Case No. D55/90

Profits tax – whether property acquired as trading or capital asset – whether intention to convert from trading asset to capital asset – Sharkey v Wernher.

Panel: Denis Chang QC (chairman), Ambrose Lau Hon Chuen and Eric Lo King Chiu.

Dates of hearing: 9, 10 and 11 July 1990.
Date of decision: 10 January 1991.

The taxpayer was a private limited company which acquired a vacant site. The taxpayer entered into a joint development agreement with the owners of adjacent properties for the redevelopment of the vacant site and the adjacent properties. At the same time the taxpayer entered into a long term tenancy agreement which was cancelled in the following year. A number of events then took place which led to the taxpayer becoming part of a group of companies which went public. The prospectus stated that the parent company intended to retain the property owned by the taxpayer as an investment for rental income. The taxpayer was assessed to profits tax on the value of the property when it became part of the public company group because there had then been a change of intention and the principle of Sharkey v Wernher was applied. The taxpayer argued that the original intention was not to trade. If however there had been an intention to trade then the principle of Sharkey v Wernher should not be applied.

Held:

The onus of proof is on the taxpayer to prove that it did not intend to trade in the property. The taxpayer had not been able to discharge the onus of proving that the assessment was incorrect in so far as its original intention was concerned. A change of intention had taken place when the taxpayer was acquired by the public company group and the rule of Sharkey v Wernher applied. Though the Board considered that the appropriate date was when the public company took over it did not upset the decision of the Commissioner that an earlier date could apply which was beneficial to the taxpayer.

Appeal dismissed.

[Editor's note: The taxpayer has filed an appeal against this decision.]

Cases referred to:

Sharkey v Wernher [1956] AC 58
Lionel Simmons Properties Ltd v Commissioners of Inland Revenue 53 TC 461
Californian Copper Syndicate v Harris 5 TC 159
The Rees Roturbo Development Syndicate Ltd v Ducker 13 TC 366
Commissioner of Inland Revenue v Waylee Ltd 3 HKTC 175

S P Barns for the Commissioner of Inland Revenue.
Chua See Hua of Ernst & Young for the taxpayer.

Decision:

This appeal raises two related issues. The first is whether the Taxpayer acquired certain property as a trading or as a capital asset. The second is whether, if the property was acquired as a trading asset, there was a conversion from trading stock into a capital asset such as to give rise to a notional profit assessable to profits tax for the year of assessment 1981/82 despite the fact that there was no actual sale by the Taxpayer in the relevant basis period.

The Taxpayer contends that the property was acquired and held at all material times as a capital asset; that, in any event, even if there was a change of intention such did not give rise to any notional profit assessable to tax.

The Revenue contends otherwise and made an assessment on the basis of a conversion from trading stock to capital asset on 23 October 1980, the date when the then directors and only shareholders of the Taxpayer disposed of all the issued shares in the Taxpayer.

The following facts are agreed:

1. The Taxpayer was incorporated as a private limited company in Hong Kong. The subscribers, Mr and Mrs A, were issued one share each out of the nominal capital of $10,000 (1,000 shares of $10 each). They also became the Taxpayer's first directors.

2. In mid-1979 the Taxpayer acquired the property known as No 4 X Street from the administrators of the estate of Mr B for a consideration of $670,000. The purchase of the property was funded by shareholders' loans from the directors, Mr and Mrs A, and who were subsequently repaid in full on 23 January 1981. At the time of the acquisition, the property consisted of a vacant site but existing on this property was a redevelopment notice in 1969 under section 3(1) of the Demolished Buildings (redevelopment of sites) Ordinance, 1963.

3. In September 1979 the Taxpayer entered into a joint development agreement with the owners of the adjacent properties located at Nos 1, 3, 5 and 7 Y Street and Nos 1 to 3 X Street. This agreement noted that general building plans for a new twenty-two storeyed building ('the new building') had been approved by the Building Authority in mid-1979.

   The terms and conditions of the joint development agreement included, inter alia, the following:

   (a) C Limited ('C Ltd'), the owner of the properties in Y Street, was to carry out the redevelopment of <u>all</u> the properties at its own cost and expense;

   (b) The Taxpayer's only contribution to the development costs was the provision of No 4 X Street and a cash amount of $450,000 payable as to $250,000 on the signing of the joint development agreement and the balance $200,000 on completion.

