Case No. D26/84

Board of Review:

William Turnbull, *Chairman*; P. G. Willoughby and Woo Man-sing, Manuel, *Members.*

12 March 1985.

Profits tax—transfer of units in various buildings to subsidiaries or associated companies—whether the units were capital or trading assets—the principle in **Sharkey v. Wernher** considered.

The Appellant company was engaged in property development. The principal issue was whether gains accruing to the Company in 1979 on the disposal of certain units in various buildings to the subsidiary companies pursuant to a plan of corporate reorganization were capital gains or profits assessable to tax. The Commissioner had determined that the gains were in the nature of trading profits assessable to tax. The Company contended that the gains were not taxable because the properties to which they related were from the beginning held as fixed assets for the purpose of producing rental income and there had been no change of intention.

Held:

(1) On the facts the units in question formed part of the trading stock of the Company and accordingly the profits which arose on the disposal of them were assessable profits.

(2) While the principle in Sharkey v. Wernher can be applicable in Hong Kong, great caution should be exercised in attempting to invoke the principle and the scope of the principle should not be extended.

Appeal dismissed.
(*NOTE:* The decision of the Board of Review is subject to confirmation on appeal to the Court.)

Luk Nai Man for the Commissioner of Inland Revenue.
Peter Whiteman for the Appellant.

Reasons:

The Appellant Company ("the Company") was a leading real estate developer in Hong Kong. The Company had been engaged in property development since August 1961 and the principal issue to be determined by the Board of Review was whether gains accruing to the Company in 1979 on the disposal of certain units in various buildings to subsidiary companies pursuant to a plan of corporate re-organisation were capital gains or profits assessable to tax. The units in question comprised commercial premises, residential premises, and industrial premises. (A subsidiary issue relating to the principle in **Sharkey v. Wernher** (1956) AC 58 is considered later in this decision).

The Commissioner had determined that the gains were in the nature of trading profits assessable to tax. The Company contended that on a true and proper legal analysis the gains were not taxable because the properties to which they related were from the very inception held as fixed assets for the purpose of producing rental income.

Units in a total of 23 buildings were involved. The buildings fell into two categories, namely 19 buildings which were constructed by the Company as a developer and 4 buildings which had been constructed by subsidiary or associated companies of the Company. Certain units in these subsidiaries or associated companies had been transferred to the company *in specie* or on their liquidation.

Counsel for the Company informed the Board at the outset that it was now the Company's case that units in 5 of the 23 buildings were in fact trading stock and not capital investment and that therefore the gains arising on the sale of those units would be subject to profits tax. This left the units in the remaining 18 buildings which the Company maintained were capital assets and not trading stock.

The principal question to be determined by this Board is whether or not the units in the 18 buildings were, as contended by the Company, long term investments or were trading assets as determined by the Commissioner.

The starting point of this Appeal is the Commissioner's determination. The reasons for the Commissioner's determination were set out by him as follows:—

"3. REASONS THEREFOR

(1) The main issue for consideration is whether the profits from the sale of properties in the period from 1 January 1979 to 4 April 1979 are trading profits from the sale of trading stock or capital gains from the realisation of capital assets.

(2) The Company was a very active property developer in the 1960s and 1970s. Over the years will the unsold units, whether developed or acquired, were grouped under Current Assets in the Company's accounts. Profits on sale of these units were all included as trading profits in the accounts and offered for assessment in its Profits Tax Returns up to and including the year of cessation—1979–80.

(3) The Company now claims that, despite its history as a property dealer certain properties were, all along, capital assets; citing in support the fact that the properties were let for rental income. That fact is, in my view, wholly equivocal; there is ample authority to show that the letting of properties for rental income, pending an opportune time for sale can be part and parcel of a course of trading in properties. It is simply another means of turning current assets to profitable account pending disposal. In this case, having regard to the Company's history and actions, the evidence of its own accounts and, indeed, the manner in which it computed its assessable profits in the computation submitted in support of its Profits Tax Return, I am completely satisfied that the properties in question were always part of the trading stock of the Company. I am reluctant to conclude that the Company's claims in regard to these properties have been prompted by the change in the legislation referred to in Fact 7 above, but in the absence of any real

> evidence to support the alleged capital nature of these assets I can conceive of no other explanation."

