Case No. D75/96

Profits tax – whether intention to trade – whether subsequent change of intention in treating properties from trading stock to fixed assets – whether such change of intention gave rise to notional profit – whether such notional profit taxable.

Panel: Ronny Tong Ka Wah SC (chairman), Edward Chow Kam Wah and Erwin A Hardy.

Dates of hearing: 14, 15, 16 and 17 October 1996.
Date of decision: 12 December 1996.

Appeal allowed.

[**Editor's note**: the Commissioner has filed an appeal against this decision.]

Cases referred to:

Sharkey v Wernher [1953] 36 TC 275
Marson v Morton [1986] 1 WLR 1348
Lionel Simmons Properties Ltd v CIR [1980] 53 TC 461
Sharkey v Wernher [1956] AC 58
All Best Wishes Ltd v CIR [1992] 3 HKTC 750
B/R 21/76, IRBRD, vol 1, 291
D55/90, IRBRD, vol 5, 420

Robert Andrews instructed by Legal Department for the Commissioner of Inland Revenue.
Denis Chang instructed by Deacons Graham & James for the taxpayer.

Decision:

Background

1. This is an appeal brought by the Taxpayer ('the Company') against a determination of the Commissioner of Inland Revenue ('the Commissioner') dated 14 November 1994 ('the Determination') by which the following assessments were confirmed:

(a) Additional profits tax assessment for the year of assessment 1987/88 dated 23 November 1992, showing additional net assessable profits of $34,385,570 (after set off of loss brought forward of $34,300) with additional tax payable thereon of $6,189,402 is hereby confirmed.

(b) Additional profits tax assessment for the year of assessment 1988/89 dated 23 November 1992, showing additional assessable profits of $955,416 with additional tax payable thereon of $162,420 is hereby confirmed.

(c) Profits tax assessment for the year of assessment 1989/90 under dated 16 December 1992, showing assessable profits of $22,180 with tax payable thereon of $3,659 is hereby confirmed.

(d) Profits tax assessment for the year of assessment 1991/92 dated 16 December 1992, showing net assessable profits of $17,759 (after set off of loss brought forward of $9,888) with tax payable thereon of $2,930 is hereby confirmed.

2. At the outset of the appeal, we were informed by the parties that an expense item of $244,000 by way of management fees is now accepted by the Revenue and the Company would make no submission on a further alleged expense item of $1,174,746.79 being a lump sum charge also in the nature of management fees so that the dispute concerning these 2 items was no longer a live issue before us.

Agreed Facts

3. All the material facts are agreed between the Revenue and the Company. The more relevant facts are as follows:

(a) The Company was incorporated as a private company in Hong Kong on 26 November 1985. It commenced its business on 20 June 1986 with two shareholders, namely, Mr A and Mr B ('the 1st Shareholders'), who were also the first directors of the Company.

(b) During 1986 the Company purchased the properties ('the Properties') set out below:

	Property	**Date of Agreement for Sale and Purchase**	**Price $**
(i)	G/F to 3/F, Road C No. 1	8-8-1986	11,500,000
(ii)	G/F, Road C No. 2	30-12-1986	10,800,000
(iii)	1/F, Road C No. 2	30-12-1986	1,700,000
(iv)	2/F, Road C No. 2	30-12-1986	1,300,000
(v)	3/F, Road C No. 2	31-12-1986	6,300,000

(c) On 14 November 1986, assignment of Road C No. 1 to the Company was completed. The Company obtained loan facilities to the extent of $11,000,000 from Bank D ('the 1st Loan') to finance the acquisition of Road C No. 1. The 1st Loan was secured by a legal charge over Road C No. 1, which was executed on 14 November 1986.

(d) The agreements for the purchase of G/F to 3/F of Road C No. 2 showed that the date of completion for each of these purchases was 27 March 1987.

(e) Road C No. 1 was classified as fixed assets and appeared as such in the Company's balance sheets as at 31 December 1986. The Company's financial statements for the period ended 31 December 1986 were audited by Company E, Certified Public Accountants.

(f) The 1st Loan together with the loans advanced from the directors were classified as current liabilities in the Company's balance sheet as at 31 December 1986.

