INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D49/92

Profits tax – correction of error – whether land should be valued at the date of possession or at the date of alleged change of intention – section 70A of the Inland Revenue Ordinance.

Panel: Robert Wei Wen Nam QC (chairman), Victor Hui Chun Fui and Gillian M G Stirling.

Dates of hearing: 9, 10, 11 and 21 September 1992.
Date of decision: 12 January 1993.

The taxpayer was a private limited company who claimed that it had been incorrectly assessed to tax and that there was a material error in that the cost of sales of certain property was understated because the land had been valued at the date of its acquisition in 1979 and not at the date when it was alleged to have become trading stock in 1982. Application was made by the taxpayer under section 70A of the Inland Revenue Ordinance for correction of the error. Evidence was called on behalf of the taxpayer which was accepted by the Board and which proved that the property was acquired by the taxpayer in 1979 as a capital asset, that there had been a change of intention in 1982 when the property was converted into trading stock and that there had been an error in the preparation of the profits tax computation.

Held:

Based on the facts proved before the Board and accepted by the Board the assessment was remitted to the Commissioner to correct the assessment against which the taxpayer had appealed.

Appeal allowed.

Case referred to:

Sharkey v Wernher 36 TC 275

Luk Nai Man for the Commissioner of Inland Revenue.
Michael Olesnicky of Messrs Baker & McKenzie for the taxpayer.

Decision:

Subject of Appeal

1. This is an appeal by a private limited company (the Taxpayer) against: (1) the Commissioner of Inland Revenue's determination to uphold the assessor's refusal to correct the 1986/87 profits tax assessment raised on it; and (2) the 1986/87 additional profits tax assessment and the 1987/88 profits tax assessment as revised by the Commissioner.

Claim

2. The Taxpayer claims that the 1986/87 profits tax computation contains a material error in that the cost of sales was understated by valuing the cost of land as at the date of its acquisition in 1979 as a capital asset instead of valuing it as at the date of its becoming trading stock in 1982 when the Taxpayer decided to hold the property for sale at a profit. The Taxpayer therefore asks for the error to be corrected under section 70A of the Inland Revenue Ordinance, and by agreement, that is the only question for this appeal. It is agreed that if this appeal succeeds, and if the parties fail to agree on the value of the property as at the date of change of intention, so that it becomes necessary for the Board to adjudicate on the matter, proceedings on valuation shall not be taken until after the determination of any further appeal or appeals following upon this decision.

3. There was a claim for industrial building allowance in respect of a store room and carparks which has since been abandoned.

Issues

4. To succeed, the Taxpayer must prove three things:

(1) That the property was acquired in 1979 as a capital asset;

(2) That there was a change of intention in 1982 when the property was converted to trading stock; and

(3) That there was an error in the preparation of the 1986/87 profits tax computation.

Agreed Facts

5. The following facts are agreed between the parties.

5.1 In 1979. the Taxpayer was incorporated as a wholly-owned subsidiary of A Ltd. Its issued share capital was, and has since remained, $2.

5.2 A Ltd was in turn a wholly-owned subsidiary of B Ltd, and had been carrying on the business of property investment and development since 1970.

5.3 May 1979. B Ltd transferred certain properties which were surplus to its operations, because of their size and location, to A Ltd, together with shares in two property-owning subsidiaries. The properties included a R site, which forms the subject-matter of this appeal. The purchase price payable by A Ltd for the site was $67,000,000, being the directors' valuation based on professional advice. In consideration, A Ltd allotted 67,000,000 shares of par value $1 each to B Ltd. The consideration for the other three properties and the shares was provided in the same manner, that is, by an allotment of shares.

5.4 July 1979. The Taxpayer's board of directors resolved to acquire the R site for $67,000,000, which was A Ltd's cost price. Minutes of a meeting of the Taxpayer's board state that the property was acquired by it as a long-term investment.

5.5 August 1979. A Ltd assigned that R site to the Taxpayer at its cost price ($67,000,000). The purchase price remained outstanding as an interest-free, on-demand loan from A Ltd.

5.6 The Taxpayer's first board of directors, who were appointed in July 1979, consisted of eight persons.

5.7 Late 1979. The Taxpayer's architects applied to the Building Authority for permission to develop the property into two towers of industrial building units.