The Commissioner's Representative did not seek to substantiate or uphold the final sentence quoted above and accordingly this Board places no weight on this suggestion by the Commissioner.

Counsel for the Company stressed, rightly in the opinion of the Board, that what was crucially important was the subjective intention of the Company at the time when the assets were acquired by the Company and that this subjective intention should be tested against objective facts and circumstance. He stated that it was not the Company's case that there had been any change of intention and that therefore the Board need only concern itself with the original intention of the Company.

Two witnesses gave evidence for the Company. The first was a Director of the Company who said that her function was to manage and control the Sales and Letting Department. The Company was a family concern with the witness and her husband were actively involved in the development of the properties under appeal. She said that it was the policy of the Company to retain one tenth in value of domestic and commercial premises for investment purposes and one third in value of industrial premises for investment purposes. She said that in each case this decision was taken prior to or simultaneously with the Company's decision to acquire and develop properties. She said that the reason for the adoption of this policy was to build up an investment portfolio of properties which would produce income to enable the Company to be floated as a public company.

The evidence given by this first witness was far from satisfactory and left much to be desired. The Board was told that Company had no documentary evidence to substantiate what the witness said. The witness and Counsel for the Company placed great emphasis on the claim that it was the intention of the Company to retain these units as long term rental producing investments so as to create a portfolio of properties to enable a public floatation to take place. We were told that in 1972 an attempt was made to float the Company as a public company and six drafts of a prospectus was prepared and a stock exchange listing date obtained. We were told that certain properties were listed in the sixth draft prospectus as investment assets for rental and that these included units in two buildings which were the subject matter of this appeal.

The witness further said that the attempt to go public was abandoned when a bid was planned by the Company to take over an already existing public company. She said that the intention was to transfer the Company's investment properties to that existing public company.

Copies of the draft prospectus and a newspaper article outlining the details of the proposed take-over bid were produced during the hearing of the appeal. These do not substantiate the proposition that the Company had a portfolio of investment units which had been created with a view to going public. In the prospectus document only 2 out of the then

portfolio of units in 11 or 12 buildings were included. In the newspaper article reference was made to the Company contributing a number of complete buildings and entire uncompleted projects which were different from the prospectus properties and the claimed portfolio of investment units. These documents do not give credence to the "one third industrial—10% commercial residential" policy which was so frequently referred to in the oral evidence, nor to the creation of a portfolio of investment properties.

To substantiate the Company's alleged policy, the witness said that when deciding the sales prices for all the units in a building she would double the price of those units which she would like to retain for investment purposes. However, some contemporary price lists were produced by the Commissioner's representative and these did not show any such price doubling. There was only the substantial price difference which one would expect between shops and residential units and small differences to reflect better locations in buildings.

The witness said that the Company's policy was known to its staff but no one else was called to substantiate the alleged policy.

With regard to the accounts of the Company and its own tax computations the situation is even less satisfactory. The Company stated in its audites financial statements and in its tax returns that all of its properties, including all of the units under appeal, were carried in its books as trading stock. This situation had continued year after year right up to the re-organisation in 1979 which gave rise to this appeal. The Company had over the years, without exception, offered and paid profits tax on the profits arising on the sale of any units in any of the buildings in question and there had never been any previous suggestion by the Company that any of the units previously sold had been capital assets. Furthermore the Company claimed none of the depreciation allowances which one would expect to find in the case of capital investments. The units to which this appeal relates were treated in every way in the accounts as trading assets.