(g) On 25 March 1987 there were changes in shareholders evidenced by a share transfer agreement ('the 1st Agreement') dated 11 February 1987.

(h) The 1st Agreement provided, among other things, that the 1st Shareholders as vendors agreed to sell to Mr F and Mr G as the purchasers the shares in the Company at a consideration of $8,666,090; that the transaction was to be completed on or before 27 March 1987 and that on completion, the purchasers should in addition to the purchase price as aforesaid repay to the vendors the deposit of consideration of Road C No. 2 and the interest free loan advanced by the vendors in the amounts of $3,380,000 and $2,583,910 respectively.

(i) On 25 March 1987 the following persons became the new shareholders of the Company ('the 2nd Shareholders') and the number of shares held by each of them were as follows:

Name of Shareholder	No of shares held
Mr F	1
Company H	2,599
Company I	3,400
Mr J	2,000
Mr K	2,000

(j) On 25 March 1987, Mr A and Mr B resigned as directors. The newly appointed directors were:

Mr F	Mr G
Mr K	Mr J
Mr L	Mr M

(k) On 25 March 1987, the Company completed the purchase of all the floors of Road C No. 2 and assignment of these properties to the Company was duly executed.

(l) On 25 March 1987, a debenture between the Company and Company N, a finance limited, was executed whereby the latter advanced a loan to the extent of $44,080,000 to the Company ('the 2nd Loan'). The 2nd Loan contained three parts as follows:

	Amount	**Purpose**
Tranche A Loan	$32,680,000	(a) financing in full the acquisition cost being $16,720,000 payable by the Company to complete the purchase of Road C No. 2 (b) refinancing in full the 1st Loan (c) refinancing in full the previous shareholder loans
Tranche B Loan	$9,400,000	financing in full the present estimated construction costs of the building
Tranche C Loan	$2,000,000	providing general working capital

(m) The 2nd Loan was repayable by three semi-annual instalments commencing 30 months from the date of the debenture or six months after the issue of the occupation permit, whichever was the earlier. The 2nd Loan was classified as current liabilities in the Company's accounts for the period ended 31 July 1987.

(n) On 24 September 1987 there were further changes in shareholders evidenced by another share transfer agreement ('the 2nd Agreement') dated 16 September 1987.

New Shareholder	No of Shares
Company O	9999
Company P	1

All the directors appointed on 25 March 1987 resigned and the new shareholders ('the 3rd Shareholders') and Company Q were appointed as new directors on 24 September 1987. The changes in shareholders and directors were reported to the Companies Registry on 28 September 1987.

(o) The directors of Company P and Company Q were as follows:

Company P	Company Q
Mr R	Mr R
Mr S	Mr S
Mrs T	
Mr U	

(p) The 2nd Agreement provided, among other things, the total consideration for the sale of the shares in the Company as follows:

Purchase price of shares of the Company		$34,188,910
ADD:		
Liabilities to be discharged by the 3rd Shareholders		
Secured indebtedness	$33,180,000	
Unsecured indebtedness	631,090	33,811,090
Total consideration		$68,000,000

(q) On 12 December 1987, the Company submitted building plans to the Building Authority to redevelop the Properties into a 17 storey commercial building.

(r) (i) The present management of the Company has no knowledge as to whether any feasibility study was prepared before or at the time when the Company committed to purchase the Properties.

(ii) The appointment of the architect was made around October 1987.

(iii) The building plan submitted on 12 December 1987 was approved on 5 February 1988.

(iv) Owing to the passage of time, the construction costs estimates, the cash flow projections and the feasibility study in respect of the approved building plan cannot now be obtained.

(v) The redevelopment was financed by the holding company, Company O by interest free loan. No loan agreement was entered into between the Company and its holding company.

(vi) The occupation permit of the new building was issued on 23 August 1994.

(vi) The new building was put up for letting by the Company.

The Revenue's Contentions

4. Having conducted its enquiries as to the circumstances surrounding the taking over of the Company by the 3rd Shareholder, the Revenue considered there was material to show that the Company changed its intention in respect of the Properties from trading stock to fixed assets on 28 September 1987 when the 3rd Shareholders took over the Company from the 2nd Shareholders.