   (c) The Taxpayer was to be granted the following units within the new building:

      (i) portion of the ground floor (later known as 'shop D');

      (ii) the offices on 10/F, 11/F and 17/F ('the promises');

   (d) During the course of construction of the new building, any of the owners, including the Taxpayer, could enter into agreements for the sale of the premises to which they were to become entitled under the terms of the joint development agreement.

   The development was completed and the occupation permit was granted in 1983.

   The Taxpayer's sole asset of note at the relevant period is the premises.

4. On the same date as the joint development agreement, the Taxpayer entered into a tenancy agreement with Madam E, the mother of Mrs A, which stated, inter alia, that:

   (a) The Taxpayer would let all of its entitlements in the new building to Madam E for a period of ten years at a monthly rental of $35,000, commencing fourteen days after issue of the occupation permit;

   (b) Madam E would lodge a rental deposit of $450,000, payable as to $250,000 on the signing of the agreement and $200,000 upon completion of the work of the new building;

(c) Madam E could assign, sublet or transfer the tenancy of the premises; and

(d) The rental agreement which had been entered into was disclosed as note 6 to the audited financial statements for the period ended in September 1980.

This agreement was cancelled in October 1980 by mutual consent.

5. In September 1980 the remaining unissued capital of the Taxpayer was allotted equally (that is 499 shares each) to Mr and Mrs A. Since that date up to the relevant period, the issued capital of the Taxpayer had remained at $10,000.

6. In October 1980 Mr and Mrs A entered into a sales and purchase agreement whereby all of the issued shares in the Taxpayer would be sold by them to Mr F for the sum of $18,671,203, payable by way of a deposit of $4,000,000 and the balance on the completion date in January 1981.

As at the date of the sale and purchase agreement, No 4 X Street was included in the Taxpayer's accounts as:

Land, at cost	$670,000
Development expenses	455,722
	$1,125,722

7. G Limited ('G Ltd') was incorporated in 1980 with an authorised capital of $10,000 divided into 100 shares of $100 each. At a directors' meeting in January 1981, it was resolved that G Ltd would be adopted as the purchaser under the first sale and purchase agreement in October 1980. G Ltd was a company owned and controlled by Mr F and Mr H. On the completion date in January 1981, Mr F and Mr H became directors of the Taxpayer and Mr and Mrs A resigned as directors on the same date.

8. Minutes of a directors' meeting in late January 1981 declared that the Taxpayer's interest in the building owned by C Ltd ('C Building') '… is and to be held by the company as long term investment and for rental income'.

9. I Limited ('I Ltd') was incorporated in 1981 as a private company in Hong Kong. At all material times, Mr F was the chairman and managing director and Mr H was the deputy managing director of I Ltd.

10. By a sale and purchase agreement in mid-1981, G Ltd agreed to sell all of the issued shares in the Taxpayer to I Ltd for a consideration of $34,671,153.

11. The prospectus issued by I Ltd mentioned I Ltd's entitlement to the premises 'which will be retained by the group as an investment. At current levels, the shops and offices are expected to produce a net rental income of approximately $2,750,000 per year'. The prospectus included valuations by a firm of surveyors of various real estate holdings of I Ltd, and also included the following notes in relation to I Ltd's interest in the new building:

(a)	Capital value as at 30 June 1981 in existing state	$37,700,000
(b)	Estimated date of completion	December 1982
(c)	Capital value when completed	$42,391,000

12. In its accounts the Taxpayer had reflected its interest in the properties, which comprised its only major asset, in the following manner:

as at 30 June 1981	-	'Property under development'
as at 30 June 1982	-	'Investment property under development'

The principal activities of the Taxpayer as stated in the reports of the directors were as follows:

as in September 1980	-	Land investment holdings
as at 30 June 1981	-	Development of property for rental
as at 30 June 1982	-	Development of property for rental
as at 30 June 1983	-	Development of property for rental
as at 30 June 1984	-	Investment in property for rental
as at 30 June 1985	-	Investment in and letting of property

Although not incorporated in the statement of agreed facts the following matters are likewise not in dispute:

(1) The Taxpayer sold its interests in C Building as follows:

Location	Date of Sale	Purchaser	Sales Price
(a) 17/F	early 1983	J Ltd	$2,500,000
(b) 11/F	early 1984	K Ltd	$3,600,000
(c) 10/F	early 1984	L Ltd	$3,123,000

(2) Shop D on the ground floor was sold in early 1989. Prior to its disposal it had been leased out to an independent party for rental income.

