



Building a better
working world

Hong Kong Tax Controversy Insight

16 November 2020

2020 Issue No. 5

Common issues under tax audit by the Inland Revenue Department (IRD) - Property transactions

Property transactions are very popular in Hong Kong. It is necessary for property owners to understand and manage their tax exposures when conducting property transactions. In this insight, we will share our observation of the IRD's practice on the taxability of gain from sales of property.

Section 14 of the Inland Revenue Ordinance sets forth the basic criteria for a person to be chargeable to profits tax. It excludes profits arising from the sales of capital assets. Therefore, it is common for taxpayers who engage in property transactions having disputes with the IRD regarding the gain on disposal of properties, i.e. whether the gain in the property transaction is of capital or revenue in nature.

Is the sale of a property considered as trade?

To determine the nature of a gain from property disposal, it is essential to firstly determine whether the property is a trading stock or a capital asset. The test of “badges of trade” is often referred to when determining whether a sale of property constitutes a trade, and hence the property is a trading stock.

Badges of trades	Details
Subject matter of realization	A property by itself can be acquired for investment or trading purposes. Therefore, other information would be relevant to ascertain the purpose of this subject matter. Such information may include the number of properties purchased, the suitability of the property to be leased out, as well as the likelihood for it to be readily sold in the market. If the taxpayer can demonstrate that the property per se cannot be employed for trading, it is more likely for the capital claim to be successful.
Motive	The intention of taxpayers to engage in a property transaction is one of the important factors in ascertaining the taxability of gain therefrom. It is necessary for taxpayer to gather evidence to affirm the taxpayer's claimed intention truly exists. We will discuss the issues regarding motive in more details below.
Length of ownership	Generally speaking, a longer period of ownership may support the claim that the property is for self-use or rental purpose, instead of trading for quick profits.
Frequency of similar transactions	A taxpayer who seldom engages in property transactions is less likely to be regarded as a property trader. Rather, if the IRD notices that the taxpayer frequently purchases and sells properties, the IRD may have a stronger opinion on the trading nature of the property being sold.
Supplementary work done	The IRD may also question the purpose of the property if substantial renovation work is done right before the disposal to enhance the property's market value for trading.
Circumstances responsible for the realization	A disposal of property, where the taxpayer has no foregoing plan to sell the property but sold it in an emergent situation, is more likely to be a sale of capital asset.

Other considering factors on property transactions

The decision that the IRD makes on the nature of property sales is concluded based on the comprehensive facts of each transaction, and the determination factors differ from case to case. In addition to the "badges of trade" as discussed above, the IRD will also examine all other relevant circumstances in relation to the property transaction to determine whether the claimed tax treatment is appropriate.

The following factors are generally considered by the IRD:

► Before acquisition

The IRD may investigate the reason(s) and event(s) leading to the asset acquisition to further scrutinize the taxpayer's intention. The financing method of property acquisition is relevant as well, for example, whether the terms of the mortgage loan allow holding the property for a long period of time.

► During the holding period

For a corporation, the classification of property on the balance sheet should match its acquisition purpose, i.e., a property declared to be a capital asset but classified as a current asset in the balance sheet may be unfavorable to the taxpayer. The IRD may also consider whether commercial building allowances have been claimed in respect of the properties sold for profits tax purposes.

A change of intention is also another area to look at during the course of ownership. For instance, the IRD may agree on a taxpayer's initial intention of holding a property as long-term investment, yet still consider the taxpayer intends to trade the said property for profits afterward. Redevelopment of the property or sudden selling promotion of it on the property market with huge effort may seem to be a change of intention.

Another common situation is where the property owners spend lengthy period of time in renovating the property to seek suitable tenants. For some reason, the property is sold without any tenancy record. Under such circumstance, the IRD may consider that the taxpayer is only waiting for good timing to dispose of the property at a peak selling price. To defend on this, the taxpayer should demonstrate that time and effort were spent on trying to lease out the property. Evidence may include records of advertisement, agreements and correspondences with leasing agency and conversations with potential tenants, etc.

► At disposal

When it comes to the disposal of property, the seventh badge of trade discussed in *Lee Yee Sing and another v. Commissioner of Inland Revenue [2008] HKCFA 105* can be referred to as well. It also takes into account the fact that whether the taxpayer had spent extra time, money and effort to sell the properties when compared with that done by an ordinary seller of capital assets. Further, the subsequent utilization of sales proceeds in another investment will help substantiate the capital claim of property transaction.

Recommendations

The conclusion of whether a person is carrying on a trade, and subsequently whether the sales of property is revenue in nature, is a matter of fact without any hard and fast rule. The IRD would need a thorough understanding on the individual background of each transaction under dispute. Therefore, when a case is selected for review, the IRD would request the taxpayer to provide all relevant information and documents in relation to the property and review the transaction in detail.