5.8 July 1980. The Building Authority approved the site formation work plan.

5.9 December 1980. The Building Authority approved the plan for demolition and hoarding at the site.

5.10 In early 1981. Mr U, the managing director of C Ltd was appointed as a director of B Ltd, A Ltd and the Taxpayer, after C Ltd had acquired slightly over 20% of the shares in B Ltd.

5.11 In early 1981. Mr V, the managing director of the D group, was appointed as a director of B Ltd, A Ltd and the Taxpayer, after the D group had acquired slightly over 10% of the shares in B Ltd.

5.12 February 1981. The Building Authority approved the building plan (consisting of a car park and two blocks of small industrial units.)

5.13 Late 1981. A professional valuation showing the value of the property in late 1981 to be $200,000,000 was prepared by Messrs E at the instruction of A Ltd.

5.14 February 1982. B Ltd resolved to distribute the shares in A Ltd to the shareholders of B Ltd, thereby dividing B Ltd and F Group into two separate groups. This became effective on 30 April 1981, and F Ltd was separately listed on stock exchange in 1982. (see chart in 5.39)

5.15 February 1982. A Ltd changed its name to F Ltd. (see chart in 5.39)

5.16 April 1982. Messrs W, X and Y became directors of F Ltd and of the Taxpayer.

5.17 May 1982. F Ltd became a listed company.

5.18 July 1982. The board of directors discussed a 'suggestion that consideration be given to the possibility of selling the property' (quotation from the minutes of the meeting).

5.19 December 1982. The Taxpayer sought approval from the Town Planning Division to modify the land use from industrial to residential/commercial use, and submitted a report that it had prepared for this purpose. This required a rezoning of the property.

5.20 March 1983. The application was rejected.

5.21 March 1983. Mr U resigned as director of F Ltd, and was replaced by Mr Z.

5.22 April 1983. Mr U resigned as director of the Taxpayer, and was replaced by Mr Z.

5.23 September 1983. Mr V resigned as director of F Ltd and the Taxpayer.

5.24 December 1983. Phase 1 site formation work had been completed, and phase 2 site formation and foundation work were in progress.

5.25 1985. The Taxpayer commenced pre-selling units, and received deposits and instalments from purchasers amounting to about $44,500,000.

5.26 February 1986. The Taxpayer completed the development. The occupation permit was issued, and the Taxpayer recognised the sales profits. The building is hereinafter called the 'G Centre'.

5.27 Total development costs amounted to about $99,000,000 (plus land costs of $67,000,000), all of which was financed by loans from F Ltd. F Ltd did not borrow funds for this purpose.

5.28 July 1987. The Taxpayer, through its tax representative, Messrs H, submitted a profits tax return (including audited accounts) for the 1986/87 year of assessment, declaring all of its profits from sales for that year to be taxable. The 1986 accounts showed the company's profits were $61,886,069. After adjustments, the profits tax computation showed taxable profits to be $63,053,529.

5.29 August 1987. A notice of assessment for the 1986/87 year of assessment was issued according to this return, showing tax due of $11,664,902. The Taxpayer paid this amount.

5.30 There was a minor tax dispute concerning the availability of depreciation allowances with respect to retained portions of the development, namely, a store room and car parks. November 1987, the IRD issued an additional assessment for the year of assessment 1986/87. December 1987, the Taxpayer, through Messrs H, objected to this additional assessment.

5.31 September 1988. The Taxpayer (through Messrs H) submitted a profits tax return (including audited accounts) for the 1987/88 year of assessment, and in its tax computation claimed that its profits ($7,757,055) were not subject to tax on account of carry-forward losses of $66,142,543.

5.32 At the same time, the Taxpayer (through Messrs H) also submitted a letter in which it claimed that the previous 1986/87 return had been prepared incorrectly, on the ground that the property had originally been a capital asset which was subsequently converted into a trading asset. Therefore, in determining the Taxpayer's assessable profits or losses, the relevant cost price should be the market value of the property as at the date of such conversion, which the Taxpayer claimed was $200,000,000 based on the professional valuation referred to in sub-paragraph 13 above. The letter specified that it was a claim for a corrective assessment to be issued under section 70A of the IRO.

