the purchase of Property 3. It was sold a few weeks later on 8 June 1996 even before the purchase was completed.

12. In a letter dated 23 May 1998 signed by Mr A and addressed to the IRD, explaining the reason for the rapid sale following purchase of Property 3, it was stated as follows:

> ' for change of residence (It was bought in around April/May 1996 and sold in July 1996 before completion of the transaction as we had regretted of the purchase. We bought it just because it was close to my mother-in-law's home and was anxious to buy one for our own residence after the sale of [Property 2] as the property market was boosting. After careful consideration, we found that it was too small of only 900 square feet, having no servant room, no parking space available, the noise intolerable, and *fung shui* not good.)'

However, as can be seen from the dates in paragraph 3 above, the Appellants had not disposed of Property 2 by the time they sold (let alone bought) Property 3.

13. Ms B said she viewed the property prior to purchase. It was about 1000 square feet. There was no servant's room. *Fung shui* was not a problem; her husband had arranged for someone to examine the *fung shui* and it was quite alright. She also confirmed that whilst location was a factor for consideration, living close to her mother was not one of her considerations in looking for a flat. Although she knew that there would be aircraft noise, she thought that, as her mother lived in the same development, she would not have a problem living there. However, soon after she purchased it, her family members and her husband said that she would not like to live there as it was much too small and District F was too noisy. She soon regretted the purchase. Upon discussion with her husband, they agreed to sell the flat and did so before the completion of the purchase.

14. Two months later, by a sale and purchase agreement dated 9 August 1996, the Appellants agreed to sell Property 2. Soon afterwards, by a sale and purchase agreement dated 20 September 1996, Mr A purchased Property 4 in his sole name. It was in the same tower as Property 3. Mr A sold it a few months later by a sale and purchase agreement dated 16 December 1996.

15. In the same letter dated 23 May 1998, Mr A explained the reason for the quick sale as follows:

> ' After selling [Property 2], the market was boosting unexpectedly. My wife and I were afraid of buying a property at an unacceptable and unreasonable price as we were changing residence. In this regard, we were very eager to buy one as soon as possible for our own use. After viewing [Property 4], I felt satisfied with it because of having a servant room which my wife had insisted on. The agent kept on telling me that the vendor has already verbally agreed to an offer made by another interested buyer and the vendor might change the selling price in view of the booming and favourable market at that time. Then I tried to contact my wife for decision, but failed for many times. On the same day while I was viewing some other properties, the agent urged me to sign the provisional agreement as soon as possible as he said that the vendor had decided to increase the price and was going to accept an offer delivered by another property agent. I was so anxious and unconscious that finally I signed the provisional agreement myself upon the failure of my final attempt to find my wife.
>
> Out of expectation, unfortunately, my wife strongly objected to this purchase when she was in knowledge of it. The reasons were as follows:
>
> (1) She had decided to give up District F as her choice for our residence when she found the planes noise intolerable.
>
> (2) She did not like the property as it was only situated on the second floor.
>
> (3) She was upset that the provisional agreement was not in joint names. In fact, we did try through the agent to persuade the vendor to allow the addition of my wife's name onto the provisional agreement. However, the vendor said that they could not and should not agree to change the particulars of the preliminary agreement as advised by their solicitors.
>
> (4) As advised by our solicitor, we had to pay extra money for stamping if my wife's name had to be added onto the Agreement/Assignment. My wife considered it not worthwhile as we had to pay double the cost of the stamp duty.
>
> (5) My wife complaint [*sic*] that the purchase price was not reasonable as no car parking space was included.'

16. Ms B said that she was very angry with her husband over this purchase. She was upset that he did not include her name as a purchaser. Further he knew very well she did not want to live

in District F because of the noise from passing aircraft. She could not explain why he did it. She said that maybe he was anxious to buy another property as they had just sold Property 2. At any rate, it was no longer relevant as he had agreed to pay the tax on the gain.

17. By a sale and purchase agreement dated 4 November 1996, the Appellants bought Property 1 for $8,850,000. They sold it about six months later by a sale and purchase agreement dated 23 May 1997 for $11,800,000, thus giving rise to a gain, the subject matter of this appeal.

