Case No. D41/91

Profits tax – property trading – whether assessor can discharge actual profit and assess notional profit – sale of property by company to director.

Panel: Henry Litton QC (chairman), Victor R P Hughes and Robert Kwok Chin Kung.

Date of hearing: 10 June 1991.
Date of decision: 26 July 1991.

The taxpayer was a company which sold a flat to its director. The Commissioner claimed that the value at which the flat had been sold to the director was less than its true market value. The Commissioner decided to disregard the sales price at which the flat had been sold to the director and to assess tax on a notional profit calculated on a higher value which the Commissioner attributed to the flat. The taxpayer appealed to the Board of Review and argued firstly that the taxpayer had not been trading and secondly that if the profit was assessable, it was wrong for the Commissioner to disregard the actual profit and tax on a notional profit.

Held:

On the facts before it, the Board held that the taxpayer had been trading and accordingly the profit was taxable. With regard to the second question, the Board held that the principle of Sharkey v Wernher and Petrotim Securities Ltd v Ayres had no application and that the Commissioner was wrong to re-assess the profit.

Appeal allowed in part.

[Editor's note: This decision can be usefully read with D47/91.]

Cases referred to:

Sharkey v Wernher 36 TC 275
Petrotim Securities Ltd v Ayres 41 TC 389
D26/84, IRBRD, vol 2, 139
CIR v Howe [1977] 2 HKTC 936

G P Bach for the Commissioner of Inland Revenue.
Dave Kwok Siu Nam of Messrs Dave Kwok & Co for the taxpayer.

Decision:

Introduction

1. This appeal is concerned with the liability of the Taxpayer to profits tax arising from the sale in early 1986 of two flats. The particulars of these sales are as follows:

(i) Flat X: sold in early 1986 to Madam A, a director of the Taxpayer, at a consideration of $900,000.

(ii) Flat Y: sold, about three weeks after the sale of flat X, to a Mr B at a consideration of $1,100,000.

2. This profit realised by the Taxpayer on the sale of the two flats amounted to $335,725 was computed as follows:

		$
Sale price:	Flat X	900,000
	Flat Y	1,100,000
		$2,000,000
Less: Book cost		1,664,275
Profit on sale		$335,725

3. In the Taxpayer's profits tax return for the year of assessment 1986/87, the gain on the sale of the two flats was treated as a capital item and, in consequence, the return showed a loss for the year of assessment 1986/87 in the sum of $627,614.

	$	$
Loss per return		(627,614)
Less: Profit on sale of flats	335,725	
Interest attributable to non-assessable income producing assets, say	744,770	1,080,495
Assessable profit		$452,881
Less: Loss brought forward and set off		166,140

Net assessable profit	$286,741

5. The adding back by the assessor of the sum of $744,770 to the assessable profits, on account of interest expenditure, forms no part of this appeal. Accordingly, arising from the year of assessment 1986/87, there was only one matter in issue as between the Taxpayer and the assessor, namely, whether the profits on the sale of the two flats amounting to $335,725 were chargeable to tax.

6. However, when the matter went before the Commissioner on objection by the Taxpayer, the Commissioner upheld the assessor on his treatment of the realisation of the two flats. As regards the sale price for flat X sold to Madam A for $900,000, the Commissioner noted that in a valuation made by the Commissioner of Rating and Valuation in August 1990 (over two years after the assessor had made his profits tax assessment), the valuation of flat X as at [the date of the sale in early 1986] (on 'existing tenancy basis for capital valuation purpose') was $1,150,000. The difference between the actual sale price of $900,000 and the valuation figure of $1,150,000 (amounting to $250,000), the Commissioner called the 'adjusted market value' in his computation and added this to the assessable profits of the Taxpayer.