5.33 February 1989. The assessor issued a notice refusing to correct the 1986/87 year of assessment.

5.34 February 1989. The Taxpayer (through Messrs H) lodged an objection against the assessor's notice of refusal.

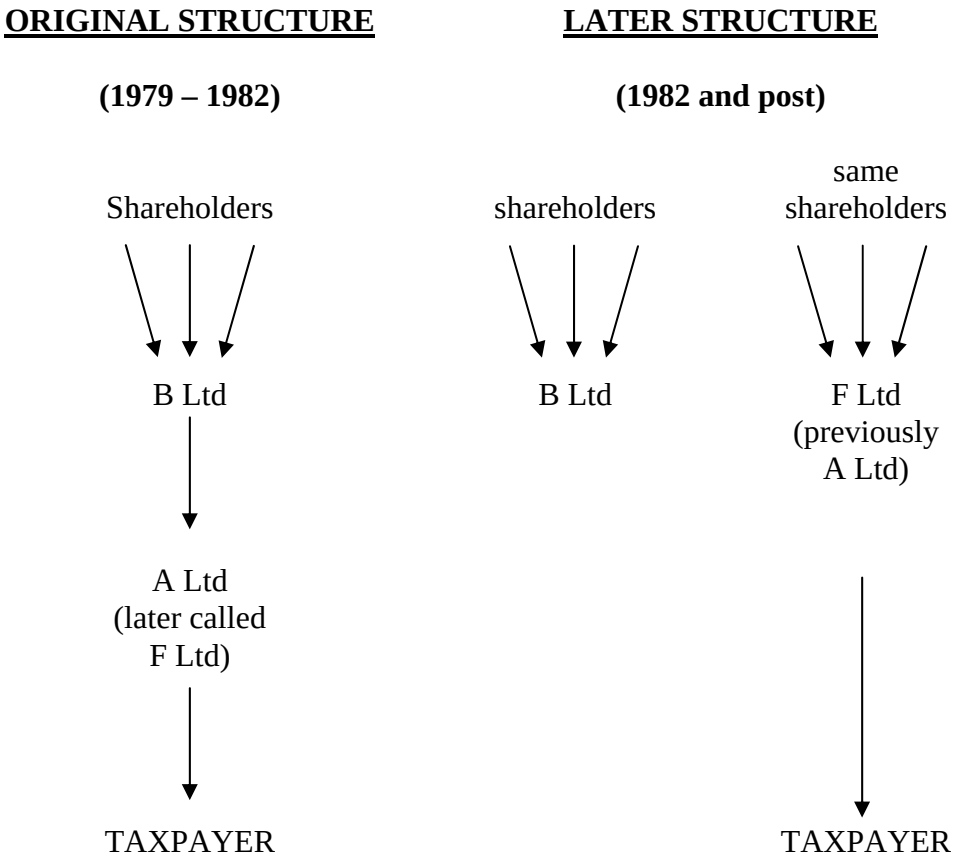
5.35 March 1989. A notice of assessment for the 1987/88 year of assessment was issued, showing assessable profits of $7,775,603 and tax payable thereon of $1,399,608.

5.36 April 1989. The Taxpayer (through Messrs H) objected to the 1987/88 year of assessment, on the grounds that the assessment was not in accordance with the Taxpayer's tax computation.

5.37 October 1991. The Commissioner issued a determination on both objections, upholding (a) the assessor's refusal to issue an assessment under section 70A with respect to the 1986/87 year of assessment, and (b) the assessment issued with respect to the 1987/88 year of assessment.

5.38 November 1991. The Taxpayer lodged a notice of appeal to the Board of Review against the Commissioner's determination with respect to the 1986/87 and 1987/88 years of assessment.

5.39



Findings of Fact

6. Five witnesses were called on behalf of the Taxpayer: Messrs V, W and X (see 5.11 and 5-16 above), Mr S, a technical partner in Messrs H and Mr T, a finance manager of I Ltd, which was a subsidiary of A Ltd, and to which A Ltd had delegated all executive management responsibilities for the operation of the A group. We find all five credible witnesses. From their testimony and documents agreed or proved before us, we have been able to find the following facts.