18. In the said letter dated 23 May 1998, Mr A explained that his wife was greatly attracted to Property 1 because the size was bigger and the price appeared to be very reasonable compared with Property 3. In addition, the management fee and the cost of club facilities were significantly lower. The house was 1,800 square feet with three bedrooms, servant's and dressing room after renovation. As to the reasons for selling the house, it was stated in the letter thus:

> ' After renovation, we were told that the green area outside the house would be (and now has been) changed to a public parking area. The traffic noise would be very serious if it was changed to a parking area. Also just corresponding to the parking area, it's a main road where traffic has been extremely busy with bus stops and minibus stops. Without the green area and with the change of land use, the noise nuisance would become more serious and intolerable. Moreover, the contractor told us that there was a very serious water leakage problem in the house. Even after renovation, we might have to face the irremediable problem of "wet" surface inside the house particularly the walls of the living and dining area. This really terrified us as we had spent a lot of money on renovation. We were afraid that if we did not sell it promptly, it would be difficult for us to find a buyer when we want to change residence and when the problem becomes more serious and apparent in summer rainy days and upon the change of land use outside our house.'

19. They viewed it together on the first inspection and later again separately. Ms B said she really liked the house. She had looked at many other houses in the same housing estate before deciding on this one. It was facing the road and thus slightly cheaper. She found the price 'amazing'. She liked the environment. The house had a large garden. It was 'almost her dream house'. She particularly liked the trees and the green area next to the house as they sheltered the house from the noise of the road. She did notice some minor water marks but that was no different from what she had experienced in Property 2.

20. After taking possession of the house, she discovered that there was very serious water damage to the walls. Such damage was not visible when she inspected the house earlier as it was hidden by the fitted furniture. When these items were moved, she saw that the damage was so serious that in some areas even the inner steel reinforcing rods were exposed.

21. The Appellants discovered a further problem about the house. In correspondence with the assessor, they said that:

> ' After renovation, we were told that the green area outside Property 1 would be (and now has been) changed to a public parking area. The traffic noise would be very serious if it was changed to a parking area.'

In their notice of appeal, however, they explained that:

> ' The management office did inform us and the contractor before our leaving Hong Kong of the change of land uses in front of the property when we were discussing details of the renovation work. Despite this, we did continue the renovation work because we were not sure whether the news was true or not...'

In giving evidence, Ms B explained that, in about January or February 1997, when she went to the management office to apply for a permit for admission of workers to carry out the renovation works, she heard that the trees would be cut down and that the green area right next to her house would be turned into a car park. As a result, she became worried about the noise and loss of the green area. However, she thought that it might just be a rumour and did not take any steps to follow it up.

22. At the time the Appellants already had plans to leave Hong Kong to pursue their studies abroad. Despite their imminent departure and the above problems, the Appellants decided to go ahead with the refurbishment. As the time was close to the Lunar New Year, and the contractor would not start work until after the holiday had ended, they just moved in and lived there for a few weeks. In February or March 1997, they left for Country J. After they arrived, Ms B applied and was accepted for a two and a half year Master of Business Administration course to commence in July 1997. Whilst they were away, their family members monitored the contractors' work and looked after the house for them.

23. The first contractor they hired was Company H. The man in charge, Mr K, told Ms B that he had done work for many other house owners in the same housing estate and knew how to deal with the water leakage problem. He assured her that the problem was remediable. Ms B produced a quotation said to be provided by Company H. However, it was dated 13 June 1997, which was after the Appellants had sold the house. Ms B explained that she obtained this from Company H after the IRD started making inquiries and that it was re-issued by Company H then. The IRD said that the first time it approached the Appellants in respect of Property 1 was by a letter dated 13 May 1998 when they were asked to file a tax return. However, the Appellants were not asked to produce documents substantiating the expenses until the IRD later requested this in a letter dated 19 November 1999. Ms B could not explain why the quotation was dated after the sale but before the IRD made inquiries. She surmised that the IRD might have made some earlier inquiries

in respect of some other properties and that she was then prompted to approach Company H for a re-issue of the quotation.

24. Before the decoration works were completed, Ms B was asked by one of her friends to give some business to another contractor. She telephoned this other contractor from Country J and asked him to give her a quotation. When he did so, she found that he was much cheaper than the first contractor. She therefore told Company H to finish off the work already commenced and gave the remaining work to this new contractor, Company I, to complete.

25. Ms B claimed that the Appellants had paid Company H $320,300. But she could not explain how she arrived at this figure. She pointed out some items on the quotation which she said Company H did complete. These items totalled more than the $320,300 claimed. She stated that they had paid Company I $202,000, and produced a quotation and a receipt. However, the quotation bears a date in 2001. The receipt also is dated 20 May 2001. The individual items on the quotation in fact add up to $203,000 and not $202,000. The day before the hearing, we were in addition provided with a statement from Company I confirming the work for 'about $200,000'.