5. On the basis the principle in Sharkey v Wernher [1953] 36 TC 275 was applicable a notional profit calculated as being the difference between the cost and market value of the Properties as the date of the change of intention was assessed as taxable profit of the Company.

The Company's Contentions

6. The Company on the other hand sought to argue that there was never any change of intention in that the Properties were always carried by the Company as fixed assets and thus for long time investment rather than as trading stock. In any event, even if there was such a change of intention, the principle in Sharkey v Wernher, *supra*, was not applicable. It follows that there were no profits upon which any profits tax could be raised.

The Issues

7. Bearing in mind these rival contentions, the parties agreed before us that there were, broadly speaking, two issues which awaited our decision, namely:

(a) One of fact as to whether there was a change of intention on the part of the Company upon the 3rd Shareholders taking over the Company; and

(b) One of law as to whether the principle in Sharkey v Wernher was applicable.

8. At one point, as regards the second issue for determination, the Company was seeking to argue that the principle in Sharkey v Wernher was either wrong or not applicable to Hong Kong. These wider propositions, however, quickly faded into the background when Mr Denis Chang, SC made his submissions before us. The main thrust of his argument, as we understand it, is really that the principle in Sharkey v Wernher, properly understood, cannot apply to the present facts before us.

Change of Intention

9. Mr Chang, SC, appearing on behalf of the Company argued forcefully that on the evidence there was no change of intention on the part of the Company in September 1987. While accepting that the burden of showing that there was no change of intention under section 68(4) of the Inland Revenue Ordinance, chapter 112 ('the IRO') was with him, he argued that there was no evidence to show that there was a change of intention in the first place so that the Determination was clearly unsupportable.

10. When pressed by this Board as to what evidence he sought to rely on in support of his contention that there was never any change of intention on the part of the Company, he broadly outlined three sets of facts which he sought to rely on. These are, in summary:

(a) That the financial statements of the Company all showed that the Properties were carried as fixed assets of the Company;

(b) That in successive agreements for the sale and purchase of the shares of and in the Company, the 1st, and subsequently, the 2nd Shareholders had warranted or represented that the financial statements of the Company were accurate and thus confirmed the intention that the Properties were carried as fixed assets of the Company. Relying on these warranties or representations, the 3rd Shareholders took over the Company; and

(c) These Properties were clearly very valuable properties so that they were capable of supporting long term investment on their own without further injection of capital from the shareholders.

11. Let us examine each of these submissions in turn.

Financial Statements

12. It is true that the relevant audited accounts of the Company treated the Properties as 'fixed assets'. Furthermore, the auditors' report further confirmed that the accounts were accurate and prepared in accordance with approved Auditing Standards. Be that as it may, the classification of the Properties as being 'fixed assets' was but a reflection of what the Company informed its accountants and its auditors as regards the former's intentions. In this sense, such a declaration is self-serving and, as Mr Chang, SC rightly recognises, not binding on either the Revenue or this Board.

13. In **Simons's Taxes**, volume B, at paragraph B3.904, this was said as to the effect of accounts:

> *'It has been laid down in many cases that neither the rights of the Crown nor those of the taxpayer can be made to depend upon the way in which the taxpayer's accounts have been prepared; nor do the rights of either side depend upon the character of the book-keeping relating to the business. Accounts are merely a statistical method of recording facts as to trading. There are a number of systems and any one properly adopted and consistently followed must be accepted, but, of course, disputes may arise as to how, under the system adopted, certain items are to be treated.*
>
> *The taxpayer's method of accounting may be of great importance where an entry is made in the accounts, nor for the purposes of convenience, or for the purpose of giving effect to particular notions of account keeping, but for the purpose of definitely deciding and of recording the fact that a decision had been come to that a certain payment is to be made out of capital and not out of income, or vice versa. In such a case the evidence afforded by the accounts would, in the absence of evidence to the contrary, be conclusive on the point.'*

14. There is no direct evidence adduced before us that any of the accounts relied on were prepared for the purpose of definitely deciding or of recording the fact that a decision had been made as to the way the Properties were to be held. Indeed, there were no minutes of any kind which suggested a conscious decision was made at any stage that the Properties were held for long term investment. Our task is thus to try to ascertain the intention of the Company from all the surrounding circumstances.