6.1 B Ltd from time to time had properties which were used in its operations but which became surplus to its requirements. In this situation, it has tended to develop such sites rather than sell them outside the group. B Ltd has never developed surplus properties in its own name, but only through subsidiary companies to which it transfers such properties prior to development. The reason for this procedure is that since 1975 B Ltd's profits have been subject to a scheme of control imposed by an ordinance. Pursuant to this ordinance B Ltd entered into a franchise agreement with the government, which restricted B Ltd's annual profits from its operations to a specified percentage of the value of assets used in the operations. Prior to 1979, B Ltd earned profits from its activities at the specified percentage level or even higher. Any excess profits were required to be transferred to a development fund. Because of the existence of the scheme of control, B Ltd did not wish to develop the

surplus sites itself, because there could have been difficulties in showing that the profits from the developments were separated from the operations, and in obtaining permission from the government to raise fee in the future.

6.2 B Ltd therefore took advice from Messrs H, a firm of certified public accountants who were at all relevant times the tax consultants, tax representative and auditors of the B group. In late 1977 Messrs H produced a memorandum on the development of properties within the B group of companies (the memorandum). It stated in the introduction that it was concerned with the group structure and taxation implications of the various alternatives available in the utilization of the properties. It contained, inter alia, the following:

> 'The median term objective of the board of B Ltd is for the properties in the group surplus to requirements of the operations to be transferred from B Ltd to subsidiaries at market value so that the shareholders of B Ltd may benefit from development of the properties without restrictions under the Franchise Agreement ...
>
> As an intermediary stage of these developments it is proposed that a separate property sub-group should be formed comprising A Ltd as the intermediary holding company together with a number of subsidiary companies which would be used as property investment companies, property dealing companies and a "suspense" company ...
>
> Land may be acquired and developed for the purpose of yielding rent as a long-term investment or may be held as a fixed asset for use in a trade, and, in either case, during the subsistence of such stage it will normally constitute a capital asset, the sale of which is not subject to tax.
>
> If however land is acquired with the objective of ultimate resale at a profit, whether before or after development, this will be an adventure in the nature of trade and the profit will be taxable. Land or land and buildings may also have been acquired as a capital asset as described in the preceding paragraph but due to changed opportunities or circumstances it may be decided to cease holding it for the original purpose and henceforth to hold it for resale whether before or after further development. In these circumstances, the growth in value subsequent to the change in intention will be subject to tax whereas the growth in value that had occurred up to that time should be regarded as capital profit.
>
> ... the most important elements of tax planning for real property transactions are as follows:
>
> (i) Segregation of long-term investment properties and dealing properties
>
> (ii) Documentary evidence of intention.

To meet these objectives, a structure of at least three companies is required, an investment company, a dealing company and a non profit-making company which will be referred to in this memorandum as a "suspense" company. In addition these companies can form a separate property group under a holding company. The latter has no taxation significance but may be advantageous from an administrative viewpoint and would of course facilitate any subsequent flotation of the property group.

The Investment Company. This would be a company, either formed for the purpose or with a previously untainted history of property investment. As supported by its Articles, it would hold property for long-term investment which it may acquire either externally or which it may itself develop. It is fundamental to the company's objective that no property held for resale or indeed any property the intention for which is uncertain should be held by the company. It should therefore be possible to demonstrate that any profit from its sale of property by the company in the course of changing its investments gives rise to a capital profit which is not liable to tax.

It is essential, notwithstanding the foregoing, that every acquisition of property by the company be documented by Board minute as to the investment purpose. Similarly, reasons for disposal should also be documented.

The Dealing Company. This would be a company, either formed for the purpose or could in fact have a history of any other activity. It would henceforth act solely as a property dealer and would acquire property, either from within the group or externally, for resale at a profit before or after further development.

It will be accepted that this company will be subject to tax on all of its profits from property sales and therefore no property other than that which it is intended to hold for resale should pass through the company.

Suspense Company. There will be occasions when property is acquired for which the intention to hold, either as a long-term investment or for resale is not certain for a period of time. Similarly, land may be developed without knowing, until the development is completed, which parts are to be held for investment and which for resale.

