Briefing note 21 December 2012

Chargeability of Profits Tax: Court of Appeal Affirms the Court of First Instance's Judgment in *Aviation Fuel Supply Company*

The Court of Appeal (**CA**) has in its recent decision (CACV 150/2011, 4 December 2012) upheld the judgment of the Court of First Instance (**CFI**) in *Aviation Fuel Supply Company v Commissioner of Inland Revenue* (HCIA 6/2009, 8 July 2011) which we have discussed in our client briefing issued on 26 July 2011. This case illustrates the importance of correctly characterising a taxpayer's business in determining whether profits tax is chargeable under section 14 of the Inland Revenue Ordinance (Cap. 112) (the **IRO**) and discusses the rarely-invoked sections 15(1)(m) and 15A of the IRO. The CA decision also illustrates how an imposition of a balancing charge by the Commissioner can be challenged.

Key issue

- Chargeability to profits tax under sections 14, 15(1)(m) and 15A of the IRO

Background

In *Aviation Fuel Supply Company*, the taxpayer won a tender of the Airport Authority (the **Authority**) to provide for an aviation fuel service system in the new airport at Chek Lap Kok built in place of the Kai Tak Airport.

As a result of the taxpayer's wining of the tender:

(a) a Franchise Agreement (the **FA**) was entered into between the Authority and the taxpayer, under which the taxpayer was responsible for financing, designing, constructing and commissioning the aviation fuel service system (the **Facility**);

(b) an Operating Agreement (the **OA**) was entered into between the Authority and a nominee company of the taxpayer (the **Operator**), under which the Operator was responsible for operating and maintaining the Facility;

(c) a Lease (the **Lease**) was entered into between the Authority and the taxpayer, as contemplated under the FA in respect of certain premises (the **Facility Area**) to enable the taxpayer to execute its work in respect of the Facility; and

(d) a Licence was granted by the taxpayer to the Operator for the Operator to use the Facility Area for performing its obligations under the OA.

The FA obliged the Authority to procure the Operator (which was responsible for collecting all the revenue generated from the usage of the Facility) to make periodic payment (the **Facility Payments**) to the taxpayer over a period of 20 years.

The FA also gave the Authority an option to make a payment (the **Accelerated Payment**) to the taxpayer, after which the Lease would terminate forthwith, vesting the Facility in the Authority, whilst the OA would continue to subsist. The Operator would thereafter make periodic payment (in an amount which was calculated differently from the Facility Payments) to the Authority instead of to the taxpayer.

The Authority took advantage of such option under the FA and made the Accelerated Payment to the taxpayer on 7 July 2003 in the amount of US$449,043,000 (the **Sum**).

CFI held that the Sum was not chargeable to profits tax pursuant to sections 14, 15(1)(m) and 15A of the IRO. The Commissioner appealed, and raised a new point before CA that, if CA upheld the CFI's judgment, the assessment should be varied such that a balancing charge is made in respect of the taxpayer regarding the Facility (for which depreciation allowances had been claimed in the previous years of assessment).

CA upheld the CFI judgment. As to the balancing charge, CA held that no balancing charge should be made in respect of the taxpayer by virtue of sections 39B(7) and 39D(3) of the IRO.

CFI's Judgment

Chargeability under section 14 of the IRO

Section 14(1) of the IRO provides that "*Subject to the provisions of this 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 this Part.*"

In order to determine whether the Sum was chargeable to profits tax under section 14 of the IRO, CFI considered:

(a) the nature of the taxpayer's trade or business;
(b) whether the Sum represented a profit arising from the taxpayer's trade or business; and
(c) whether the Sum was capital or income in nature.

CFI held that the Sum was not chargeable to profits tax under section 14 of the IRO because:

(a) the taxpayer's business was to build and exploit the Facility, earning fees from the operation of the Facility (and not, as the Commissioner had contended, to build the Facility in exchange for the right to be paid the Facility Payments);
(b) the Sum did not arise from the taxpayer's business; and
(c) having regard to the purpose of the Accelerated Payment (being to terminate the taxpayer's business, as opposed to be a substitute for the Facility Payments), the Sum was a capital receipt.

Chargeability under section 15(1)(m) and 15A of the IRO

Section 15(1)(m) of the IRO provides that, "*sums received or receivable by a person as consideration in respect of the transfer of a right to receive income, as provided for in section 15A"* shall for the purpose of the IRO be deemed to be *"receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong*" and therefore chargeable to profits tax.

Pursuant to section 15A(1) of the IRO, "*where (a) a right to receive income is transferred by a person to another person; and (b) consideration has been received or is receivable in respect of the transfer, the amount of the consideration shall, notwithstanding the exclusion relating to the sale of capital assets contained in section 14, be treated as a trading receipt arising in or derived from Hong Kong by the transferor from a trade, profession or business carried on in Hong Kong"* unless the exception under 15A(3) applies, i.e. where the right (to receive income) being transferred *"arose from the ownership by the transferor of a legal or equitable estate or interest in the property and, before or at the time of that transfer, the transferor also transferred that estate or interest to the transferee.*"

CFI held that the taxpayer had a right to receive income (in the form of Facility Payments) from the Operator, but there was no transfer of a right to receive income from the taxpayer to the Authority, because, *inter alia*, (1) the Facility Payments paid to the taxpayer was different from the periodic payments to be made to the Authority; and (2) the right of the Authority to receive periodic payment from the Operator (after the Authority had paid the Accelerated Payment to the taxpayer) was in place due to the OA well before the Authority made the Accelerated Payment. The process involving a termination of the taxpayer's right to receive income and a triggering of the Authority's right to receive income could not be regarded as a transfer under sections 15(1)(m) and 15A(1) of the IRO.

