

applicable in Hong Kong (see B/R 21/75 IRBRD 291) this Board considers that great caution should be exercised by the Commissioner in attempting to invoke the principle and further this Board considers that the scope of the principle should not be extended. As counsel for the Company pointed out, if it was to be extended to cases such as the present consideration would have to be given as to whether or not the sale of the units should be considered as one overall package in which case prices below the valuer's figures would be increased and prices above the valuer's figure reduced. In his determination the Commissioner stated that "quite apart from the fact that the differences here are relatively small, it would be quite inappropriate to exclude from assessment profits which actually accrued to the Company". However, in the Board's opinion it would be equally inappropriate to include profits which did not actually accrue to the Company. If this had been a **Petrotim Securities Ltd. v. Ayres** situation involving a sale or disposal of assets to associated persons at substantially below market value this Board would be bound by the **Sharkey v. Wernher** as extended in the **Petrotim** case principle. This is not, however, the situation in this case and the determination of the Commissioner on this point is set aside.

The assessment is ordered to be remitted to the Commissioner to be revised on the basis of the actual profits which accrued to the Company, excluding notional profits attributable to what the Commissioner claimed to be the excess of market value over sales price.

Case No. D27/84

Board of Review:

H. F. G. Hobson, *Chairman*; John Haggarty and Peter P. L. Li,
Members.

28 February 1985.

Profits tax—whether sale of the units in a building constituted trading or was the realisation of an investment consequent upon a change of circumstances—appellant's change of intention from that of investment in relation to the property concerned to that of trading.

In 1972, the Appellant company purchased a site. The site was then cleared. Eventually a 29-storey factory building was constructed and the units therein were sold off. The Commissioner of Inland Revenue determined that the acquisition of the site, the development and the sale of the units in that development were in the nature of a trade. The appellant argued that at the time of purchase in 1972 the property was intended to be developed as a mixed godown-factory building as a long term investment but in 1976 the director changed his mind and decided upon a building comprising factories only, he having abandoned the idea of a godown.

Held:

On the evidence given the Appellant Company never formed any firm intention to buy the subject site as a long term investment.

Appeal dismissed.

A. J. Halkyard for the Commissioner of Inland Revenue.
Peter C. L. Lo of Messrs. Woo, Kwan, Lee & Lo for the Appellant.

Reasons:

The Taxpayer, a company incorporated on the 6 November 1970, purchased a property in Kwai Chung (the "Subject Site") in December 1972. The site was then cleared and eventually a 29-storey factory building was constructed which was finished in 1976/77 whereupon the units therein were sold off.

The issue before us was whether the sale of these units constituted trading or was simply the realization of an investment consequent upon a change of circumstances. Should the second alternative apply then the next issue would be to determine when the Taxpayer changed its intention from that of investment in relation to the property concerned to that of trading.

Mr. Peter C. L. Lo, Solicitors, represented the Taxpayer whilst Mr. A. J. Halkyard appeared for the Inland Revenue Department (IRD) and was assisted by Mr. Hong Po-shan.

The Statement of Facts upon which the Commissioner of Inland Revenue had reached his Determination that the acquisition of the Subject Site and the development and the sale of the units that development were in the nature of a trade.

C gave evidence on oath for the Taxpayer and said that he was at all material times a Director, the Chairman and the majority shareholder of the Taxpayer. He was also the sole proprietor of a construction company namely CSK which had been actively involved both in construction for others and in development on its own account and where the development was for its own account (or for the account of companies in which C was himself the principal

shareholder) then with one exception all such developments were treated as being in the nature of trade, all of the units in the developed properties being sold off. In one instance however a company in which C was the majority shareholder retained part of a redeveloped building and let off it as a restaurant—this was the sole example of an investment activity by C other than the one before us.

C averred that he purportedly incorporated the Taxpayer company to serve as an investment vehicle for his family and incorporated into the title of the company the names of two of his sons and for two years after the incorporation he was looking about for a suitable investment opportunity. In 1972 through the introduction of his bankers he met a L then the manager of TSS, who told him that the return on godowns was very good. This attraction led C to look for suitable premises to develop as a mixed godown—factory building (“Composite Building”). He learnt of the Subject Site which he thought suitable for the purpose of redevelopment as a Composite Building. Thus C’S evidence was that at the time of the purchase in December 1972 he intended that the property be developed as long term investment and moreover that the investment would take the form of a mixed godown—factory building.

The Subject Site having been purchased for HK\$2,977,000 C instructed architects to draw up plans which were submitted to the Building Authority in February 1973. Notwithstanding that the costs, estimated at HK\$10,523,000 of a Composite Building would be greater than that for a building dedicated solely to factories, due to the need to meet the floor-loading specifications for godowns, C determined to proceed with the Composite Building. He was aware that the Crown Lease provisions of the Subject Site did not permit godowns and that he would need to obtain a change of use modification but was under the firm impression that such change of user would be allowed upon payment of a modest premium.

C further said that at the time these first plans were prepared it was the Taxpayer’s intention, as personified by himself, to retain not only the godown area but also the factories as an investment: the Taxpayer would itself operate the godown area, engaging L to manage that business because C had no experience of godown management. The flatted factories on the other hand would be let out. L would receive some interest in the godown business—but not shares in the Taxpayer—however C was quite vague as to what form that interest would take. C said that the godown itself would act as an attraction for the letting of the factory units. He said that in

March 1973 his architects prepared an estimate of the likely return of the redeveloped Composite Building which in total would be about HK\$4,723, 698 per annum and C was also of the view that the cost of the development of the Composite Building would be in the order of HK\$13,500,000 which together with the land cost would give a figure of HK\$17 million approximately, thus the estimated return would be approximately 27%. Application for change of user was made in May 1973 and the District Office advised the terms on which modification of the Lease would be granted. Due to negotiations on one of the terms, formal modification was not approved until July 1976 by which time C had changed his mind and decided upon a building comprising factories only, he having abandoned the idea of a godown.

