HCIA No.5/98

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE
INLAND REVENUE APPEAL No.5 of 1998
(ON APPEAL FROM THE INLAND REVENUE BOARD OF REVIEW)

BETWEEN:

THE COMMISSIONER OF INLAND REVENUE — Appellant

and

QUITSUBDUE LIMITED — Respondent

Coram: The Hon Madam Justice Yuen in Court
Dates of hearing: 25-26, 28 January 1999
Date of handing down of Judgment: 30 April 1999

JUDGMENT

In 1986, Quitsubdue Ltd ("the Taxpayer") bought all the units in two buildings, No. 42 and No. 44 Cameron Road, in Tsimshatsui, Kowloon. In 1987, it started the process of redeveloping the properties. A new commercial building was built, for which an Occupation Permit was obtained in 1994. Thereafter the Taxpayer has been renting out the units in the building.

In the course of this process, the shares in the Taxpayer company changed hands twice. The first transfer of shares was in February-March 1987, when the two individuals who were the first shareholders and directors ("the 1st Shareholders") sold their shares to a group of persons and companies ("the 2nd Group of Shareholders"). The second transfer was in September 1987, when the 2nd Group of Shareholders sold their shares to the present shareholders ("the 3rd Shareholders").

Assessment to profits tax

In 1992, the Commissioner of Inland Revenue charged the Taxpayer with certain additional profits tax assessments for the years of assessment 1987/1988 and 1988/1989, and profits tax assessments for the years of assessment 1989/1990 and 1991/1992.

This was done on the basis that the Taxpayer's intention from the time it acquired the properties in 1986 up to September 1987 was to trade in the properties, and it was the Revenue's case that the Taxpayer changed its intention and started holding them as fixed assets in September 1987, when the 2nd Group of Shareholders transferred their shares to the 3rd Shareholders. The Revenue, on the basis that the principle in **Sharkey v Wernher** [1956] AC 58, 36 TC 275 applied, assessed the Taxpayer's profits as a notional profit calculated from the difference between the cost and market value of the properties as at the date of change of intention.

Determination by Commissioner

The Taxpayer appealed from those assessments. In 1994, the Commissioner made a determination confirming those assessments.

Board of Review Decision

The Taxpayer appealed from that determination to the Board of Review. The Board allowed the appeal on the following basis. It found, in favour of the Revenue, that the Taxpayer had acquired the properties as trading stock, and that there had been a change of intention in September 1987, when the 2nd Group of Shareholders transferred their shares in the Taxpayer company to the 3rd Shareholders. The Board proceeded on the basis that the principle of law enunciated in **Sharkey v Wernher** applied. However, the Board went on to find that since the properties had never been disposed of by the Taxpayer, profits tax could not be raised.

Case Stated

The Revenue appealed from the Board's decision by way of case stated. The questions of law for the opinion of the Court were as follows :-

(1) Whether, as a matter of law and on the facts found by it, the Board was correct in holding that the principle in **Sharkey v Wernher** was not applicable to this case when in September 1987 there was a change in the intention of the Company with regard to the Properties.

(2) Whether, as a matter of law and on the facts found by it, the Board was correct in holding that :

<u>at paragraph 46 of the Decision</u>

(a) "Although the Company might have the intention to trade, it had taken no steps to deal in the Properties"

(b) "As far as the Company is concerned, there is no evidence it has undertaken any property trading activities"

(c) "The Properties here were never disposed of. There was no carrying on of trade as in the case of **Sharkey v Wernher**, *supra*."

(d) "There was no pre-existing need to draw up a profits and loss account for the purposes of profits tax".

Additional Question

To this, the Taxpayer sought to add an additional question, in the following terms:

(3) Whether, on the facts found by the Board and having regard to the decision in **Edwards v Bairstow**, the Board erred in law in concluding, at paragraph 43 of the Stated Case, 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".

This was opposed by the Revenue. The Board declined the Taxpayer's request. It gave no reasons for that decision.

I considered that in all the circumstances of this case, the additional question should be allowed to be raised. All the material facts were agreed between the Revenue and the Taxpayer. What was disputed between the parties was the proper conclusion to be drawn from those facts.

It is clear from **Edwards v Bairstow** [1956] AC 14 that if the facts found (or agreed) were such that the true and only reasonable conclusion from them contradicts the determination, there would also be an error in law. In my view, it should be open to the Taxpayer to submit to this Court that the facts of the case were such that "the true and only reasonable conclusion" contradicted the determination.

There is no question of unfairness to the Revenue. Substantively, it would be unfair to the Taxpayer if it were not permitted to try to uphold the Board's decision on this alternative ground. Procedurally, the Revenue had been put on notice for a substantial time that the Taxpayer was seeking to argue this additional question so it is not as if it has been taken by surprise.