26. These two sums now claimed, $320,300 and $202,000, total much less than the original claim of $1,000,000. In the said letter dated 23 May 1998, Mr A submitted a statement of gain on disposal of Property 1 as follows:

Sale price	:	$11,800,000
Purchase price	:	$8,850,000
Agency fee on purchase	:	about $88,000
Agency fee on sale	:	about $110,000
Legal fee on purchase	:	about $317,500
Legal fee on sale	:	about $29,000
Insurance premium	:	about $10,000
Stamp duty	:	about $243,575
Payment to bank (mortgage)	:	about $300,000 (including penalty, interest and appraisal fee)
Renovation	:	about $1,000,000
Net profits	:	about $851,925

27. When Ms B was asked about the discrepancy between the $1,000,000 originally claimed and the revised figures, Ms B explained that at the time the IRD was asking about the money spent on Property 1 and the Appellants had then included the amount spent on the furniture. She mentioned in particular a crystal ceiling light and a dinner table and chairs. As these were not in fact sold with the house that was the minor correction she made to her notice of appeal at the commencement of the hearing.

28. As stated above, the IRD wrote to the Appellants on 19 November 1999 requesting documentary proof of the $1,000,000 renovation fee by way of bank statements and passbooks to substantiate the payment. In reply by letter dated 28 February 2000, Ms B stated that the sum comprised 'different payments in about February, March, April and May 1997 by (the Appellants) and family members. No documents are found.' She was again asked at the hearing whether she could produce any such evidence of payment. She explained that her sister had moved house. Some payments were made by her sister-in-law or by her husband and she did not want to bother her family.

29. After the renovation works had been completed, Ms B's sister went to inspect the house and discovered that the walls were still wet. Company I explained that the leakage problem was irremediable, short of pulling down and rebuilding the walls. The problem was said to have been experienced in many of the houses in the same housing estate. The water leakage problem was later confirmed in answer to an independent inquiry by the IRD.

30. After the renovation works had started, Ms B's sister and the contractor also said that the green area next to the house would be turned into a car park. Worried that this might happen before they sold the house, the Appellants put Property 1 on the market. Ms B was contacted by long distance telephone and urged to sell. Initially she refused but finally gave in and her sister signed the sale and purchase agreement for them.

31. Ms B also gave evidence that they had a very good friend Mr L, who used to live next door to them and who decorated their Property 2 for them. They asked Mr L for his advice on the decoration of Property 1. Mr L said that there was no need to do a lot of designer work; all they needed to do was to buy some nice furniture and display items. They then asked him to make the purchases for them. They did not give him a shopping list or a budget. As they had been friends for a very long time, they were used to buying things for each other and being reimbursed for the purchases. She produced several receipts which she explained were purchases made by Mr L for Property 1. These are included in the list in paragraph 6 above. However, the garden furniture, the cutlery drawer and the hanger were apparently purchased in May 1997 after Property 1 had already been sold. Ms B explained that she had not told Mr L about the sale until later.

32. Ms B returned to Hong Kong in June 1997 when the sale was completed. She went back to Country J in July 1997 to commence her course of study. While still in Country J, the Appellants purchased Property 5 in late December 1997. The current depression of the property market 'had wiped out any profit they made on the sale of the earlier properties'. Property 5 is at present let and she is now living with her sister.

The law

33. The law is well settled. Whether a property is a capital asset or trading stock depends on the intention at the time of acquisition. A mere declaration of intention is of limited value. It must

be judged by considering the whole of the surrounding circumstances. Things said at the time, before and after, and things done at the time, before and after.

34. The onus is upon the Appellants to persuade us that the determination is erroneous.

Reasons for decision

35. The entire case turns on the Appellants' credibility. Ms B gave evidence and conducted the case by herself. She appears to be a highly intelligent person. She conducted the case capably and was prompt and confident in her answers to questions. We considered he evidence carefully and observed her demeanour closely.

36. Although Property 3 is not an issue in this appeal, it is relevant to Ms B's credibility. Her case was that having lived in Property 2 for some five years, she and her husband were looking for a future matrimonial home to replace Property 2. Strangely, she said that she did not discuss with her husband the type of property they wanted. But they were presumably looking for comparable if not better housing. Thus it appeared to us curious that they should decide to buy Property 3 since it was much smaller and in a noisier environment than Property 2. The difference in size was considerable. Property 2 was 1,700 to 1,800 square feet whereas Property 3 was only 900 or at most 1000 square feet. It did not have servant's quarter whereas they had a live-in maid when residing at District D. It seemed highly unlikely that they purchased it for their own residence. This in turn cast doubt on Ms B's declared intention in purchasing Property 1 later that year; and also on her credibility.