7. The justification for this treatment was stated by the Commissioner in his determination in these terms:

> '(3) Having come to the conclusion that the two properties were the Taxpayer's stock-in-trade, I shall then consider the price at which [flat X] was sold. The principle espoused in Sharkey v Wernher 36 TC 275 and Petrotim Securities Ltd v Ayres 41 TC 389 is that when a trader disposes of his stock other than by way of sale, either for his own use or to a third party, at less than the full market value, the trader must bring into his accounts, for tax purposes the market value of the stock at the time of its disposal.
>
> (4) [Flat X] was sold to one of the directors at a price substantially below the market price. I do not accept that the sale was in the course of its trade. In consequence the profits on its sale, must be increased to reflect the value appraised by the Commissioner of Rating and Valuation.'

8. Accordingly there arises for our determination on this appeal two questions:

(i) Whether the Taxpayer was, at all material times, engaged in an adventure in the nature of trade, as the Commissioner contends, or whether the sale of the two flats was the realisation of capital assets, as the Taxpayer contends. This is a question of fact which we must determine having regard to all the relevant circumstances, bearing in mind of course that the onus of proof lies upon the Taxpayer.

(ii) Whether the so-called 'principle' in Sharkey v Wernher and Petrotim Securities Ltd v Ayres requires the profits realised on the sale of flat X to be computed on the basis of a notional sale price of $1,150,000 (being the 'market value' of the flat as determined by the valuation of the Commissioner of Rating and Valuation) rather than the actual price realised by the Taxpayer of $900,000 on the sale of the flat to Madam A.

Captial Asset or Trading Stock

9. We deal first with question (i) above. Little is known concerning the history and operations of the Taxpayer. The reason for this, according to the Taxpayer's representative at the hearing, is that the Taxpayer has since the year 1986/87 changed hands.

10. At all times the Taxpayer had an issued capital of $2. In its tax returns, the business of the Taxpayer was described as 'general investment and nominees and property agents'.

11. The following persons were the Taxpayer's directors:

Madam A
Mr C
Mr D

Madam A is the wife of Mr C, but nothing is known concerning the beneficial ownership (if any) of the directors in the Taxpayer.

12. The balance sheet of the Taxpayer as at 31 December 1983 discloses that the Taxpayer had net current assets amounting to $240,914 and fixed assets of only $4,720 consisting of 'furniture and equipment'. The Taxpayer was therefore plainly unable, from its own resources, to acquire the two flats.

13. Flat X was acquired in 1984 for $820,000 and, on the same day, the property was mortgaged to a bank to the extent of $680,000 to secure 'general banking facilities'. Two months later, flat Y was acquired at a consideration of $780,000 and, on the same day, it was mortgaged to the same bank to the extent of $620,000 to secure 'general banking facilities'. In other words, the two flats were purchased on the basis of over 80% bank financing. The two flats were acquired subject to existing tenancies. Accordingly, the Taxpayer received rental income from the two flats after their purchase.

14. No viva voce evidence was adduced at the hearing on behalf of the Taxpayer as to its intentions in acquiring the two flats. The board minutes, such as they were, were silent on the point. It is possible, of course, that the directors of the Taxpayer intended, at the time of acquisition, to inject further funds into the Taxpayer to discharge the mortgages, using the Taxpayer as a vehicle for long term investments in real estate. However, nothing which has been put before us suggests this was so.

15. It is not clear from the financial statements (which were put before us not by the Taxpayer's representative but by Mr Bach representing the Commissioner) what precisely were the activities of the Taxpayer at the relevant time. In the year in which the two flats were acquired, apart from rental income, the Taxpayer was also in receipt of interest income amounting to $173,037 and commission in the sum of $217,459. In the same period the Taxpayer also paid out commission amounting to $37,709. This was referred to at the hearing as 'property agency commission' but no substantiating evidence was put before us.