Accordingly in the exercise of my discretion, I allowed the additional question at the outset of the hearing. This decision is fortified by the judgment of the Court of Appeal in **Emerson Radio Corp v CIR**, CACV 196/1998 (unreported) pp.10-11, delivered after the hearing of the present case, in which it was held that the words of s.69(5) Inland Revenue Ordinance cap. 112 are wide enough to permit the Court to determine a question of law which it considered arose from the Case Stated, even if it were not contained in it.

Issues

The issues that arose for the Court's determination were :-

(1) Did the Taxpayer acquire the properties as trading stock, only to change its intention in September 1987 to hold them as fixed assets?

(2) Did the principle set out in **Sharkey v Wernher** apply, either generally, or in the circumstances of this case?

(1) Did the Taxpayer acquire the properties as trading stock, and change its intention in September 1987?

There are a number of manifestations of the Taxpayer's intention for the properties. None of these pieces of evidence is conclusive, but they all show consistently that as far as the Taxpayer is concerned, it had always treated the properties as fixed assets, and not as trading stock.

Financial Statements

First there are the Taxpayer's financial statements, in which the properties have been classified throughout as fixed assets.

In the Directors' Report to Shareholders for the year ending 31 December 1986, the principal activity of the company is expressed to be property investment.

The Balance Sheet as at 31 December 1986 identifies the properties as the Taxpayer's fixed assets. The company's auditors were of the opinion that the Balance Sheet was properly drawn up so as to exhibit a true and fair view of the state of affairs of the company according to the best of their information and explanations given to them and as shown by the books of the company.

This was also the case for the Balance Sheet as at 31 July 1987, and the Balance Sheet as at 31 December 1987, with different firms of auditors giving similar certification.

These assertions by the Taxpayer are of course not conclusive, and it may be said (as the Board did) that they are self-serving, but they remain primary direct evidence of the Taxpayer's treatment of these properties.

Warranties of truth of financial statements

Of greater weight are the contents of the two Agreements for the sale of the shares in the Taxpayer company, by the 1st Shareholders and by the 2nd Group of Shareholders respectively, where the sellers back up the Taxpayer's treatment of the properties with warranties, given at the cost of personal indemnities.

In the Agreement for the sale of shares by the 1st Shareholders, the sellers warranted to the purchasers that the company had not since its incorporation carried on any other business other than for the purpose of purchase and holding of the properties [Cl. 5(d)].

They also warranted that the financial position of the company was as disclosed in the balance sheet and profit and loss account [Cl.5(e)] - these financial statements having stated that the properties were held as fixed assets.

These warranties were backed up by an indemnity given by the 1st Shareholders [Cl.7], such warranties to subsist for as long as may be necessary [Cl.8].

Similar warranties were given by the 2nd Group of Shareholders when they sold their shares.

It would be noted that the 1st Shareholders were individuals, who were the 1st directors of the Taxpayer company. The 2nd Group of Shareholders comprised two individuals and at least one substantial company. The fact that they fortified the warranties with their personal indemnities must add some weight to the veracity of the company's financial statements.

I would therefore differ with respect from the conclusion of the Board (at paragraph 23 of the Case Stated) that these warranties carry even less weight than the financial statements as they were only warranties given "by the shareholders of the Company *qua* shareholders, and not as purporting to speak for the Company". The company had itself spoken, in the form of the financial statements, and the shareholders were, so to speak, "putting their money where the company's mouth was" by backing it up with personal indemnities.

Redevelopment

Then there were the actual steps taken by the Taxpayer to obtain vacant possession of the properties for redevelopment. It would appear that before February 1987, the Taxpayer had already started the process of obtaining vacant possession of at least some parts of the properties (see the schedules to the Agreement for the sale of shares by the 1st Shareholders dated 11 February 1987).

This process was obviously continued by the Taxpayer between February and September 1987, as ex gratia payments and compensation were being made to tenants for the surrender of units (see Cl.2(b)(i) and the 2nd schedule to the Agreement for the sale of shares by the 2nd Group of Shareholders dated 16 September 1987).

It has been submitted for the Revenue that this process of redevelopment was to make the properties more attractive as trading stock in the 1 year between the time of acquisition and September 1987. In my view, the fact that the Taxpayer engaged itself in repossessing the units is (at least) as consistent with an intention to hold the properties long-term, as with an intention to trade in the properties during that 1 year. An owner of a property intending to trade in it would be less likely to engage in the tedious process of negotiating with tenants for repossession than an owner intending to hold it long-term.