37. At the time which the Appellants purchased Property 1, they had already planned to pursue their studies abroad. Thus there appeared to be no particular hurry to purchase a replacement home. However, they had by then sold Property 2. They might wish to retain a Hong Kong base during their absence and purchase a replacement property before their departure. The question is whether they did acquire Property 1 for their future residence as claimed.

38. It is easy to say that a property is intended for self use. However a quick disposition as in this case is inconsistent with such an intention. It is necessary to consider the reason given for the sale. Ms B described Property 1 as almost her dream house. She placed special emphasis on the green area next to it. Yet shortly after she took possession, she heard that the trees which mattered so much in her decision to purchase were going to be cut down, the green area was going to disappear, and a car park would be put in its place. This would bring about noise and pollution. Instead of trying to find out more about this potential problem, Ms B stated that she regarded it as possibly a rumour and went ahead with expensive refurbishment when there was no hurry for this work to be done immediately if the property was intended for much later self use. Their relatives were recruited to 'monitor' the situation. Ms B failed to give any convincing account as to what further confirmation they later received which turned the rumour into a concrete reason for selling. Although the green area did eventually become a car park, the more important issue here is when

and how the Appellants discovered that the rumour had become a reality. Ms B failed to give a clear and credible account as to what transpired to prompt them to change their mind.

39. Another reason for the sale was the extensive seepage of water through the internal walls. Ms B said that she relied on the first contractor (Company H) who told her that the problem could be remedied. No evidence was given that either Ms B or her husband took steps to verify this statement. The quotation that she obtained from Company H for the renovation works did not include any item for waterproofing or such remedial work. The quotation which she later obtained from Company I did mention waterproofing but only for the balcony and roof. Ms B claimed that the plastering and the painting work included in the quotations were intended to remedy the water damage. However, this would not be adequate in the case of the very serious water damage which had exposed the internal steel reinforcing rods.

40. The Appellants had originally claimed that the renovation cost was $1,000,000. When cross-examined on this, Ms B said that the figure included the cost of the furniture as the IRD had enquired as to how much they had spent on the property. However, the letters of the IRD and the Appellants both referred to 'gains on disposal'. The Appellants undoubtedly understood the reason for and the significance of the question from the IRD. They should have known that furniture is not a deductible item unless it was sold together with Property 1. The claimed figure of $1,000,000 was significantly higher than the amount now claimed. It raises a serious doubt as to the integrity and honesty of the Appellants. The Appellants also made an excessive claim in respect of bank charges and agency fee.

41. Even for the reduced amounts now claimed, the Appellants did not produce a single document which evidenced any payment to either contractor. Ms B said that smaller amounts such as $10,000 were paid by cash and larger amounts such as $100,000 were paid by cheque. The total amount paid to the two contractors was alleged to be more than half a million dollars. The greater portion should accordingly have been paid by cheque and must therefore have been recorded on bank statements. The period in question is precisely defined. It all happened during the few months after Chinese New Year in 1997. It should have been easy to trace the bank evidence for at least some of the payments made to either Company H or Company I. No such evidence was produced. Ms B said that she did not want to bother her family members. Yet she had no qualms about bothering her family when she was in communication with them from Country J when they were supposedly furthering the decoration and furnishing work on her behalf.

42. Although Ms B did produce some documents such as re-issued quotations or receipts to support her claims, these documents were not particularly helpful. They were not evidence of payment. The dates were also problematic. No credible explanation was given as to why the quotation from Company H bears a date in June 1997, which was after the sale of Property 1 and before the IRD had asked for a tax return. It is quite possible that some decoration work was carried out. The property did have a water seepage problem. It might make sense for the Appellants to cover the water marks with a coat of paint. Decoration work to improve the

marketability of the property is not inconsistent with an adventure in the nature of trade. However, owing to the reasons already given, we are not satisfied as to the cost that was truly incurred by the Appellants for the renovation works.

43. Ms B also claimed some expenses for purchases made by their friend Mr L on their behalf. Two such receipts bore dates after Property 1 was sold. Ms B stated that she had asked her sister to put Property 1 on the market sometime before the sale. Even though at the time she had not made up her mind definitely to sell it, we would have expected her immediately to tell Mr L to defer making purchases for Property 1. After all, there appeared to be no special hurry to furnish the house. In any case, such furniture and cutlery purchased after the sale of the house are not deductible expenses.

44. As the decoration work is linked with the other reason given for the quick sale, we are left in serious doubt as to the true reason. In these circumstances, we are not prepared to find that Property 1 was acquired as a capital asset and for use as a matrimonial home. The onus is on the Appellants to persuade us that the assessment is erroneous, we have not been so persuaded and accordingly dismiss the appeal.