This problem is overcome by holding or developing such uncertain property in a suspense company. When the intention for the property is formed, a board minute clearly documenting the decision should be made and the property transferred to the relevant investment or dealing company at a price equal to the cost to the suspense company. The suspense company thus makes no profit and this is an important feature of its contribution to the plan. Any temptation to uplift the price of property transferred should be resisted as the suspense

company may become a dealing company with the tax consequences that would follow from that.

Suggestion. It is important that B Ltd remains as an operating company in certain field and does not become involved in property development, investment or dealing. These functions should be carried out by the companies formed for those purposes. As the land in question has been held for many years as a fixed asset of B Ltd's trade, so long as B Ltd does not become involved in any development of the land following its decision to release the land from its use as a fixed asset there should be no question of tax being chargeable on any profit derived from its sale by B Ltd. It is therefore necessary to transfer the land from B Ltd to the appropriate property company and desirable to make the transfer at current market value in order to optimise the profit that will be free of tax. A suitable board minute should be made by B Ltd covering these facts and the transfer price should be supported by a professional valuation.

As to which company or companies the land should be transferred to, this depends upon whether or not a firm intention in respect of any separately identifiable parts of the land has been formed. Any parts for which a firm intention has already been formed should be transferred to the investment or dealing company as appropriate and a relevant board minute recorded by the recipient company as well as B Ltd. Where however intentions are not yet crystallised, transfer should be to the suspense company where development can take place and when intentions are formed for the developed property, appropriate transfers would be made to the investment or dealing companies at cost to the suspense company. Suitable board minutes should be prepared at that time by the suspense company and the recipient companies as evidence of the intentions at that time.'

6.3 On 16 March 1978, the memorandum was approved by the board of directors of B Ltd. By that time four properties had already become surplus to the operations. Three of these were at sites R, S and T (the first of which was developed into the G Centre and is the subject of this appeal). Previously, these sites had been in remote locations, but were now in urban areas. The fourth property was the Q Building. It was also decided to release this property from B Ltd's operations. This property consisted of two ground floor shops which were used to serve the public, and a first floor flat which was being used as a staff sports club. However, B Ltd decided to stop providing the service and to cease the operations of the sports club. The Q Building was therefore no longer necessary in B Ltd's operations. B Ltd decided to develop the sites, and to rent out the Q Building. It also decided to sell the four properties to its wholly owned subsidiary, A Ltd, in exchange for shares in A Ltd. The intention was that A Ltd in turn would sell the properties to separate subsidiaries of its own, depending on whether they were to be developed for resale or held for long-term investment in accordance with the recommendations set out in the memorandum.

6.4 Of the four properties, the S and T sites were marked for development partly for sale and partly for investment, while the R site and the Q Building were marked for investment. There were two reasons for dividing the properties in this way. First, although A Ltd was financially sound and had spare cash, it could not afford to develop and hold all three sites for the long term. Some had to be sold to finance those which were to be held. Secondly, the R site could not be developed for residential purposes because of zoning requirements, but the other two sites could be so developed. In choosing which sites to keep and which to sell, the choice was clear. Generally, B Ltd did not wish to hold residential properties for long-term investment, because it was administratively more difficult to collect rents from tenants of small residential units. P Mansions, a property of the group already developed, was a good example: the residential units were sold but the commercial shops were retained. It was therefore decided to keep the R site, after it had been developed into industrial units, and to develop the other two sites primarily as residential units, which had better sale potential. As for the Q Building, it was already developed. It was intended all along to continue holding this property. It was transferred to A Ltd's subsidiary, J Ltd, and was retained until it was sold in 1991.

6.5 Mr X was responsible for implementing the property transfers from A Ltd to its subsidiaries on the basis of Messrs H's advice. He is the general manager of B Ltd, and has been employed by B Ltd since 1960: originally as an accountant; from 1968 to 30 May 1979 as chief accountant; from 1 June 1979 to 1989 as assistant general manager (finance); and since 1989 as general manager.

6.6 Mr X's proposed structure for the property transfers was as follows:

(1) The formation of the Taxpayer as a wholly owned subsidiary of A Ltd and as an investment company to purchase the R site from A Ltd and hold it as a long-term investment;

(2) The formation of K Ltd as a wholly owned subsidiary of A Ltd and as a suspense company to purchase the S and T sites from A Ltd and develop them into residential and commercial units; the formation of a dealing company to purchase from K Ltd the residential units for resale; and the formation of two investment companies to purchase the commercial units from K Ltd and hold them as long-term investments; and

(3) The formation of J Ltd as a wholly owned subsidiary of A Ltd and as an investment company to purchase from A Ltd the Q Building and hold it as a long-term investment.

