Case No. BR 21/76

Board of Review:

S. V. Gittins, *Chairman*, S. C. C. Cheung, M. W. Y. Choy and M. W. Kwan, M*embers*.

10 December 1978.

Profits tax – private company – land developer and property holder – construction of building for sale – conversion to public company – transfer of unsold units in building to fixed assets – whether cost of the units or their market value was the proper figure to be taken into account for profits tax purposes.

The taxpayer was formed as a private company in 1962 to carry on the business of a land development and investment company. In that year, it acquired certain tenement flats which it subsequently demolished for the erection in 1964 of a new building, part of which contained 96 tenement flats and the other, a hotel.

In 1966 the taxpayer also carried on the business of a restaurant and hotel. Between 1967 and 1970 the taxpayer sold 68 of the tenement flats but made no sales thereafter, and since 1968 carried on the hotel business after divesting itself of the restaurant. By a special resolution passed on the 19th February 1973 the taxpayer was converted into a public company and by minute dated 20 February 1973, the directors declared an intention to retain the unsold flats and shops for rental income, and resolved that they be transferred to fixed assets for accounting purposes. The total cost of the flats and shops was assessed at \$1,814,459. However in a prospectus issued on 28 February, their market value was assessed at \$8,902,000.

The Commissioner of Inland Revenue determined profits tax for the year 1974/75 on the notional profit resulting from the transfer. The taxpayer appealed against the determination contending that it had ceased to trade in property in 1969, that the transfer was made to itself and therefore the principle in *Sharkey & Wernher* (36 T.C. 275) did not apply.

On appeal.

Decision: Appeal dismissed. Assessment as determined by the Commissioner confirmed.

H. Litton, Q.C. for the taxpayer.
Osman Ghafur for the Commissioner of Inland Revenue.

Case referred to:-

1. Sharkey v. Wernher, 36 T.C. 275.

Reasons:

1. This is an appeal against the Profits Tax Assessment for the year of Assessment 1974/75 of $7,306,030 with tax payable thereon of $1,095,904.

2. The following facts were agreed:-

(a) K. Ltd. (the Company) was incorporated on 10th May 1962 as a private company under the Companies Ordinance, Hong Kong. The objects for which the Company was established are, amongst other things, to carry on all or any of the business usually carried on by land development companies, land investment companies, land mortgage companies and building estate companies in all their several branches. By a special resolution passed on the 26th September 1966, the object clause in the Company's Memorandum of Association was altered by the addition of a sub-clause so as to enable the Company to, *inter alia*, carry on the business of hotel, restaurant, etc. By a special resolution passed on the 19th February 1973, the Company adopted new Articles of Association and was converted into a public company. By a prospectus dated 28th February 1973, the Company offered a number of shares to the public for subscription.

(b) The Company used to draw up accounts annually to the 31st March in each year, up to and including the 31st March 1972. Then it changed its annual accounting date to 31st December, and the first set of accounts drawn up to this new accounting date was that for the nine months 1st April 1972 to 31st December 1972.

(c) The Company commenced business shortly after incorporation. On the 4th July 1962, it acquired the property at Sec. F. of I.L. 1149 together with the old tenement building erected thereon. In June 1964, the Company pulled down this old building and proceeded to erect on the property a 14-storey new building. The left wing of this new building was designed as tenement flats which were to be offered for sale, while the right wing was designed for use in a hotel business, which the Company intended to operate. The new building was completed on 3rd January 1967, on which date the occupation permit was issued, and consists of the following units:-

		Area
(i)	Left Wing, 2nd to 13th floors (12 floors) 8 tenements flats (A to H) per floor = 96 flats ………….	59,908 sq.ft.
(ii)	Right Wing, 2nd to 13th floors (12 floors) guest rooms ………………………………………………….	47,667 sq. ft.
(iii)	1st floor, whole floor (left and right wings) ………….	10,856 sq. ft.

(iv)	Ground floor, Shops A and B ………………………..		7,308 sq. ft.
(v)	Ground floor, Shop C and lobby ……………………..		2,618 sq. ft.
		Total Building Area ………..	128,357 sq. ft.

(d) While the building work was in progress, the Company offered the tenement flats, the 1st floor, and the three shops on the ground floor for sale, and flats were sold. A price list, dated October 1965, was distributed to the public by the Company. During the five years ended 31st March 1967 to 1971, the Company sold 68 of the 96 tenement flats. The last of the 68 flats, Flat D on the 12th floor, was sold on 10th August 1970 when the purchaser paid the deposit direct to the Company, which deposit the Company handed over to its solicitors on 26th September 1970 to complete the legal formalities. Since then, there has been no sale of flats.