K, a Chartered Surveyor of substantial credentials, gave evidence as an expert on two aspects, namely, the likelihood of developers in or about 1972 building godowns for resale and secondly as to the valuation of the Subject Site as of September 1975 and April 1976, his evidence on this second aspect serving two purposes, the one to indicate the remarkable increase in values between September 1975 and April 1976 which might act as a catalyst in changing the Taxpayer's original intention and the other purpose being concerned with establishing a valuation to be agreed or contested by the IRD in the event that we were to conclude that there was a change of intention on either of the two dates referred to thereby necessitating a remittance by us back to the IRD.

K's evidence on the first aspect was that in his experience no developer had built godown buildings for resale save for instances where one godown owner might sell his property to another godown operator. He attributed this to the fact that certain godowns catered to certain trades requiring specialized equipment and without a captive buyer in mind there is a risk that the developer will build an unsuitable configuration—hence in his experience it is the godown operators who build to meet their own specific requirements. Moreover K did not think it was feasible to build a godown for sale in units to multiple operators due to the conflicting interests of the operators and the management problems which would inevitably arise.

As to the inducement aspect Mr. Kan by reference to comparative, albeit government, sales of nearby properties valued the Subject Site as of September 1975 at HK\$3,860,000 as against April 1976 when it had increased in his estimation to HK\$11,600,000 i.e. 300% increase in about 6 months. This K believed was due to the

fact that although the oil crisis in 1973 had made itself felt in Hong Kong in March 1974, when the stock market began to drop dramatically from a peak of 1 700 to 400—further dropping to 165 by the end of 1974. By 1975 manufacturers were becoming accustomed to living with high energy costs, consequently matters stabilized so that by 1976 with its resurgence of experts there was almost a rush back into property purchasing. He also said that between September 1975 and April 1976 it was unlikely that there was any particular increase in development costs because although material costs had for a while after the oil crisis been inflated due to the fears of suppliers, their inflated costs were greater than were warranted, competition then led to prices beginning to fall again to more realistic levels. We should mention that K gave his evidence in a very forthright fashion and the logic of his arguments was readily understood.

Earlier in 1974 while negotiations were taking place between the Taxpayer and the District Office about the change of user, the Taxpayer instructed its solicitors to advertise the property for sale by sealed tender. This is of course extrinsic evidence of a proposed sale not only prior to completion of the building but also before a change of user was confirmed. C testified that this was no more than a means of testing the market to determine whether or not the idea of a Composite Building was one which in the eyes of potential buyers was attractive. As it happened no tenders were received. We realize the Taxpayer was not bound to accept any tender it received, nevertheless the details contained in the invitation to tender are such as to suggest a genuine invitation, not merely “testing the market”, a rather remarkable approach since we would have expected the Taxpayer to rely upon estate agents/surveyors rather than resort to this elaborate charade: only a year earlier he had been content to rely upon his architect and the views of L when he concluded that godown would be a fruitful venture. Despite the absence of any tenders the Taxpayer did not abandon the idea of incorporating a godown into a building until, according to one version of his evidence given in a prepared statement, September 1975 i.e. about 18 months later. If the purpose of the invitation was truly directed at determining whether or not a godown/factory mix was an attractive proposition, then the lack of bids would surely have led to the Taxpayer to conclude that it was not and thereupon proceed with a building dedicated to flatted factories alone. The alternative version given in cross-examination is that he did decide to abandon the godown idea after the abortive invitation to tender: though this is more consistent with the notion of testing the market it is at odds

with pressing on with the modification needed for a godown, as witness a letter by the Taxpayer's solicitors dated 15 October 1974.

Accordingly we are not convinced that the invitation to tender made in early 1974 was a sham—we believe it was genuine attempt to resell. We think that if, as happened in 1976, he had been overwhelmed by eager buyers he would definitely have sold—he implied as much by saying that “in business flexible measures should be adopted”.

The next issue for consideration therefore is whether the invitation was brought about by a change of mind, i.e. from an original intention to hold long term for investment or merely another means of selling the Taxpayer's stock-in-trade in a single parcel as opposed to converting it, by construction, into a number of saleable units. In this last regard we think the following remarks are pertinent.

C testified that the Taxpayer company was formed as an investment vehicle and pursuant to this purpose bought the Subject Site in December 1972, yet in May of 1973 he had the Taxpayer company buy another property as a trading venture. C admitted to a flexible outlook thereby indicating the attitude of a trader rather than that of a firm long-term investor. C at one point testified that the godown venture was fundamental to the investment idea but that is at variance with another statement he made, namely that he had no intention to resell until 1 April 1976 i.e. long after the godown idea was abandoned. We have grave doubts as to the seriousness of C's intention to actually run a godown in conjunction with L, not only because there was no documentary evidence to support the statement but also because C said he did not wish to proceed with the godown business because he would need to rely upon outsiders but L was himself an outsider. C was adamant that he had no thought of selling until 1 April 1976 when the Directors minuted a change of intention. In fact the Taxpayer contracted a sale on the 26 March 1976. In short we did not consider C's evidence at all satisfactory and are of the opinion that C as the personification of the Taxpayer never did form any firm intention to buy the Subject Site as a long term investment. We have reached this conclusion notwithstanding the evidence given by Mr. Peter Lo that to do so would be a risky venture. Several legal authorities were referred to and we have taken them into account but do not propose to deal with them because we do not consider that the conclusions we have reached are at variances with the principles therein enunciated.

The Taxpayer's appeal is therefore dismissed.