6.7 The structure was approved by B Ltd's and A Ltd's boards of directors. In May 1979 B Ltd transferred the four properties to A Ltd (for the transfer of the R site see 5.3 above). That was followed by the further transfer of the four properties from A Ltd to the two investment companies and the suspense company respectively (for the transfer of the R site to the Taxpayer see 5.5 above). Messrs H and Messrs L, B Ltd's solicitors, had prepared the Memoranda and Articles of Association of these companies, and in so doing

maintained a distinction as they considered appropriate between the three types of companies.

6.8 In 1979, apart from the properties transferred to it as mentioned above, A Ltd already held some long-term investment properties in its own name. These properties had all been used previously by B Ltd, but had become surplus to its requirements. This included the commercial portion of P Mansions and the O Building, both of which had been developed by A Ltd and held as long-term investments. Also, A Ltd owned the N Building which was then tenanted and was held as a long-term investment. In addition, A Ltd acquired from B Ltd all the shares of two property investment companies and held these shares at all times as long-term investments. Those subsidiaries in turn held their property (the M Building) as long-term investments. A Ltd had only traded in small residential units in P Mansions in 1974, and in the L Building (which was near the O Building) in 1973/74. As small residential units were less satisfactory for long-term investment because of the difficulties in collecting rent, A Ltd only held commercial properties as long-term investments. So, when A Ltd developed P Mansions, it retained the commercial portion as a long-term investment, but sold the residential portion. The L Building was sold because the management took the view that it did not make good investment sense to own two buildings with same business which were close to each other.

6.9 To complete the separation of surplus properties from the operations, plans were made to take the properties out of the B group altogether by distributing B Ltd's shares in A Ltd to the shareholders of B Ltd, so that the same shareholders would become the owners of two entirely separate groups of companies. This was accomplished in early 1982; A Ltd, now re-named F Ltd, became a listed company in May 1982 (see 5.14 above).

6.10 The property transfers from A Ltd to its subsidiaries were completed in 1979. Thereafter Mr X ceased his day to day involvement with the activities of the A group (later known as the F group) and focussed principally on the activities of B Ltd, although on 1 April 1982 he was appointed as a director of F Ltd and of the Taxpayer in a non-executive capacity and attended the board meetings of both these companies.

6.11 Mr W was a manager of A Ltd from 1967 to April 1982 when he was appointed to the board of directors of A Ltd. He was a director of I Ltd and was the head of a senior management team of I Ltd, which was responsible for the day to day management of the A group's property activities, including the R site development as from 1980. Mr W was closely involved in the activities of the Taxpayer from its incorporation in June 1979; In April 1982 he was appointed to the board of directors of the Taxpayer.

6.12 In early 1981 Mr U was appointed as a director of B Ltd, A Ltd and the Taxpayer (see 5.10 above). Shortly thereafter he requested a report on the R site project. At that time, the intention of the Taxpayer was to hold the property as a long-term investment. On 22 January 1981, Mr W wrote a letter to Mr U on the progress of the project, in which Mr W referred to the development as being tenanted upon completion. Building plans had already been submitted for the development of the site into two blocks comprising relatively

large industrial units which were thought to be appropriate for generation of rental income and long-term investment.

6.13 In early 1981, Mr V was appointed as a director of B Ltd, A Ltd and the Taxpayer (see 5.11 above). Both Mr U and Mr V were from companies which were well-known property dealers; they had a more aggressive approach for the R site and wanted the Taxpayer to develop it for sale. On 23 February 1981, the general manager of I Ltd appointed a committee consisting of Messrs U, V and W to plan the R site development; this was done in view of the positions taken by Messrs U and V regarding the future of the R site.