Retention of the properties

Lastly a most important piece of evidence is the fact that the properties have never been disposed of, or even been put up for sale by the Taxpayer at any stage.

Board's finding of Taxpayer's intention

Hence, both the Taxpayer's expressed intentions and its actions with regard to the properties have been consistent throughout with its classification of the properties as fixed assets. Given that there was never any expressed intention on the part of the Taxpayer to treat the properties as trading stock and the properties were in fact never disposed of, one must examine closely the Board's finding that the properties were, contrary to the pieces of evidence summarised above, acquired as trading stock.

The Board concluded that the Taxpayer intended to acquire the properties as trading stock as a result of (i) the shareholders' activities in the transfer of shares in the Taxpayer company, and (ii) the lack of steps taken by the Taxpayer to ensure that it would be able to maintain the properties for long-term investment.

Transfer of shares by 1st Shareholders

At paragraph 32 of the Case Stated, the Board referred to the 1st Shareholders' transfer of their shares. It said: -

> "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 in 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 first point that I would make is that there *was* evidence (in the form of financial statements and actions, as summarised above) showing that the intention of the Taxpayer was to hold the properties as fixed assets. It is difficult to see what sort of “independent” evidence was required by the Board. The Taxpayer’s financial statements were certified by three different firms of auditors. It is not disputed that the Taxpayer did engage in repossession of various units after it acquired the properties.

Further I would query why the Taxpayer company’s expressed intentions and actions, which all point one way, should be affected by the intentions of the shareholders for their own shares. Counsel for the Revenue accepts that there is nothing inherently incongruous for a person wearing the cap of a director to decide that the company should invest in properties, and wearing the cap of a shareholder, to decide to sell his shares in the company.

This was not a situation where the Board thought it legitimate to lift the corporate veil, and the Revenue does not suggest that there were any grounds for doing so. Indeed, the Board was at pains to reiterate the principle that a company is a separate entity from its shareholders (see paragraph 49 of the Case Stated).

However, the Board in effect equated the shareholders’ intentions for their shareholdings with the Taxpayer’s intention for its properties. In my view, this was not a legitimate exercise. If the shareholders were trading in the shares (or as the Board expressed it “trade the Properties through the sale of shares” - see paragraph 32 above), it is the shareholders who should be taxed on the profits they derived from the activity of buying and selling the shares; it is not the company which should be taxed, when it has all along classified the properties as fixed assets, and has never even tried to dispose of them.

In any event, it is well-established that a shareholder has no proprietary interest in the property of the company of which he is a shareholder. The concept that a person trades in properties through trading in shares of a property-holding company has been questioned by the Judicial Committee of the Privy Council (cf **Beautiland Co Ltd v C.I.R**. 3 HKTC 520).

Further even if one adopts a concept of shareholders trading the properties “through the sale of shares”, that could only work if the company is identified or equated with the properties. Such an identification with the properties would operate on the basis that the company would be holding onto the properties, not that it would be parting with them. So I venture to think that even if one adopted that concept, that would still be consistent with the conclusion that the company acquired and held the properties as fixed assets.

In conclusion, I take the view that whatever the intentions of the 1st Shareholders for their shares, that does not reflect on the Taxpayer's intention for the properties when it acquired them, an intention which was clearly expressed in the financial statements, fortified by the warranties given in the two sale agreements and verified by the fact that the Taxpayer has never put up the properties for sale.

Transfer of shares by 2nd Group of Shareholders

The Board also found that the actions of the 2nd Group of Shareholders showed that the Taxpayer was still treating the properties as trading stock (see paragraph 38 of the Case Stated). I would not repeat the comments I have made above on the fallacy of that reasoning.

In addition however, the Board placed some emphasis on a letter from one of the 2nd Group of Shareholders, Guangdong Water Conservancy & Hydro-Power Engineering Development Co. Ltd. ("GWH").

This letter was written in December 1989 in reply to a letter from the Profits Tax Assessor who had sought information on the basis of GWH's valuation of shares in 3 companies which it had disposed of. One of those companies was the Taxpayer company. The Revenue was querying GWH's assertion that the shares had been purchased with a view to dividend income. The query was probably made with a view to ascertaining whether GWH was liable to profits tax assessment for trading in the shares.

GWH's answer was to the effect that it was only after it had invested in the Taxpayer company's shares that it discovered that the investment was unsuitable, because substantial advances were required for redevelopment, and because the redevelopment would take several years. Consequently, it decided to dispose of the shares.

Thus the point addressed in the correspondence was whether GWH had acquired the shares in the Taxpayer company as an investment by GWH, not whether the Taxpayer acquired the properties as an investment by the Taxpayer. So understood, the relevance and weight of that letter to the point under consideration in this case must be substantially discounted.