15. The principle to be applied on the question of ascertaining intent is well settled and cannot be doubted. In Marson v Morton [1986] 1 WLR 1348, ***Sir Nicholas Browne-Wilkinson V-C*** said (at page 1348 of the report):

> *'It is clear that the question whether or not there has been adventure in the nature of trade depends on all the facts and circumstances of each particular case and depends on the interaction between the various factors that are present in any given case. The most that I have been able to detect from the reading of the authorities is that there are certain features or badges which may point to one conclusion rather than another.'*

16. The learned Judge then went on to list out (at page 1348 to 1349 of the report) some of these features or badges, which are of course by no means exhaustive:

(a) Whether the transaction was a one-off transaction?

(b) Was the transaction related to the trade which the taxpayer otherwise carries on?

(c) What is the nature of the subject matter?

(d) What was the way in which the transaction was carried out?

(e) What was the source of finance of the transaction?

(f) Was work done to the item purchased before it was resold?

(g) Was the item resold in one lot or broken down into saleable lots?

(h) What were the purchasers' intentions at the time of purchase? and

(i) Did the item provide enjoyment for the purchaser?

In approaching these questions, common sense must be applied.

17. In Lionel Simmons Properties Ltd v CIR [1980] 53 TC 461, Lord Wilberforce said (at page 491G):

> *'Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment? Often it is necessary to ask further questions: a permanent investment may be sold in order to acquire another investment thought to be more satisfactory; that does not involve an operation of trade, whether the first investment is sold at a profit or at a loss. Intentions may be changed. What was first an investment may be put into the trading stock – and, I suppose, vice versa. If findings of this kind are to be made precision is required, since a shift of an asset from one category to another will involve changes in the company's accounts, and possibly, a liability of tax (cf. Sharkey v Wernher [1956] AC 58). What I think is not possible is for an asset to be both trading stock and permanent investment at the same time, nor to possess an indeterminate status – neither trading stock nor permanent asset. It must be one or other, even though, and this seems to me legitimate and intelligible, the company, in whatever character it acquires the asset, may reserve an intention to change its character. To do so would, in fact, amount to little more than making explicit what is necessarily implicit in all commercial operations, namely that situations are open to review.'*

18. Mortimer J (as he then was) in All Best Wishes Ltd v CIR [1992] 3 HKTC 750 summed up the position well (at page 771):

> *'The Taxpayer submits that this intention, once established, is determinative of the issue. That there has been no finding of a change of intention, so a finding*

that the intention at the time of the acquisition of the land that it was for development is conclusive.

I am unable to accept that submission quite in its entirely. I am, of course, bound by the Decision in the ***Simmons*** *case, but it does not go quite as far as is submitted. This is a decision of fact and the fact to be decided is defined by the Statute – was this an adventure and concern in the nature of trade? The intention of the taxpayer, at the time of acquisition, and at the time when he is holding the asset 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 as 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. Indeed, decisions upon a person's intention are commonplace in the law. It is probably the most litigated issue of all. It is trite to say that intention can only be judged by considering the whole of the surrounding circumstances, including things said and things done. Things said at the time, before and after, and things done at the time, before and after. Often it is rightly said that actions speak louder than words.'*

19. It follows that the classification of the Properties as 'fixed assets' in the financial statements of the Company is by no means conclusive. One must look at all the circumstances to see if that self-declaration of intent is borne out by the facts.

Warranties and Representations

20. The warranties and representations contained in the two successive share sale agreements are no different in nature from the self-declaration of intent one sees in the financial statements of the Company. If anything, they must carry less weight as they only purport to be warranties and representations made by the shareholders of the Company *qua* shareholders and not as purporting to speak for the Company.

Valuable Properties

21. Mr Chang, SC was at pains to emphasise that the Properties were (and probably still is) extremely valuable and *capable* of sustaining long term investment without and difficulty. He also adduced a considerable body of evidence to support this contention. We hope we will be forgiven for not setting out here the nature of that evidence for we do not doubt the proposition as put by Mr Chang, SC. The Properties were undoubtedly *capable* of self-sustaining as a long term investment but the question we have to answer is: *were* they being held as long term investment?