The IRD would apply risk management to identify property transaction cases which are *prima facie* speculative activities in the nature of a trade. Upon identification, a property transaction questionnaire would be issued to these sellers to collect information regarding the date and amount of property purchase and sales, expenses incurred, profits earned, intention of purchase, and the reason of disposal, etc. This questionnaire would help the IRD to preliminarily examine the property transaction in question. The IRD may raise further queries to taxpayers to determine whether the property disposal is revenue in nature and whether the taxpayers fail to inform the IRD of the chargeability of such gain to profits tax.

In Hong Kong, the onus of proof lies with the taxpayers. Thus, it is crucial for taxpayers to keep proper documentation on the purchase of properties, showing the intention of maintaining capital assets, for at least 7 years after the property transactions.

Further, if taxpayers would like to engage in property development or redeveloping an existing building, it is recommended to consult tax professionals for the potential tax exposure, before engaging in actions that may otherwise be interpreted as entering into a trading venture.

Hong Kong office

Agnes Chan, Managing Partner, Hong Kong & Macau
 22/F, CITIC Tower, 1 Tim Mei Avenue, Central, Hong Kong
 Tel: +852 2846 9888 / Fax: +852 2868 4432

Ian McNeill
 Deputy Asia-Pacific Tax Leader
 +852 2849 9568
 ian.mcneill@hk.ey.com

Non-financial Services

Ernst & Young Tax Services Limited
 David Chan
 Tax Leader for Hong Kong and Macau
 +852 2629 3228
 david.chan@hk.ey.com

Greater China Tax Controversy
Co-Leader
Hong Kong Tax Controversy Leader

Ernst & Young Tax Services Limited
 Wilson Cheng
 +852 2846 9066
 wilson.cheng@hk.ey.com

Greater China Tax Controversy
Co-Leader
China Tax Controversy Leader

Ernst & Young (China) Advisory Limited
 Carrie Tang
 +86 21 2228 2116
 carrie.tang@cn.ey.com

Greater China Tax Policy
Leader

Becky Lai
 +852 2629 3188
 becky.lai@hk.ey.com

Financial Services

Ernst & Young Tax Services Limited
 Paul Ho
 Tax Leader for Hong Kong
 +852 2849 9564
 paul.ho@hk.ey.com

Business Tax Services / Global Compliance and Reporting**Hong Kong Tax Services**

Paul Ho
 +852 2849 9564
 paul.ho@hk.ey.com

Sunny Liu
 +852 2846 9883
 sunny.liu@hk.ey.com

China Tax Services

Cindy Li
 +852 2629 3608
 cindy.jy.li@hk.ey.com

US Tax Services

Michael Stenske
 +852 2629 3058
 michael.stenske@hk.ey.com

International Tax and Transaction Services**International Tax Services**

James Badenach
 +852 2629 3988
 james.badenach@hk.ey.com

Jacqueline Bennett
 +852 2849 9288
 jacqueline.bennett@hk.ey.com

Vanessa Chan
 +852 2629 3708
 vanessa-ps.chan@hk.ey.com

Adam Williams
 +852 2849 9589
 adam-b.williams@hk.ey.com

Transfer Pricing Services

Justin Kyte
 +852 2629 3880
 justin.kyte@hk.ey.com

Transaction Tax Services

Rohit Narula
 +852 2629 3549
 rohit.narula@hk.ey.com

Asia-Pacific Tax Centre**Tax Technology and Transformation Services****International Tax and Transaction Services****Indirect Tax****Global Compliance and Reporting**

Albert Lee
 +852 2629 3318
 albert.lee@hk.ey.com

Robert Hardesty
 +852 2629 3291
 robert.hardesty@hk.ey.com

US Tax Desk

Jeremy Litton
 +852 3471 2783
 jeremy.litton@hk.ey.com

Operating Model Effectiveness

Edvard Rinck
 +852 2675 2834
 edvard.rinck@hk.ey.com

Tracey Kuuskoski
 +852 2675 2842
 tracey.kuuskoski@hk.ey.com

Cherry Lam
 +852 2849 9563
 cherry-lw.lam@hk.ey.com

EY | Assurance | Tax | Strategy and Transactions | Consulting

About EY

EY is a global leader in assurance, tax, strategy, transaction and consulting services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. For more information about our organization, please visit ey.com.

© 2020 Ernst & Young Tax Services Limited.
 All Rights Reserved.

APAC no. 03011352
 ED None

ey.com/china

About EY's Tax services

Your business will only succeed if you build it on a strong foundation and grow it in a sustainable way. At EY, we believe that managing your tax obligations responsibly and proactively can make a critical difference. Our 50,000 talented tax professionals, in more than 150 countries, give you technical knowledge, business experience, consistency and an unwavering commitment to quality service – wherever you are and whatever tax services you need.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, legal or other professional advice. Please refer to your advisors for specific advice.

Follow us on WeChat

Scan the QR code and stay up to date with the latest EY news.