16. Looking at the financial position in the following year (that is, the year ending 31 December 1985) one sees the Taxpayer receiving rent totalling $209,363 but, at the same time, paying out interest totalling $721,373. The bank loans for the two flats were repayable on demand. The two flats, upon acquisition, are reflected in the Taxpayer's financial statements as 'fixed assets' but, viewing the activities of the Taxpayer as a whole through the financial statements, it is impossible to conclude that the Taxpayer's intention was to hold the flats as long term investments. Unless the shareholders were prepared to inject substantial capital into the Taxpayer to enable the Taxpayer to discharge the bank loans, it is plain that the only way in which the Taxpayer could repay the bank loans was by resale of the flats.

17. The Taxpayer relies strongly on the fact that the two flats were, at the time of acquisition, income-producing. The Taxpayer argued that the flats were not trading stock. However, no evidence was put before us as regards the terms of the tenancies and, in particular the duration of the tenancies. Generally speaking, a trader would prefer to resell with vacant possession, but this does not mean that, given the right circumstances, a trader would not purchase a tenanted flat. In our view, the fact that the flats were purchased with sitting tenants is, in this case, quite neutral.

18. Within less than two years, the flats were resold. No evidence was adduced before us regarding the circumstances of sale. However, the short period during which the flats were held by the Taxpayer in no way suggests they were intended for long term investment. Some vague material was put before us that the proceeds of sale were redeployed in investment in shares in Australia. But what precisely was the Taxpayer's involvement or the nature of the operations it concerned we do not know.

19. Another factor upon which the Taxpayer relies is this: in the profits tax computations for the years of assessment 1984/85 and 1985/86, the assessor had allowed as a deduction in each year a rebuilding allowance, thereby indicating in effect his acceptance at that time that the flats were held as capital assets. This is a factor which, clearly, weighs in the scale in favour of the Taxpayer. One would assume that the assessor, looking at the facts and circumstances before him, would consider the matter carefully before he concludes that the flats were properly treated as capital assets. Obviously, he had before him the financial statements of the Taxpayer in which the flats were classified as 'fixed assets'. What, however, he did not have before him was the fact that, within less than two years, the flats were resold. We do not have sufficient material before us to judge whether

the assessor had discharged his duty properly at the time the rebuilding allowance was given, nor is it our function to do so. However, assessors do make mistakes. Whilst we do note this point as one in the Taxpayer's favour, we are not persuaded that having regard to all the circumstances of the case, the Taxpayer ever intended to hold these two flats as capital assets. The burden is on the Taxpayer to show that the assessment was incorrect; the Taxpayer has totally failed to discharge the burden in this regard.

20. Having concluded, as we do, that the profit made on the resale of the flats was chargeable to profits tax, the question arises as to whether the Commissioner was correct when he increased the assessor's assessment by the figure of $250,000, being the difference between the 'market value' and the actual sale price.

'Market Value'

21. The difficulty we face in this case is this: the Taxpayer's representative confined his submissions, such as they were, to the first issue, and seemed to have accepted that if he failed to persuade us that the flats were capital assets, then the assessment as varied by the Commissioner was correct.

22. However, looking at the material before us, it is difficult to conclude that there was satisfactory evidence of 'market value' concerning flat X. The facts, broadly, are these:

(i) Flat X was sold in early 1986 for $900,000 to Madam A less than three weeks before flat Y was sold. Flat Y was sold for $1,100,000; that is, a difference of $200,000.

(ii) At the time of purchase in 1984, flat X was purchased at a consideration of $40,000 more than flat Y. This, superficially, suggests that flat X is more valuable, particularly as it was purchased about two months before flat Y, at a time of rising values.

(iii) The facts stated above do suggest that the consideration of $900,000 was not the highest price which the flat could have commanded, by comparison with flat Y, if all conditions were equal.

(iv) What, however, we do not know are the terms and conditions of the existing tenancies which might well have explained the difference in 'market value'. Nor do we know how big the flats were.