(3) In its 1983/84 profits tax return the Taxpayer disclosed a profit of $2,259,732 on the sale of 17/F of C Building. This was included as an 'extraordinary item' and not offered for assessment.

In its 1984/85 profits tax return the Taxpayer disclosed a profit of $5,835,527 on the sale 10/F and 11/F of C Building. Similarly, this profit was included as an 'extraordinary item' and not offered for assessment.

(4) The assessor on 31 July 1985 raised on the Taxpayer the following assessments:

1983/84 Year of Assessment

Basis period: year ended 30 June 1983

	$
Adjusted loss per computation before depreciation allowance	(933,395)
Less: Gain on disposal of property	2,259,732
	$1,326,337
Less: Loss set off	110,905
Net assessable profits	$1,215,432
Tax payable thereon	$200,546

1984/85 Year of Assessment

Basis period: year ended 30 June 1984

	$
Adjusted loss per computation before depreciation allowance	(2,083,873)

Less: Gain on sale of property	5,835,527
Assessable profits	$3,751,654
Tax payable thereon	$694,055

(5) The tax representative of the Taxpayer objected against the assessments and on reviewing the evidence the assessor subsequently considered that, at the date of transfer of ownership of the issued capital of the Taxpayer from G Ltd to I Ltd in May 1981 there was a 'change of intention' in relation to the Taxpayer's interest in C Building from 'trading' to 'investment'. Applying Sharkey v Wernher, the assessor on 9 February 1988 raised on the Taxpayer the following 1981/82 profits tax assessment:

Section 59(3) and section 59(1) proviso

	$	$
Sale consideration of shares to I Ltd in May 1981		34,671,153
Less: Amount attributable to cost of share capital	10,000	
Development cost	455,722	465,722
		$34,205,431
Less: Cost of land		670,000
Notional profits on change of intention		$33,535,431
Tax payable thereon		$5,533,346

(6) The Taxpayer objected to the above assessment. The Commissioner determined that whilst the Taxpayer was owned and controlled by Mr and Mrs A its interests in the property were trading stock but that when control and ownership was transferred to G Ltd (and not, as the assessor had held, when the shares were transferred from G Ltd to I Ltd) there was a change of intention. On this basis the assessable profits changed from $33,535,431 to $17,531,431 as follows:

1981/82 Year of Assessment

	$	$
Consideration for sale of shares to G Ltd		18,671,203

Less: Cost of share capital	10,000	
Development cost	455,722	465,722
		$18,205,481
Less: Cost of land		670,000
		$17,535,481
Less: Audit/other expenses		4,050
Assessable profits		$17,531,431
Tax payable thereon		$2,892,686

Section 14 of the Inland Revenue Ordinance provides that subject to the provisions of the Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with the Ordinance.

Section 2(1) defines 'trade' (unless the context otherwise requires) as including 'every trade and manufacture, and every adventure and concern in the nature of trade'.

The general principles are well-settled. Per Lord Wilberforce in Lionel Simmons Properties Ltd v Commissioners of Inland Revenue 53 TC 461 states :

> ' Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment? Often it is necessary to ask further questions: a permanent investment may be sold… Intentions may be changed. What was first an investment may be put into the trading stock – and, I suppose, vice versa. If findings of this kind are to be made precision is required, since a shift of an asset from one category to another will involve changes in the company's accounts, and, possibly, a liability to tax (Sharkey v Wernher [1956] AC 58). What I think is not possible is for an asset to be both trading stock and permanent investment at the same time, nor to possess an indeterminate status – neither trading stock nor permanent asset. It must be one or other, even though, and this seems to me legitimate and intelligible, the company, in whatever character it acquires the asset may reserve an intention to change its character. To do so would, in fact, amount to little more than making explicit what is

necessarily implicit in all commercial operations, namely that situations are open to review.'