Acquisition of the Properties

22. In order to determine the intention of the Company at the time of the purchase of the Properties, one must go back in time to look at the history of the activities of this going concern.

23. The Company was incorporated as a private company on 26 November 1985 but did not commence its business until 20 June 1986. It was very likely a shelf company since it only had an authorised capital of $10,000 divided into 10,000 shares of $1.00 each. Only 2 shares were issued and paid up when the Company commenced its business. They were taken up by the 1st Shareholders.

24. As soon as the Company was acquired by the 1st Shareholders, it bought Road C No. 1 on 8 August 1986 at $11,500,000 with the 1st Loan. The purchase was completed on 14 November 1986. The 1st Loan was secured by a legal charge also executed on 14 November 1986 and was repayable on demand.

25. In December, the Company agreed to purchase various floors of Road C No. 2:

Property	**Date of Agreement for Sale and Purchase**	**Price $**
(a) G/F	30-12-1986	10,800,000
(b) 1/F	30-12-1986	1,700,000
(c) 2/F	30-12-1986	1,300,000
(d) 3/F	30-12-1986	6,300,000
	Total:	20,100,000

26. It is significant to note that Road C No. 2 was bought with no finance being arranged for its completion. Only a deposit was paid, presumably on shareholders' funding. The total deposit paid was $3,380,000 or 16.8% of the total purchase price. In other words, in order to complete these purchases, the Company needed to borrow at least another $16,000,000. There is no evidence to show any step at all was taken to ensure that the Company would be able to maintain these properties for long term investment.

27. The 1986 accounts were, of course, not signed until 2 March 1987 by which time the 1st Agreement dated 11 February 1987 in favour of the 2nd Shareholders was already signed. In fact, the 1986 accounts (up to 31 December 1986) only covered Road C No. 1. The purchase of Road C No. 2 were merely noted as a capital commitment. Even then the net loss for the period between 20 June 1986 and 31 December 1986 was stated as $34,300.15. The liabilities for the purchases of Road C No. 2 were not shown.

28. Thus, the position as at December 1986 is that the Company had bought the Properties at a total cost of some $30,000,000 but no step had been taken to either complete

the purchase of Road C No. 2 or to arrange long term finance if the intention were to hold the Properties as long term investment.

29. Instead, the 1st Shareholders sold the 2 shares in the Company by the 1st Agreement. The intention of the 1st Shareholders obviously was not to hold the shares in the Company, and thus in turn, the Properties for long term investment. Rather, the circumstances are such that their dealings bore all the badges of trading in property, or more specifically, trading property for short term profit. We are conscious of the argument that the Company did not sell the Properties. However, given that the shareholders intended to trade the Properties through the sale of shares, there is no independent evidence to suggest that the intention of the Company as regards the Properties was any different or that it had changed to long term investment by March 1987.

The Company's Intention In March 1987

30. What then was the Company's intention in March 1987 up to September 1987 when the shares of the Company again changed hands?

31. After the Company was acquired by the nominees of the 2nd Shareholders in March 1987 further shares were allotted so that the full authorised capital of $10,000 was taken up. On the same day, the purchases of Road C No. 2 was completed by the raising of the 2nd Loan.

32. The 2nd Loan was divided into 3 tranches: the first tranche of $32,680,000 was used to finance the cost of acquisition of Road C No. 2, to refinance in full the 1st Loan and to refinance in full the previous shareholders' loans. The 2nd Loan was a short term loan. It was repayable by 3 semi-annual instalments commencing 30 months from the date of the debenture under which the 2nd Loan was advanced or 6 months after the issue of the occupation permit, whichever was the earlier. No long term finance to sustain the development and long term holding thereafter was ever arranged.

33. The interim accounts of the Company for the period 6 March 1987 to 31 July 1987 were not signed until 19 August 1987, some 6 months after the shares in the Company were acquired by the 2nd Shareholders. Although in these accounts, the Properties were treated as fixed assets, the financial position of the Company as shown by the accounts was precarious. There was an outstanding bank loan of some $33,100,000 not to mention other current liabilities. The rental income for the period was only $417,341.90. This was set against general expenses of about $1,300,000 of which bank loan interest and charges alone accounted for $746,097.53.