CFI further held that, if the word "transfer" should have extended meaning such that there was a transfer of right to receive income from the taxpayer to the Authority, there was a transfer of the relevant property (which must have included at least the Facility) from which the Facility Payments was derived from the taxpayer to the Authority (by operation of law upon the termination of the Lease), thereby bringing the Sum under the exception provided for in section 15A(3) of the IRO.

CA's Judgment

CA agreed with CFI's reasoning and conclusion, and upheld the CFI's judgment.

Chargeability under section 14 of the IRO

The Commissioner argued before CA, *inter alia*, that:

(a) the taxpayer's business was a construction business, and that the taxpayer had earned rights to be paid the Facility Payments by building the Facility;

(b) the Facility Payments were paid to the taxpayer for its recovery of the costs of building the Facility, and not for the taxpayer to share in the operating results of the Facility; and

(c) the Accelerated Payment was paid to accelerate the taxpayer's recovery of the costs of building the Facility and was in substance a pre-payment of the Facility Payments. It should therefore be treated as revenue receipts of the taxpayer.

The Commissioner further argued that even where the taxpayer's business was (as the taxpayer contended and which CFI had accepted) to acquire the Facility and to exploit the Facility, the Sum should be treated as income receipt (and hence be chargeable to profits tax) on the following three alternative bases:

(a) the Sum was a pre-payment of the taxpayer's future stream of income;

(b) the Sum was paid to compensate for the taking away of the taxpayer's business and for the taxpayer's loss of income (and not for the loss of a capital asset); or

(c) the Sum was paid in exchange for the right to receive income (the right to receive income being the business which the taxpayer had sold).

CA did not agree with the Commissioner's characterisation of the taxpayer's business, the Facility Payments and the Accelerated Payment, and further rejected the Commissioner's argument that the Sum was income receipt.

Chargeability under section 15(1)(m) and 15A of the IRO

CA agreed with the CFI's reasoning and conclusion that there was no transfer of right to receive income from the taxpayer to the Authority, and agreed that even where there was a transfer of a right to receive income, the exception under 15A(3) of the IRO would apply such that no profits tax would be chargeable under 15(1)(m) and 15A of the IRO.

Balancing charge

Before CA, the Commissioner raised that, if CA upheld the CFI judgment, a balancing charge should be made on the taxpayer in relation to the Facility (for which depreciation allowances had been claimed in previous years of assessment) pursuant to sections 16G, 35 and 39D of the IRO.

CA allowed the Commissioner to raise the point about balancing charge (which was not raised before CFI), despite the taxpayer's objection that, *inter alia*, as the six years time limit had passed, no additional assessment could be raised on account of the balancing charge. CA agreed with the Commissioner that its seeking of a variation of the assessment to take into account of the balancing charge, if CA upheld the CFI judgment, was a plea for consistency and was within the jurisdiction of CA. It did not agree with the taxpayer's contention that the Commissioner was seeking a new assessment on a different and wider basis than the assessment under objection.

CA also considered that, although the point of balancing charge could and should have been raised in CFI, the taxpayer would not suffer any procedural unfairness because, *inter alia*, if the matter was remitted to the Commissioner to vary the assessment taking into account of the balancing charge, the taxpayer would be able to furnish further materials to the Commissioner as it sees fit, and further that the taxpayer would be able to appeal pursuant to section 60(1) of the IRO.

On the substantive merits, the Commissioner argued that the payment of the Accelerated Payment was:

(a) a sale of the prescribed fixed assets for the purpose of section 16G(3) giving rise to proceeds of sale;

(b) either a sale of the taxpayer's interest in the industrial building or structure giving rise to sale monies under section 35(1)(a) or the termination of its leasehold interest giving rise to compensation monies under section 35(1)(b); and

(c) a cessation of the taxpayer's business within section 39D(2), where the plant and machinery were not passed by succession, giving rise to sale or compensation monies.

CA considered that the question which it had to decide was whether the assets for which depreciation allowances were claimed had passed by way of succession such that a balancing charge would not be made by virtue of section 39B(7) and 39D(3) of the IRO. On this question, the Commissioner argued that the taxpayer's business ceased upon the termination of the Lease when the Sum was paid to the taxpayer, whilst the taxpayer contended that its business of exploiting the Facility was succeeded to by the Authority.

CA agreed with the taxpayer and held that the Authority succeeded to the taxpayer's business of exploiting the Facility, with the goodwill and Facility being transferred to the Authority on the payment of the Sum, and hence no balancing charge would be made by virtue of section 39B(7) and 39D(3) of the IRO.

Conclusion

As CA recognised in its judgment, a correct analysis of the taxpayer's business is important in determining whether profits tax is chargeable. Such characterisation of a person's business, as we have noted in our previous client briefing issued on 26 July 2011, has important implications on the two essential questions: whether the profit in question arises from the person's trade or business; and whether the profit is capital or income in nature.

The CA decision also provides an example of how to challenge the Commissioner's variation of assessment to take into account a balancing charge, in cases where a taxpayer has successfully challenged a levy of profits tax.

It is not yet known whether the Commissioner will appeal against the CA's decision. We will keep you informed of any development in a future briefing.

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