Other authorities cited to us include the well known judgment of Lord Justice Clerk in Californian Copper Syndicate v Harris 5 TC 159, the judgment of Rowlatt J in The Rees Roturbo Development Syndicate Ltd v Ducker 13 TC 366 on the meaning of 'capital asset', the Court of Appeal's decision in Commissioner of Inland Revenue v Waylee Ltd 3 HKTC 175 on the relevance of the purpose and intention of those who constitute the controlling or directing mind of the taxpayer when ascertaining the purpose and intention of the taxpayer.

Quite clearly Mr and Mrs A together constituted the directing mind of the Taxpayer at the time of acquisition of the property. However, neither Mr A nor Mrs A was called as a witness with the result that this case has to be decided without the benefit of any direct evidence from them, evidence which would have been tested by cross-examination.

It was a condition of the joint redevelopment agreement that the Taxpayer would if required by C Ltd join with the latter in entering into a building mortgage of the properties the subject of the redevelopment (that is including the Taxpayer's property) to secure to C Ltd the construction costs of the new building up to the extent of $11,000,000 Hong Kong currency. The joint redevelopment agreement also stipulated that prior to the issue of the occupation permit in respect of the new building none of the parties thereto could assign, mortgage, charge or otherwise deal with their respective properties or any part thereof. The only exception being the signing of any agreement for lease of any floor or floors to which the particular party was entitled under the joint redevelopment agreement; there was also a provision which gave liberty to the parties to pre-sell the units to which they were respectively entitled but subject to the land officer's prior written consent and subject to all the prices on deposits or other sums payable by the prospective purchasers under such agreements being paid to such held by a firm of solicitors as stakeholders to be dealt with only in such manner as might be approved by the land officer.

It follows that the ability of the Taxpayer to make use of its interest in the property (and in the joint redevelopment) to raise finance for its own purposes was limited. Because of its low capital base and the fact that Mr and Mrs A had not capitalised the loans out of which the purchase of the property was funded the Taxpayer was effectively financially dependent on (a) Mr and Mrs A not recalling the loans but continuing to support the Taxpayer and (b) the forward leasing of any premises to which it was entitled under the joint redevelopment agreement.

As regards (a), there is a dearth of evidence as to Mr and Mrs A's financial ability to continue to support the Taxpayer. The fact that the joint redevelopment agreement envisaged that none of the parties would encumber their properties prior to the issue of the occupation permit (except by way of the building mortgage to be entered into at the instance of C Ltd as aforesaid) probably meant that any properties injected into the scheme would have to be unencumbered to begin with. It mortgage; the fact that they either had or were able to find the monies to fund the purchase without mortgaging the property would not in the circumstances enable the Board to conclude that Mr and Mrs A probably had the means to continue to support the Taxpayer.

As regards (b), the Taxpayer's burden of the construction costs was, on the face of the documentation, taken care of by way of the tenancy agreement referred to in agreed fact 4 above. As we understand the position, whilst the tenancy agreement is described as such in the agreed facts it has always been the Revenue's case that this was no arm's-length transaction but was domestic financing arrangement that could be easily undone (and was in fact cancelled in October 1980). Under the agreement, Madam E was to pay the deposit of $250,000 on the same day that the Taxpayer had to pay the like amount to C Ltd; a further sum of $200,000 was payable on the same date when a like amount was payable to C Ltd under the joint redevelopment agreement. We know nothing about Madam E who was the mother of Mrs A. Several features in the agreement, such as the term of ten years at a fixed rental and the failure to annex any form of tenancy agreement to the agreement despite an express reference to the form in the body of the agreement, all in our view go to support the Revenue's contention that what we are looking at is not an arm's-length commercial transaction.

We find that little if any reliance can or should be placed on the said agreement between the Taxpayer and Madam E as evidence of any intention on the part of the Taxpayer to hold the property as a long term investment or even if its financial ability to do so during the time when Mr and Mrs A were shareholders and directors.

The onus of proving that the assessment appealed against is excessive or incorrect is on the taxpayer: section 68 of the Inland Revenue Ordinance.

We find that the Taxpayer has not discharged the onus of proving that the assessment, insofar as it was based on the premises that the property was acquired by the Taxpayer as a trading asset, was incorrect or that the assessment was otherwise excessive.