(v) The so-called 'valuation' which has been placed before us is a mere assertion in a memo from the Commissioner of Rating and Valuation to the Commissioner of Inland Revenue. It was dated 23 August 1990 and, with reference to flat X, all it says is this:

> 'My valuation of the above property is $1,150,000 as at [the date of the sale of flat X] on existing tenancy basis for capital valuation purpose.'

23. On a purely factual basis we feel uncomfortable in putting reliance on a 'non-speaking' valuation of this kind. However, as the burden of proof is on the Taxpayer, and no attempt was made at all to challenge the valuation, we would feel bound to uphold the Commissioner's determination if we were able to accept his basic approach.

24. The substantial question, therefore, is whether, as a matter of law, the so-called 'principle' of Sharkey v Wernher and Petrotim Securities Ltd v Ayres is applicable at all to the facts of this case.

Petrotim Securities Ltd v Ayres

25. Although the Commissioner in his determination referred first to Sharkey v Wernher in applying the principles of law as he understood them, in fact the case which must have been paramount in his mind was Petrotim Securities Ltd v Ayres. Sharkey v Wernher is authority for applying market value as the basis of assessment in certain circumstances, but this only comes in after a tribunal has determined, as the Special Commissioners did in Petrotim Securities, that the sale should be disregarded for tax purposes in the first place.

26. In his reasons for increasing his assessment by $250,000 the Commissioner said:

> ' [Flat X] was sold to one of the directors at a price substantially below the market price. I do not accept that this sale was in the course of its trade.

This seems to us to be a dangerously sweeping statement. When we asked the Commissioner's representative in the course of the hearing whether section 61 of the Inland Revenue Ordinance was of relevance in this case, his first answer was 'no'. Later on, in the course of further submissions, he seemed unsure of the position.

27. Section 61 of the Inland Revenue Ordinance is in these terms:

> ' 61. Where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessable accordingly.'

28. The power under section 6l is given to the assessor as part of his process of assessment. It is plain in this case that the assessor never applied his mind to section 61. Far from considering the sale in early 1986 of flat X to Madam A as 'artificial' or 'fictitious' or 'not intended to be given effect to', the assessor gave effect to it and assessed the Taxpayer on the basis of the profits derived from that sale.

29. When we came to the Commissioner in dealing with the objection under section 64, his position was not at all clear. He said that the 'principle espoused in Sharkey v Wernher and Petrotim Securities Ltd v Ayres is that when a trader disposes of his stock other than by way of sale, either for his own use or to a third party, at less than the full market value, the trader must bring into his accounts, for tax purposes the market value of the stock at the time of its disposal'. This seems to suggest that, in his view, the law as stated in those two cases somehow required that the transaction be disregarded.

30. The Commissioner's process of reasoning is not easy to follow. He said:

> '... having come to the conclusion that the two properties were the Taxpayer's stock-in-trade, I shall then consider the price at which [flat X] was sold [emphasis added].'

On the evidence before the Commissioner, and before us, the only price at which flat X was sold was the contract price of $900,000. If in truth there was a sale, the only possible conclusion which anyone can reach is that the Taxpayer sold the flat for $900,000 and Madam A purchased the flat for that price. Upon this factual foundation, how could the 'principle espoused' in Sharkey v Wernher and Petrotim Securities Ltd v Ayres require the trader to 'bring into his accounts, for tax purposes, the market value of the stock at the time of its disposal'?

31. Putting the best complexion upon the Commissioner's process of reasoning, as expressed in the three sentences of his reasons for determination (as set out in paragraph (4) of his determination and reproduced in paragraph 6 above) it is this:

(i) The 'sale' of flat X to Madam A was not at full market value.

(ii) The 'sale' of flat X to Madam A was at a price so 'substantially below the market price' that the 'sale' could not be accepted as a transaction entered into by the Taxpayer in the course of its trade; perhaps it was not a 'sale' in any real sense at all.

(iii) Following the reasoning in Petrotim Securities Ltd v Ayres, the transaction should be disregarded altogether.