Further, insofar as that letter purported to state that the "3 Companies [the Taxpayer being one] are incorporated to acquire pieces of land to construct properties for dealings", it is not known what was the source of that information. The signatory of the letter was never a director of the Taxpayer company. His statement cannot be treated as evidence of the intentions of the Taxpayer's directors.

GWH held 34% of the shares. Although that was the single largest shareholding, it remained a minority stake. The other shareholders comprised (i) Hardpart Co. Ltd., a company that was associated with two individuals named Ho, who were the original purchasers of the shares under the agreement with the 1st Shareholders,

(ii) an individual named Qian and (iii) an individual named Rao. There was no evidence that these other shareholders were GWH's nominees or trustees, contrary to the assumption made by the Board. Indeed, when the shares were sold to the 3rd Shareholders, they were sold by GWH, Hardpart, Mr Qian and Mr Rao as 4 separate vendors, each of them as "registered and beneficial owners of the shares in such numbers as set out opposite their respective names" (see recital (2) in the Agreement dated 16 September 1987).

There were 6 directors of the Taxpayer - the two persons named Ho, Mr Qian and Mr Rao were all directors of the Taxpayer. There were two other directors who could be presumed to represent GWH's interests. There is no evidence that GWH, who had 2 seats out of 6 on the board, controlled the board of directors of the Taxpayer company at any time.

Further as to the statement in GWH's letter of the circumstances at the time of acquisition of the properties, there is no evidence at all that the signatory or GWH had any connection with the directors or shareholders of the Taxpayer at the time the properties were acquired, in the year before GWH came onto the scene. The relevant sentence started with the words "as advised". However, there is no indication as to who gave that advice. Nor is it known what is meant by the term "dealings".

Notwithstanding the above, the Board treated this letter as an important piece of evidence against the Taxpayer which somehow overrode or undermined the primary contemporaneous evidence of the Taxpayer's intention to acquire the properties as fixed assets. In my view, in the light of the matters considered above, that conclusion was not justified.

In any event, the Revenue's case for assessment is based on the properties having been acquired in 1986 as trading stock, not that the properties became trading stock when the 2nd Group of Shareholders gained control of the Taxpayer company in March 1987. Thus, this letter is of little help to the Revenue in any event.

Steps taken for long-term investment

The second limb of the Board's finding was that the Taxpayer did not take steps to ensure that it would be able to maintain the properties financially for long-term investment.

It should be noted that the Board actually accepted the Taxpayer's case that the properties were extremely valuable, and were by themselves capable of sustaining long-term investment. The Board found that "the properties were undoubtedly *capable* of self-sustaining as a long term investment" (see paragraph 24 of the Case Stated); what the Board found was that the Taxpayer did not do what it undoubtedly could have done - to sustain the properties financially as long-term investment.

With respect to the Board, this conclusion was not justified. It appears that the Taxpayer had managed to acquire the properties at extremely good prices. No. 44 Cameron Road was acquired for $11.5m. The 1st Shareholders made interest-free loans of $2.5m. to the Taxpayer and the Hua Chiao Bank provided facilities to the extent of $11m. So finance was more than adequate, and more importantly, it was actually made available.

As for the units in No. 42 Cameron Road, the total purchase price was $20.1m. The Board remarked that as at December 1986, no step had been taken to complete the purchase of No.42 or to arrange finance. But with respect to the Board, the agreement for the purchase of No.42 was only made on 30 December 1986, completion date was in March 1987 and it would only be by that time that finance was needed.

By completion date, the Taxpayer did in fact obtain finance from Hang Seng Finance Ltd. of $44.08m. This loan was contained in three parts :-

Tranche	**Amount**	**Purpose**
Tranche A	$32.68m	(a) financing in full the acquisition cost being $16.72m payable by the company to complete the purchase of 42 Cameron Road
		(b) refinancing in full the Hua Chiao Bank loan
		(c) refinancing in full the 1st Shareholders' loans
Tranche B	$9.4m	financing in full the estimated construction costs of the building
Tranche C	$2m	providing general working capital

So again, it is clear from the above that finance was not a problem, and that the Taxpayer had taken steps to obtain it. The fact that the loan was a short-term building mortgage loan does not detract from the point. As for the Board's remark in paragraph 35, it would not have been necessary for the Taxpayer in March 1987 to arrange, so many years in advance, for finance for long-term holding after redevelopment. According to Mr Chang SC who had taken the Board to evidence of amortization, leasing tables and interest rates, the loan was only 50% of the capital value of the properties.