Indeed on the whole of the evidence, and on the agreed facts, we find that the actions of Mr and Mrs A, objectively considered, were directed at making a quick return on their outlay; that they made use of a corporate vehicle – the Taxpayer – for that purpose; that the Taxpayer acquired the property, and joined the redevelopment project, as part of a scheme of profit-making at a time when the property market was very buoyant; that the opportunities for a quick return were there and in fact were exploited by Mr and Mrs A who had so arranged matters that they could as part of the scheme of profit-making cancel a domestically arranged 'tenancy agreement' which would otherwise have been an encumbrance adversely affecting the marketability of the Taxpayer's interest in the property and in the redevelopment (and thus also the value of Mr and Mrs A's shares in the Taxpayer). Further by reasons of matters earlier referred to we find that the financial viability of the Taxpayer (and thus its ability to retain the property interest) was largely depended on Mr and Mrs A that is until a third party interested in taking over and injecting fresh funds or in providing alternative finance came into the picture.

We note from the Commissioner's determination the reference to an explanation given by a firm of solicitors (who were apparently then acting for Mr A) as to why the A's had to dispose of their interest: 'due to shortage of funds our client was unable to finance the development project any further, and he did not want to commit himself to any loan arrangements because [the Taxpayer] might not be able to let out the flats or generate sufficient rental in the future to repay the loan. Under such circumstances, our client had to give up the project and dispose of the whole business to interesting (sic) parties'.

We do not think this explanation even if admissible assists the Taxpayer; but since the Revenue does not seem to have relied on it as part of their case we have not drawn inferences adverse to the Taxpayer from this explanation.

We have, however, considered the well known 'badges of trade' when arriving at our conclusions, including the 'supplementary work' that had to be undertaken to a property that was vacant and non-income producing at the date of acquisition and one that was subject to a redevelopment notice. Everything considered we find that the property was acquired not as a capital but as a trading asset; and that, in any event, the acquisition was or was part of a trade or adventure in the nature of trade.

Since however there was no actual disposition of the asset in the relevant basis period but a disposition of the shares of the Taxpayer the remaining issues have to be considered.

First, just as an investment may be put into trading stock, a trading asset may also change its character to that of a capital asset.

Second, we hold that the principle in Sharkey v Wernher is not prevented from applying merely because the asset had wrongly been characterised in the accounts.

Third, we do not agree with the Taxpayer's submission that Sharkey v Wernher is applicable only when there are already pre-existing (that is prior to any relevant change of intention) two distinct groups of activities within a business, one trading the other investment. The change of intention can itself bring into existence a new and distinct line of activity.

As regards whether there was a change of intention and if so when, it is not at all surprising that the Revenue itself has had some difficulties in reaching a conclusion on the available evidence. The assessor originally located the change of intention at the beginning of May 1981. By then Mr and Mrs A were truly out of the picture altogether; I Ltd, which became the holding company of the Taxpayer, had got or was getting into the saddle; its declared and documented policy was that the property should be retained by the group as an investment. Had the Commissioner upheld the assessor's assessment and not looked for an earlier date for the change of intention (which he determined as at 23 October 1980) the assessable profits would certainly have been higher, that is $33,535,431 instead of

$17,531,431. As we see it the Commissioner felt able to reduce the assessable profits to $17,531,431 because the chairman and managing director of I Ltd was none other than the same Mr F who purchased the shares from the A's and then caused G Ltd a company owned and controlled by him and Mr H (who became the deputy managing director of I Ltd when it was subsequently incorporated in 1981) to adopt the purchase of shares and, after completion thereof, to sell the shares to I Ltd. Thus Mr F and later Mr H were seen as the connecting link and the Commissioner must have proceeded on the basis that their intention was the same as I Ltd, an intention which was then imputed to the Taxpayer at the time when the A's agreed to dispose of their shares and displaced the original intention of the A's as the directing mind of the Taxpayer.

It seems to us that it was only after I Ltd got firmly into the saddle that its intention could clearly also be attributed to that of the Taxpayer. However in all the circumstances we do not think it is fair to go back on the reduction already made by the Commissioner. We find that there was a change of intention on the part of the Taxpayer during the relevant basis period giving rise to notional assessable profits; that the change occurred upon or following the disposal of the A's interest in the Taxpayer and in any event by the date when I Ltd acquired the shares; that there was no evidence that if there was such a change of intention during the basis period the assessable profits should have been lower than the amount determined by the Commissioner.

We confirm the assessment and dismiss the appeal accordingly.