6.14 On 20 February 1982, Mr V wrote to Mr W, inter alia, in the following terms:

> 'As concerning Scheme N (that is, the scheme in respect of the R site) ... we have the following comments:
>
> 1. Possible subdivision of the factory/showroom at ground floor is to be indicated.
>
> 2. Large units at 1st floor to 12th floor are to be subdivided if possible.
>
> 3. Provision of lifts serving the top floor is to be incorporated.
>
> Regarding the above point No 3 it is essential that such lift provision be made possible otherwise it would be very difficult to sell the top floor units. In this connection, our architect has been in touch with Messrs A (that is, the Taxpayer's architect) to explain to them such possibility and was advised that upon preliminary review such provision would be possible if the typical floor height was to be reduced to say 2.9m (which is a bit low) OR alternatively minor ramps were to be introduced at lift landings of say the topmost two floors. This is an important aspect and should be studied in greater detail.'

6.15 There were a number of meetings among the three; Mr U was represented mostly by his sons, Messrs Ul and U2. The meetings were often attended by other representatives and architects from the A group. Messrs U and V wanted the subsidiaries of A Ltd, including the Taxpayer, to sell their properties. Because Messrs U and V's companies owned a total of 30% of the share capital of the B group and F group, and because they were experts in property matters, by a gradual process the boards of F Ltd and the Taxpayer eventually agreed that the R site should be sold.

6.16 The minutes of the board meeting of the Taxpayer on 8 July 1982 read, inter alia, as follows:

> 'Consideration of selling property at [R]

> It was suggested that consideration be given to the possibility of selling property at [R]
>
> It was suggested to invite brokers to find buyers. Offers from potential buyers will be submitted to directors for consideration/approval.'

6.17 Over the next couple of months, the Taxpayer could not find buyers for the R site. On 23 September 1982 there was a board meeting of F Ltd, the minutes of which contain the following:

> 'Consideration of the tenders for the appointment of Quantity Surveyor for [property at R]
>
> It was suggested that consideration be given to the possibility of modifying the use of [property at R] and it was proposed that the appointment of Quantity Surveyor for the captioned site be pending.'

6.18 It has been the practice of the F group since 1982 to tape all the directors' meetings of group companies. The tape of the board meeting of the Taxpayer held on 8 July 1982 established that consideration was in fact given to the possibility of selling the R property. Furthermore, W's evidence, which we accept, was that 'over the next couple of months, we could not find buyers'. We take that to mean that efforts, albeit unsuccessful, were in fact made to find buyers; from that we infer that the directors had in fact decided to find buyers and had authorised the procurement of offers from potential buyers. The directors might or might not have approved any such offers, but, by the decision to have offers submitted to them for consideration/approval, the directors opened the door to sale at an acceptable price; in our view, the Taxpayer from that moment onwards held the R property for sale. In this regard, W stated:

> ' At a directors' meeting held on 8 July 1982, it was decided to sell the [R] site, and to arrange for brokers to find buyers. This is the first date on which the board definitely agreed to sell the property.'

We accept that evidence.

6.19 The tape of the board meeting held on 23 September 1982 established that the directors considered alternative methods of selling the R property, such as reducing the size of the projected industrial building units and converting the permitted use of the site from industrial use to residential/commercial use; and that the meeting, dominated by Messrs U1 and V, was in favour of the latter alternative, which, it was thought, offered better sales prospects. This would involve a modification of use and an application for rezoning approval. It was therefore decided by the directors not to appoint a quantity surveyor as additional charges would have been incurred in case of a change of plans. An application for rezoning was lodged in December 1982 but was rejected on 24 March 1983 because the property was close to a gas supply site. It was therefore decided by the management to develop industrial units for sale; the building plans were modified to reduce the size of the

units; this was because Mr V had by his letter dated 20 February 1982 (see 6.14 above) convinced the management that to assist sales, it would be better for smaller units to be constructed.

6.20 The Taxpayer's decision to hold the R property for sale was reflected in the Taxpayer's audited accounts for calendar year 1982, which were signed by the auditors on 12 May 1983. In those accounts and in accounts thereafter up to and including the 1986 accounts, an additional Accounting Policy 1(a) was inserted. It is headed 'Property Under Development' and reads as follows:

> 'Property under development is stated at cost less provision for anticipated losses where this is considered appropriate by the directors. Provision for anticipated losses is determined by reference to the directors' estimates of future selling prices of completed property. Cost includes cost of land, all development expenditure and interest where applicable.'