(e) The profits made by the Company from the sale of flats in the building were brought into charge to Profits Tax, as were the profits on rental from flats not yet sold, in the relevant years of assessment, and nothing turns on this point.

(f) On the 18th March 1967, the Company commenced to operate a hotel business on the 2nd to 13th floors, right wing and the lobby on the ground floor of the building. The Company transferred the restaurant business to A. Co. Ltd. on 1st July 1968, but is still carrying on the hotel business. The profits from these two business have also been charged to Profits Tax in the Company's hands.

For Profits Tax purposes, the flats used for the hotel business and the restaurant business (these notwithstanding the cessation on 30th June 1968) have been accepted as fixed assets and Rebuilding Allowances granted on them.

(g) In the Company's Balance Sheet, all the units of the building in hand at balancing date have always been shown as "Stock of Unit Flats" under "Current Assets", and the following items appear in the Balance Sheet at 31st December 1972:-

Current Assets

Stock of Unit Flats at Directors' Valuation 31st December 1972 –

Tenement Flats and Shops ……………………………..	$1,814,459	*(a)*
Hotel Department …………………………………...	3,862,710	*(b)*
Restaurant Department ………………………………...	1,091,869	*(c)*
	$6,769,038	

Item *(a)* is made up of 28 tenement flats on the left wing and Shops A and B on the ground floor; item *(b)* is made up of the 2nd to 13th floor of the right wing and Shop C and Lobby on the ground floor; item (c) is made up of the 1st floor. For Profits Tax purposes, the costs of these units were agreed as follows:-

(a)	Tenement Flats and Shops ……………...	$1,323,619 (22,391 sq. ft.)
(b)	Hotel Department ……………………….	$2,972,542 (50,285 sq. ft.)
(c)	Restaurant Department ………………….	$ 641,740 (10,856 sq. ft.)
		$4,937,901 (83,532 sq. ft.)

(h) On the 10th February 1973, the Directors of the Company valued the remaining units in the building, as summarised in the preceding paragraph, in the amount of $30,000,000. The same units were valued at $30,900,000 on 20th February 1973 by H.K.D. Estate Agents Ltd. (the Valuers). On the 20th February 1973, the Directors at a meeting resolved to transfer these remaining units to fixed assets and to adopt the valuation of $30,000,000. The minutes of the Directors Meeting read as follows: -

"K. LIMITED

Minute of the Meeting of Directors held at the Registered Office on 20th February 1973 at 6.00 p.m.

(1) In view of the Company being converted into a public Company, and the shares being offered to the public, the Company have to maintain a steady income, it was resolved that the unsold flats and shops at a total cost of $1,814,459 (as per schedule attached), which are now being leased for rental income purposes be transferred to fixed assets for accounting purposes together with the premises now being occupied for the Company's hotel and restaurant operations at a cost of $3,862,710 and $1,091,869 respectively.

(2) A Revaluation Report from H.K.D. Estate Agents Ltd. was produced for the consideration of the Directors. In this report a total of $30,900,000 was placed on the properties mentioned above. It was resolved that for the purposes of the prospectus to be issued, a valuation of $30,000,000 be placed on those properties.

CHAIRMAN"

In the prospectus dated 28th February 1973 issued by the Company valuations by the Directors and Valuers were set out and can be summarised as follows:-

	Directors' Valuation at 10/2/73	*Valuers' Valuation at 20/7/73*
28 Tenement Flats ………………………….	$ 4,202,000	$ 4,202,000
Shops 3-5, 9, 11, 11A & B, and 15 …………	4,700,000	
	8,902,000	8,680,000
Shops 17 & 17A ……………………………	3,300,000	

2/F to 13/F, 11-17A ………………………..	12,798,000	13,000,000
1/F, 3-17A ………………………………….	5,000,000	5,018,000
	$30,000,000	$30,900,000

(i) The Company's Profits Tax Return for the year of assessment 1974/75 showed an assessable profit of $1,572,810, and was supported with a tax computation and a copy of its accounts for the year ended 31st December 1973. On the 15th August 1975, the Assessor raised on the Company a Profits Tax assessment for the year of assessment 1974/75 in the amount of $10,143,030, computed as follows:-