The Board had also concluded that the financial position of the Taxpayer was "precarious", because of the size of the outstanding bank loans, as opposed to the rental income for the period (paragraph 36 of the Case Stated). The Board was looking at the financial statements as at 31 July 1987. By that time, however, repossession had already commenced to prepare the properties for redevelopment. With respect to the Board, it was not a meaningful exercise to compare rental income with bank charges.

In conclusion, far from the Taxpayer not taking steps to maintain the properties financially for long-term investment (as the Board found), the evidence shows that the Taxpayer was able to and did obtain adequate finance for the redevelopment of the properties, a process that took several years and which is consistent with the Taxpayer's stated intention of holding the properties as fixed assets, as indeed it has done.

Conclusion

My conclusion on the first issue is therefore that the evidence shows clearly that the Taxpayer had acquired the properties as fixed assets, so that there was no change of intention in September 1987. The answer to the 3rd question must therefore be "Yes".

(2) Did the principle in Sharkey v Wernher apply?

The 2nd issue and the 1st and 2nd questions in the Case Stated therefore do not arise. However in deference to the submissions made and in case I am wrong on the 1st issue, I shall deal with them as well. For the reasons set out below, I take the view that the principle in **Sharkey v Wernher** does not apply, whether generally or in the circumstances of this case.

The facts of that case are well-known. The Taxpayer there carried on two enterprises, that of running a stud farm and that of racing stables. The profits of the stud farm were taxable, whereas those from the racing stables were not. She transferred some horses from her stud farm to her racing stables. She accepted that some amount must be credited in the accounts of the stud farm in respect of the horses upon their transfer, as expenses for the rearing of those horses had previously been debited therefrom. The question was how that amount was to be calculated.

By a majority, the House of Lords held that she must bring into her trading account for tax purposes the market value of the stock at the time of disposition.

This decision has remained good law in England, but has been questioned in Hong Kong (see the decisions of the Board of Review in D41/91 and D47/91 and the views of the authors of Taxation of Property Transactions in Hong Kong pp.63-8).

I start off with first principles. The undisputed principle is that a person cannot trade with himself (**Dublin Corp v M'Adam** 2 TC 387, 397; **Sharkey v Wernher** p.296, 298). If he cannot trade with himself, it must follow that he cannot make a profit out of trading with himself. The charge on profit in s.14 of the Inland Revenue Ordinance is a charge on real profit. So, it follows that a person cannot be charged with profits tax on "self-trade" as it does not exist.

The problem arises with self-suppliers. It was thought that if a self-supplier such as the Taxpayer in that case was not chargeable to profits tax, that would give him a tax advantage which would be unfair to non-self-suppliers (**Sharkey v Wernher**, 306). Viscount Simonds expressed the quandary thus : -

> "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" (p.298)

The House of Lords decided by a majority that the credit to the trading account must be of the market value of the commodity at the time of supply, because that was the value of what the self-supplier received.

For my part, I would prefer Lord Oaksey's solution that the amount credited should be the amount of the expenses incurred to produce the commodity.

The unfair tax advantage does not occur in the self-supplier obtaining the commodity. The unfair tax advantage occurs in his being able to deduct the expenses from his trading account. When a self-supplier supplies himself with a commodity, he is not trading with himself - he is withdrawing that commodity from his stock-in-trade. If he chooses to do that, he should correspondingly pay back whatever he deducted from his trading account as the expenses for that commodity. There would then be no unfair tax advantage.

Put another way, it is not a question of his disposing of his stock-in-trade for nothing (*cf* **Sharkey v Wernher** p.297) The point is that the commodity is no longer his stock-in-trade, so he can no longer include the expenses for that commodity in his trading account.

For the reasons above, I take the view that to charge him with profits tax based on the market value of the commodity, when he has not traded at all, would be contrary to profits tax liability under s.14.

Conclusion

My conclusion on the second issue is therefore that the principle in **Sharkey v Wernher** does not apply.

The answer to the 1st question is therefore "as a matter of law, the Board was correct in holding that the principle in **Sharkey v Wernher** was not applicable".

The answer to the 2nd question is :-

(a) Not applicable;

(b) Yes;

(c) Yes;

(d) Yes.

Order

In the circumstances, this appeal fails. I will give an order nisi that the Revenue pay the Taxpayer's costs.

(MARIA YUEN)
Judge of the Court of First Instance
High Court

Mr Robert Andrews (instructed by Department of Justice) for the Revenue/ Appellant

Mr Michael Flesch QC, Mr Denis Chang SC and Mr RK Sujanani (instructed by Ford Kwan & Co) for the Taxpayer/Respondent