Counsel for the Company asked the Board to accept that a mistake had been made in the preparation of the audited accounts and tax returns. This the Board cannot accept. There had been a change of auditors and tax representative and one firm of public accountants had handled the tax matters and audited accounts up to the period ended 31 March 1975. New auditors took over and handled the Company's audited accounts and tax matters from then onwards. Both firms of auditors certified the audited accounts and they were signed in some cases by one and in some cases by two directors. The declaration on the tax return was signed by a Director of the Company in each year. No representatives from either of the two firms of auditors were called to give evidence. The Director who made the declarations accompanying the tax returns also failed to give evidence. No explanations were given for this.

The principal witness was asked a number of questions in cross examination with regard to the audited accounts and tax declarations. Her answers were to the effect that she had no knowledge regarding the accounts or accounting matters. She said that she left it to the Company's accountant who was a company employee. This employee was not called to

give evidence. The explanations given by the witness and Counsel for the Company regarding the failure of this employee to give evidence were confusing.

If a tax payer wishes to challenge the accuracy of its own audited statements and tax declarations made by a director it is not sufficient merely to say that either a mistake was made or that the accounts were kept in a particular form which was incorrect "for convenience". Evidence to substantiate the mistake must be given in the strongest terms. In this case no such evidence was given.

The second witness called to give evidence on behalf of the Company was a chartered surveyor who gave evidence to the effect that it would not be usual practice for a property company holding trading property assets to grant leases of unsold units at full economic rents and to retain many properties for periods in excess of 5 years and in some cases in excess of 15 years. This witness did not give any direct testimony relating to the units the subject matter of this appeal nor indeed with regard to the Company itself or the Company's policy.

Counsel for the Company referred the Board to a number of features which he said supported the contention of long term investment. These included the facts that the Company largely self financed its developments, owned the units in question for long periods of time, granted leases of the units at full economic rents, granted leases even though they would fetter subsequent sales of units, invariably renewed leases, took no initiative to sell units once the units had been let, disposed of all of the units the subject matter of this appeal as part of a plan of corporate re-organisation and not on the open market and, in the case of four properties, did not originally acquire the units in a manner indicative of a trader because the units were distributed *in specie* on liquidation of other companies. There is some doubt as to whether the evidence of the witnesses fully substantiated all of these features. However, even assuming that they were all fully substantiated this Board considers that they are far from sufficient to substantiate the claim that these were investment assets. The Inland Revenue Ordinance clearly places the onus of proof on the tax payer who disputes the Commissioner's determination. Where the tax payer is also disputing its own documentary evidence in the form of audited accounts, tax declarations, tax computations and contemporary sales brochures the onus of proof is heavy. In this case the Appellant has come no where near to discharging this burden of proof. This Board has no hesitation in finding as a fact that the units in question formed part of the trading stock of the Company and accordingly that the profits which arose on the disposal of the units when the corporate re-organisation took place are assessable profits so far as the Company is concerned.

Having decided the principal question in issue in favour of the Commissioner it is now necessary to consider the subsidiary question relating to the **Sharkey v. Wernher** principle. This is a technical legal matter and being a subsidiary issue was not argued in detail before the Board by either the Counsel for the Appellant or the Commissioner's representative. The evidence given was that when selling the units as part of the corporate re-organisation, the Company sold them to subsidiary or associated companies at what the board of directors

considered to be the then full market value. A subsequent valuation was made by professional valuers which demonstrated that the board of directors had indeed reached a very accurate assessment of the market value. The difference in value between that reached by the directors and that reached by the independant valuer were almost identical. Evidence was given in the course of the hearing that a professional valuation should be within 10% of the correct market value in normal circumstances. In every case the prince at which the Company sold the units was well within 10% of the professional market valuation. In such circumstances this Board finds that there is no room for the application of the principle of **Sharkey v. Wernher** (1956) AC 58. That principle in summary is that where a trader disposes of part of his stock-in-trade, other than by way of sale, either for his own use or to a third party, at less than the full market value (see **Petrotim Securities Ltd. v. Ayres** (1963) 41 TC 389), the trader must bring into his accounts for tax purposes the market value of the stock at the time of its disposal. While the principle in **Sharkey v. Wernher** can be 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 accured 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.