Profits returned ………………………………………………			$ 1,572,810
Add:	Notional Profit re Trading Stock transferred to Capital Assets:-		
	Market value of stocks ……………...	$9,902,000	
	Less: Cost thereon ………………….	1,323,619	8,578,381
			10,151,191
Less:	Further Rebuilding Allowances:-		
	Cost ………………………………...	$1,323,619	
	Less: Land cost therein ……………..	235,499	
		$1,088,120	
		¾% thereon	8,161
		Assessable Profits	$10,143,030

In this assessment, the Assessor adopted the Directors' valuation of $8,902,000 but made an arithmetical error in overstating it by $1,000,000. He also granted a Rebuilding Allowances on the flats transferred to Fixed Assets.

3. The Company objected to the assessment and the Commissioner's Determination thereon was that the Profit Tax Assessment for the year of assessment 1974/75 be reduced to Assessable Profits of $7,306,030 with Tax payable thereon of $1,095,904. The Company has appealed to the Board of Review against this Determination.

4. Mr. H. gave evidence on behalf of the Company. From his evidence we make the following findings:-

(a) The witness, his father and his sons have extensive business interests in the Philippines.

(b) His father purchased the premises in 1952.

(c) He acquired the property from his father and formed the Appellant Company in 1962 to receive the assignment. This was then the sole property owned by the Company or the witness in Hong Kong.

(d) The shareholders of the Company were mainly members of his immediate family.

(e) The witness controlled the Company as the head of the family which owned most of the shares.

(f) He decided to redevelop the property and arranged a building mortgage from the Hang Seng Bank for up to $4 million and in addition he had overdraft facilities of up to $1 million which latter was partly used for construction.

(g) The old buildings were demolished at the end of 1964 after taking exemption proceedings.

5. Other aspects of H.'s evidence which were not accepted by the Revenue, were as follows:-

(a) That being satisfied in about September 1969 that the Bank mortgage could be repaid by funds from his Philippines business, he decided to cease selling tenement units and instructed the caretaker to cease such sales and withdraw price lists.

(b) The sale of Flat D12 on 10th August 1970 was not in the ordinary course of business, but as a favour to the owner of Flat D11 to whom the witness's brother-in-law, L. was under an obligation.

(c) That it was the Company policy throughout not to sell the shop units despite their listing on the Sales brochure without prices but with the notation that prices were to be negotiated instead of stated amounts which were set down for domestic units.

6. Under cross examination H. testified *inter alia* as follows:-

(a) He only visited Hong Kong from the Philippines about once a month.

(b) During the construction of the building L. took charge.

(c) L. was in charge of sales.

(d) Although the Sales brochures were issued in October 1965, owing to the depressed state of the property market, there were no sales prior to the completion of the building in 1967 and prices obtained were less than the listed prices.

(e) The witness received no information from L. concerning inquiries for the purchase of shops.

(f) In early 1967 the Company carried on 4 businesses, viz. property holding, property dealing, hotel and restaurant.

(g) The minute dated 20th February 1973 was the sole written evidence of the Company's intention to retain the unsold flats and shops for rental income. There was no earlier documentary evidence to this effect to support the witness's averment that the decision was made in 1969.

(h) That the rental income from the flats and shops was required to generate income to cover the dividend forecast in the prospectus when the Company went public.

(i) That the contents of the minute of 20th February 1973 stated the correct position.

7. In view of the admission in 6(i), the continued appearance of the unsold flats as current assets in the Company's Balance Sheet up to 31st December 1972, the Company's Profits Tax computations to 31st March 1971 admitting profits tax to be chargeable on profits on sales, the absence of any corroborative evidence from the caretaker and L. that sales were to cease in September 1969, the majority of the Board find as a fact that the Company did not intend to cease trading in property until the beginning of 1973.

8. One member of the Board found that the Bank statement produced in evidence convincingly supported H.'s evidence that his intention throughout was to sell only a sufficient number of flats to supplement his ability from his personal resources to repay the Bank loan raised for the development of the property and that sales were stopped by him on about 12th August 1970.

9. Despite the attractive argument of Mr. Litton's that the principle of **Sharkey v. Wernher**[1] is not applicable to the present case, we are of the unanimous opinion that it 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.

10. We therefore hold that **Sharkey v. Wernher** applies and that the Determination is correct.

11. The appeal is dismissed and the assessment appealed against is confirmed.

[1] 36 T.C. 275.