(iv) Instead of the sale price of $900,000, the Taxpayer must be treated for tax purposes as having, on the credit side of its accounts, the figure of $1,150,000 which is the market value of the flat. This would accord with the approach of the court in Petrotim Securities Ltd v Ayres, applying the reasoning in Sharkey v Wernher to compute the 'profit' on the basis of the market value at the time of 'sale'.

32. It seems to us that what the Commissioner has done in applying the so-called 'principle' in the two cases referred to above is to have given himself a power of dealing with objections against assessments which are not set out in the statute. He is applying

English case law and not Hong Kong statute law. Section 61 of the Inland Revenue Ordinance empowers the assessor to disregard a transaction which he considers to have been 'artificial' or 'fictitious' or 'not intended to be given effect to'. As mentioned above, when we asked Mr Bach, the Commissioner's representative at the hearing, whether section 61 was being applied, his first answer was 'no'. This was not surprising as there is no mention whatever of section 61 in the determination and, of course, the assessor plainly never applied his mind to it. Later, when pressed by us as to how, then, the Commissioner was empowered to disregard the sale to Madam A at $900,000, Mr Bach adverted to section 61.

33. A representative's inability to deal with questions consistently is, of course, by no means conclusive as regards the validity of the point, but it certainly highlights the defect in approach.

34. Petrotim Securities Ltd v Ayres was a case where the 'sale' of assets was at figures so derisory that the Special Commissioners found as a fact that what the company was doing was in fact to 'deliberately set out to make a very substantial loss' (see 41 TC 389 at 395). The conclusion which they reached was this: 'it therefore seems a fair inference to draw that in relation to those transactions the company, at the time of the sales, was no longer acting as a dealer or financier and accordingly the sales were not made in the course of the company's trade'. In relation to one parcel of stocks and shares, these had been acquired by the company for £478,573. At the time of the transaction in question, the realisable market value on the stock exchange of those shares was £835,505. The company 'sold' the shares to a wholly owned subsidiary for £205,000. In relation to the other transaction which was impeached, the company had bought bonds (3% war loans) for £104,769 and, four days later, 'sold' these to a wholly owned subsidiary for £10,000. In these circumstances, it is not surprising that the Special Commissioners came to the view that, in truth, the company was simply setting out deliberately to make a loss on the transactions.

35. It is worth emphasising that, under the scheme of the Income Tax Acts in the United Kingdom, there is no statutory equivalent to section 61 of the Inland Revenue Ordinance. The position in Hong Kong is therefore quite different. We find it difficult to see any justification for the Commissioner in Hong Kong exercising some 'common law' power to disregard a transaction, outside the scope of section 61 of the Ordinance, by invoking a 'principle espoused' in Sharkey v Wernher and Petrotim Securities Ltd v Ayres, decisions under a tax regime wholly different from that of Hong Kong. Indeed, we question whether the Commissioner has the power to apply the 'principle espoused' in Petrotim Securities Ltd v Ayres at all, when the Inland Revenue Ordinance in Hong Kong makes express provisions which seem to be aimed at a very similar situation. If in truth what the Commissioner is saying is that the 'sale' to Madam A was a sham, a device in order to disguise the fact that the Taxpayer was simply giving its property away to a director, this could have been stated in plain terms, and there was no need to invoke any so-called 'principles' stated in English tax cases. But the consideration of $900,000 was real and not illusory, so any conclusion based upon the proposition that the transaction was a sham must be plainly flawed.

36. Assume that the assessor had, in a proper case, exercised his discretion under section 61 to disregard a sale, treating it as not having been made by a company at all. What would the assessor do in adjusting the accounts of the taxpayer? What would he put on the credit side of the taxpayer's accounts? It must be right in such circumstances to put a figure representing the market value of the property sold. To this limited extent, it could be said that the assessor is applying the 'principle espoused' in Petrotim Securities Ltd v Ayres and Sharkey v Wernher. In the context of Hong Kong statute law, it is difficult to think of other circumstances under which the 'principle' in those two cases could be applied. In this regard we echo the words of caution of the Board in D26/84 reported in IRBRD, vol 2, 139.