34. And yet, no steps were taken to arrange long term finance or broaden the capital base of the Company with, for example, an increase of paid up capital. It is thus hardly surprising that when the accounts for the entire financial year were prepared, the auditors had to qualify the accounts of the Company as a going concern. By the end of the 1987 financial year, the rental income of the Properties were stated as $931,339.90 against expenses totalling $3,305,611.91. Bank interest alone amounted to $1,326,356.77.

35. It was in these circumstances that on 16 September 1987, the 2nd Shareholders sold the shares of the Company to the 3rd Shareholders. Again, the circumstances of the sale of the shares had all the badges of a trade in property by the 2nd Shareholders through the sale of the shares. If that was their intention, there is no independent evidence to suggest that the intention of the Company as regards the Properties was any different.

Letter of 21 December 1989

36. Not only that but there is a very significant piece of evidence that points the other way. On 21 December 1989, a Director of Company I wrote to its own accountants in answer to a query raised by the Revenue and stated that:

> '[The Company was] incorporated to acquire pieces of land to construct properties for dealings. After initial investment was made, the directors discovered that a lot of money for development will be required by way of advance by shareholders. Moreover, large construction procedures and sales transactions of flats will only be completed several years later. Hence, the directors of the Company considered that it is not suitable to the Company to advance a lot of money to support these plans and no longer desirous to continue in such investment. The directors decided to dispose of the said share investment though much profit may be gained after the completion of the construction projects three to five years in future.'

37. The letter concluded with these words:

> 'At present, [Company I] is holding the shares of 9 property Companies, three of the properties are still waiting the approval of the building plan and two of the properties have been completed and are distributing now, while others are under development. Dividends are expected to pay, after sales of the properties and taxation.'

38. Despite valiant efforts by Mr Chang, SC to argue the contrary, it is clear that the Director was representing to the accountant the intention of Company I at the time when it held the shares of the Company. It is also beyond dispute that the general trading activities of Company I were those of a property dealing trader. Their approach to the Company was no different from their approach to other property development companies owned by them at the time. There is nothing to suggest this intention was any different from the remaining shareholders of the Company at the time who undoubtedly were either nominees or associates of Company I and were of the same mind.

Our Finding of Fact

39. In our view, there was sufficient material for the Commissioner to come to the view that the original intention of the Company was to trade the Properties; that this intention was maintained until September 1987 when the 3rd Shareholders took over the

Company and arranged long term finance to develop and hold the Properties as long term investment.

40. It is trite law that the burden under section 68(4) of proving the assessment appealed against is incorrect lies with the Company. We do not regard that burden as having been discharged as far as the issue of intention of the Company is concerned. On the contrary, we find, on the evidence, as a fact that the original intention of the Company was to trade the Properties and that intention did not change until the 3rd Shareholders took over the Company in September 1987.

The Principle in Sharkey v Wernher

41. That, however, is not the end of this appeal. For the Revenue to succeed, we have to be satisfied that the assessment appealed against is correct and not excessive. The issue here is: given the fact that the Properties were never disposed of by the Company, could profits tax be raised upon a mere change of intention?

42. The Revenue relied heavily on Sharkey v Wernher, *supra*. It is important to note the facts of that well known case. They are these: the wife of the taxpayer carried on a stud farm as a trade. She also carried on the activities of horse racing and training, which were agreed not to constitute trading. Five horses were transferred from the stud farm to the racing stables. The cost of breeding these horses were debited in the stud farm accounts. On the question of the amount to be credited as a receipt the taxpayer contended that the proper figure to be brought in in respect of the transferred horses was the cost of breeding. The Crown, on the other hand contended that the market value of the horses which was considerably higher, was the proper figure. It is significant to note that it was conceded by the taxpayer that consequent upon the transfer of the horses, *some* figure in respect of the transferred horses fell to be brought into the stud farm accounts as a receipt.