Commenting on the significance of Accounting Policy 1(a), Mr S stated in his evidence:

> 'This is a common Accounting Policy note for a company which holds property under development for sale purposes. The effect of the policy is to ensure that the property will not be stated at a value which exceeds the net realizable value. This is a requirement of paragraph 19(a) of the Hong Kong Society of Accountants' Statement No 123, issued in January 1980, which was the applicable statement for all relevant years up to 1983 (and which was replaced in 1984 by a similar statement). That paragraph applies only to properties under development which are held with the intention to re-sell, and not to properties under development held for other purposes. (The alternative is to state in the appropriate note to the accounts, in which the value of the property under development is shown, that the property is valued at "lower of cost and net realizable value", but the result is the same.)
>
> There was no suggestion in the 1982 to 1985 accounts that the net realizable value of the property was less than its cost price, so there was no need to make an actual provision in the accounts, but the fact that the policy changed is indicative that the asset was now a trading asset.
>
> The accounts for the pre-1982 years are consistent with a view that the property was being held for long-term investment. There is no indication in those accounts that the property was being held for sale. The fact that the new Accounting Policy was added to the 1982 accounts would indicate to a knowledgeable reader that some events occurred during that year with respect to the property which had the effect of converting the property into an asset held for sale. A person knowledgeable in accounting matters would therefore conclude that, during 1982, the company ceased to hold the property as a long-term asset and thereafter held the property as an asset for sale.'

We accept Mr S's evidence.

6.21 At all relevant times Mr T was a finance manager of I Ltd and was first employed by that company in 1978. It was part of his duties to supervise the preparation of draft accounts of the F group companies for audit purposes and to liaise with Messrs H the auditors. Before he joined I Ltd, he had been employed by Messrs H from 1972 to 1978, first as an audit trainee and thereafter as an assistant manager. He is a member of the Hong Kong Society of Accountants and a fellow of the Association of Certified Accountants. During his employment with Messrs H, he did tax computations which were passed on to the tax department of Messrs H, but he never worked in that department. Accounting Policy 1(a) was inserted in the 1982 acocunts of the Taxpayer on the advice of Messrs H that this should be done as the company records showed an intention to sell the property at R.

6.22 The audited accounts of the Taxpayer for 1986 contained a provision for tax to the amount of $11,664,902; this was based on the draft accounts for that year which contained a like provision. The tax provision was a mistake which arose from Mr T's erroneous assumption that the Taxpayer's profits from the sales of the units of the G Centre were taxable; he was ignorant of the Sharkey v Wernher principle that growth in value prior to change of intention from holding for long term to holding for resale is capital profit. The mistake was repeated in the audited accounts of the Taxpayer. In April I987 Messrs W and X attended the Taxpayer's board meeting at which the 1986 accounts were approved. Mr W was one of the two directors who signed the accounts; he did not know that the tax provision was a mistake. As for Mr X, he was aware of the Sharkey v Wernher principle, but, during the few minutes during which the accounts were laid before the meeting for approval, the tax provision escaped his attention. There is no evidence as to exactly why the auditors failed to correct the mistake; however, leaving aside the actual mechanics which led to the failure of the audit, we are of the view that it was due to some shortcoming in the audit process as opposed to any deliberate shutting of their eyes to the existence of the mistake; on the basis of our findings which are based on the evidence which we accept, there can be no motivation for such conduct. The mistake found its way into the 1986/87 profits tax return and the 1986/87 profits tax computation, on the basis of which the 1986/87 notice of assessment was issued and the tax of $11,664,902 paid. Later in 1987, the auditors notified Mr T of the mistake and informed him of the Sharkey v Wernher principle.

Conclusions

7. Our conclusions on the three issues are as follows:

(1) That the R property was acquired in 1979 as a capital asset;

(2) That there was a change of intention on 8 July 1982 when the R property was converted into trading stock; and

(3) That there was an error in the preparation of the 1986/87 profits tax computation.

Decision

8. This case is hereby remitted to the Commissioner for the 1986/87 profits tax assessment to be corrected in accordance with our conclusions set out in 7 above, with liberty to the Commissioner to apply for directions in case of disagreement between the parties as to the outcome of the correction; provided that no such application shall be made until after the determination of any further appeal or appeals following upon this decision.