Section 61 of the Inland Revenue Ordinance

37. It is perhaps worth emphasising that the discretion to 'disregard' a transaction is vested in the first place under section 61 in the assessor. Assume that in a particular case an assessor had never applied section 61: is the Commissioner, in entertaining an objection under section 64 of the Inland Revenue Ordinance, entitled to apply it for the first time? The answer is yes: see CIR v Howe [1977] 2 HKTC 936 at 955. The Commissioner's task is to review the assessment and he has the power under section 64(2) to increase the assessment. But one would expect the Commissioner to be extremely slow in exercising this power in the circumstances where the assessor had never invoked section 61, and before doing so would afford the taxpayer ample opportunity to make representations, and bring forward facts, to show why the section should not be invoked in this way.

38. We are not here concerned with the propriety, or otherwise, of the Commissioner's exercise of his powers under section 64; all that we are concerned with is to deal with the appeal under the provisions of section 68 of the Ordinance. What we have before us, however, is this situation:

(i) The assessor treated the transaction as a sale of flat X to Madam A for $900,000 and assessed the Taxpayer accordingly.

(ii) The Commissioner, without any additional facts before him, except the valuation made by the office of the Commissioner of Rating and Valuation, as far as we can see, treated the transaction as not being a 'sale in the course of [the Taxpayer's] trade', and assessed the Taxpayer on the basis of a notional sale at $1,150,000 which the Taxpayer had never made.

39. What are the facts which led to this result? They seem to add up to no more than the following:

(a) The sale at $900,000 was $200,000 below the price of flat Y, sold by the Taxpayer at about the same time. Assuming (and this is a matter of pure speculation) that the flats were identical in every respect, including the terms of the tenancies to which the sales were subject, this represents a discount of about 20%.

(b) The cost price of the flat was higher than flat Y.

(c) This sale was to a director of the Taxpayer, the wife of another director.

(d) A 'non-speaking' valuation of a person employed in the office of the Commissioner of Rating and Valuation has valued the flat at $1,150,000.

40. What we have stated above are, in effect, all the facts upon which the exercise of judgment was apparently made. It seems to us to be a very slender foundation indeed; unjustified upon the facts and wholly wrong in law in applying the 'principles' in the two English cases.

41. The charge on 'profit' in section 14 of the Inland Revenue Ordinance is a charge on real profit, not on notional profit which a taxpayer never made. Since the Taxpayer in this case never challenged, factually, the finding of undervalue, we must conclude that the sale to Madam A was at an undervalue – that is to say, at a discount to the market price. But what fiscal consequences flow from this fact? The Inland Revenue Ordinance contains no provisions similar to section 27 of the Stamp Duty Ordinance, chapter 113 which enables the collector to assess stamp duty based upon the 'gift' element of a transaction. Assume, for instance, that Madam A were herself a trader in real estate and, in turn, sold flat X a year or two later at a profit. Would her tax liability as a trader under section 14 be computed on the basis of a notional sale to her at $1,150,000 in early 1986, or on the actual cost price (thereby yielding a higher figure for profits tax purposes)? The answer, as it seems to us, must be that she would be assessed on the basis of the actual cost of the trading stock, not the higher notional cost. When it comes then to assess the Taxpayer, what principles of law, or of commercial accountancy, require the Taxpayer to be assessed on the basis of a sale at a notional figure and not the actual figure? We are aware of none.

Conclusion

42. In the circumstances of the case, the appeal is dismissed, but we order that the revised assessable profits as computed by the Commissioner in his determination be discharged and the assessment of the assessor showing net assessable profits in the sum of $286,741 be restored.