43. In the leading speech of **Viscount Simonds**, the learned law lord started by questioning why the case was not argued on the basis that as the wife of the taxpayer received nothing, her trading account should be credited with nothing (see page 296 of the report). But in the light of the concession, he went on to consider the relevant authorities and concluded thus:

> *'My Lord, how far is this principle, which is implicit in the judgments that I have cited and in the admission upon which this case has proceeded, supportable in law? That it conflicts with the proposition, taken in its broadest sense, that a man cannot trade with himself is, I think, obvious. Yet it seems to me that it is a necessary qualification of the broad proposition. For if there are commodities which are the subject of a man's trade but may also be the subject of his use and enjoyment, I do not know how his account as a trader can properly be made up so as to ascertain his annual profits and gains unless his trading account is credited with a receipt in respect of those goods which he has diverted to his own use and enjoyment. I thin, therefore, that the admission was rightly made that some sum must be brought into the stud farm account as*

a receipt though nothing was received and so far at least the taxpayer must be regarded as having traded with himself. But still the question remains, what is that sum to be. I suppose that in the generality of cases in which the question arises in a farming or any other business, for example, where the farmer supplies his own house with milk, or a market gardener with vegetables, an arbitrary or conventional sum is agreed. The House was not given any information as to the prevailing practice. Now the question precisely arises … But it appears to me that when it has been admitted or determined that an article forms part of the stock-in-trade of the trader, and that upon his parting with it so that it no longer forms part of his stock-in-trade some sum must appear in his trading account as having been received in respect of it, the only logical way to treat it is to regard it as having been disposed of by way of trade. If so, I see no reason for ascribing to it any other sum that that which he would normally have received for it in the due course of trade, that is to say, the market value. As I have already indicated, there seems to me to be no justification for the only alternative that has been suggested, namely, the cost of production. The unreality of this alternative would be plain to the taxpayer, if, as well might happen, a very large service fee had been paid so that the cost of production was high and the market value did not equal it.'

44. **Lord Radcliffe** in his speech said (at page 306):

'My Lords, with these considerations in mind, I must now say what I believe to be the right way to deal with the present case. When a horse is transferred from the stud farm to the owner's personal account, there is a disposition of trading stock. I do not say that the disposition is made by way of trade, for that is a play on words which may beg the question. At least three methods have been suggested for recording the result in the stud farm's trading accounts. There might be others. Your Lordships must choose between them.

First, there might be no entry of a receipt at all. This method has behind it the logic that nothing in fact is received in consideration of the transfer, and there is no general principle of taxation that assesses a person on the basis of business profits that he might have made but has not chosen to make. Theoretically, a trader can destroy or let waste or give away his stock. I do not notice that he does so in practice, except in special situations that we need not consider. On the other hand, it was not argued before us by the Respondent that this method would be the right one to apply: and a tax system which allows business losses to be set off against taxable income from other sources is in my opinion bound to reject such a method because of the absurd anomalies that it would produce as between one taxpayer and another. It would give the self-supplier a quite unfair tax advantage.

Secondly, the figure brought in as a receipt might be cost. That is what the Respondent contends for. It is not altogether clear what is to be the basis of such an entry. No sale in the legal sense has taken place nor has there been

any actual receipt: the cost basis, therefore, treats the matter as though there had been some sort of deal between the taxpayer and himself but maintains that in principle he can only break even on such a deal. I do not understand why, if he can be supposed to deal at all, he must necessarily deal on such self-denying terms. But then the Respondent argues that the cost figure entered as a receipt is to be understood as a mere cancellation of the cost incurred to date. The item of stock transferred to the owner's private account is shown by that very event to have been "withdrawn" from the trade and the only practical course is to write out of the trader's account the whole of the cost bona fide, but mistakenly, entered in respect of it. I think this a very attractive argument, but its weakness is that it does not explain why such cancellation should take place. This is not put to us as a case in which, there being no market, cost is the best available estimate of value. The fact that an item of stock is disposed of not by way of sale does not mean that it was any the less part of the trading stock at the moment of disposal. On the contrary, it was part of the stock of the venture at every moment up till then and whatever was spent upon it was rightly entered as a part of the costs and expenses of the trade. Its disposal do not alter that situation …

In a situation where everything is to some extent fictitious, I think that we should prefer the third alternative of entering as a receipt a figure equivalent to the current realisable value of the stock item transferred … The realisable value figure is neither more nor less 'real' than the cost figure, and in my opinion it is to be preferred for two reasons. First, it gives a fairer measure of assessable trading profit as between one taxpayer and another, for it eliminates variations which are due to no other cause than any one taxpayer's decision as to what proportion of his total product he will supply to himself. A formula which achieves this makes for a more equitable distribution of the burden of tax, and is to be preferred on that account. Secondly, it seems to me better economics to credit the trading owner with the current realisable value of any stock which he has chosen to dispose of without commercial disposal than to credit him with an amount equivalent to the accumulated expenses in respect of that stock. In that sense, the trader's choice is itself the receipt, in that he appropriates value to himself or his donee direct, instead of adopting the alternative method of a commercial sale and subsequent appropriation of the proceeds.'

45. From these passages we do not understand the basis of that decision to be that a man can be taxed for something which he never receives. Rather, in our view, the proposition to be extracted from Sharkey v Wernher, *supra*, is this: where a trader disposes of part of his stock-in-trade for personal purposes, his accounts must be credited with the market value of the item disposed of for the purposes of calculating his profits and loss in the trade.

46. That is not the case here. Although the Company might have *the intention* to trade, it had taken no steps to deal in the Properties. There is no evidence that the Properties

were ever put up or advertised for sale. In this respect, the activities of the shareholders must be separated from those of the Company. The shareholders might have embarked upon activities to trade the underlying assets of the Company. If so, they can be charged with profits tax for the profits they made. But that is not the case in front of us. The shareholders are separate entities from the Company. That is the corner stone of our company law. As far as the Company is concerned, there is no evidence it has undertaken any property trading activities. There is no legislation to tax a person's intentions. If a person sits in the comfort of his home and dreams of selling his house, he cannot be charged with profits tax if he subsequently changes his mind without ever disposing his house. The Properties here were never disposed of. There was no carrying on of trade as in the case of Sharkey v Wernher, *supra*. There was no pre-existing need to draw up a profits and loss accounts for the purposes of profits tax. It follows there was no need to record a fictitious receipt entry representing the value of the stock disposed of in computing the Company's liabilities for profits tax. In other words, the situation in Sharkey v Wernher, *supra*, simply did not arise.

47. The Revenue also sought to rely on two previous decisions of this Board purporting to apply the rule in Sharkey v Wernher. The first is B/R 21/76. But in that case, there was clear evidence that the taxpayer had carried on the trade of property dealing with the tenement flats. This is clear from paragraph 9 of the decision where the Chairman of the Board said:

> *'... we are of the unamimous opinion that [the rule in Sharkey v Wernher] is applicable in the present case where the Company carried on inter alia the businesses of property dealing and property holding and transfers assets from the former to the latter.'*

48. In other words, the facts were virtually identical with those in Sharkey v Wernher. We do not think this decision is of any assistance to the Revenue.

49. The next case relied on is D55/90. Ironically, that was a decision of Mr Chang, SC when he last sat as Chairman to this Board. Equally, in that case, there was some evidence of an existing trade. At page 430 of the decision, the Chairman said:

> *'Everything considered we find that the property was acquired not as a capital but as a trading asset; and that, in any event, the acquisition was or was part of a trade or adventure in the nature of trade.'*

50. Insofar as the Mr Chang, SC, sitting as Chairman in that case was of the view that 'the change of intention can itself bring into existence a new and distinct line of activity' (at page 430), that opinion was not necessary for the decision and is in any event not supported by any authority we have been shown. With the greatest respect, the Board in that case never attempted to analyse the true basis of the decision in Sharkey v Wernher and we do not find the decision in D55/90 to be of any great assistance to us.

51. It follows that neither decision supports the contention of the Revenue. In our view, the issue of law must be answered in favour of the Company and the appeal allowed insofar as the additional profits tax assessments are concerned. In view of the mutual concessions referred to in paragraph 2 hereof, we think we better hear the parties on the precise order we should make.