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Tax Analysis

Hong Kong Tax

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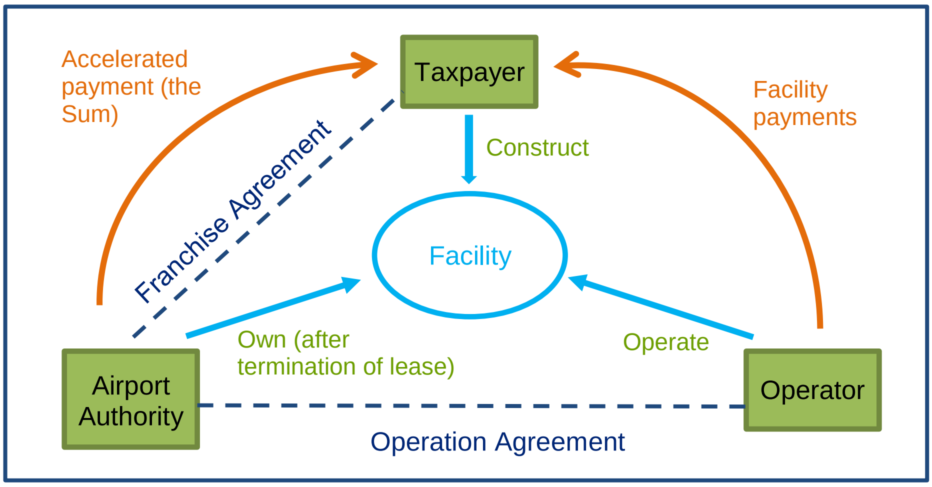
Hong Kong courts rule lump sum received on termination of contract not taxable

Hong Kong's Court of Final Appeal (CFA) issued a decision on 15 December 2014, concluding that a lump sum amount received upon the termination of a contract was not subject to profits tax under section 14 of the Inland Revenue Ordinance (IRO) (*Aviation Fuel Supply Co v Commissioner of Inland Revenue* (CIR) (FACV 14/2013)). Although the CFA's decision was based on the specific facts and circumstances of the case, the CFA's ruling, along with the earlier decisions of the two lower courts, provide useful guidance on various issues, including the distinction between capital and revenue, the transfer of a right to receive income and the recapture of tax depreciation.

Background and facts of the case

The relevant agreements and payments can be summarized as follows:



- Aviation Fuel Supply Company (Taxpayer) and the Airport Authority entered into a Franchise Agreement under which the Airport Authority granted the Taxpayer a franchise to design and construct a Facility for the supply of aviation fuel at the Hong Kong airport.

- According to the Franchise Agreement, the Airport Authority granted the Taxpayer a lease of the Facility for a 20-year term and the right to nominate an Operator to operate and maintain the Facility.

- The Taxpayer nominated an associated company as the Operator that entered into an Operating Agreement with the Airport Authority. The Operator would earn fees from users of the Facility and pay the Taxpayer periodic payments that were expected to help the Taxpayer recover the costs incurred in constructing the Facility, in addition to a reasonable rate of return.

- According to the Franchise Agreement, the Airport Authority had the right to terminate the franchise and lease after a certain period of time by electing to pay the Taxpayer an accelerated payment calculated on the net present value of future Facility payments.

- The Airport Authority elected to terminate the franchise and lease, and made the accelerated payment of USD 449 million ("the Sum") to the Taxpayer.

Summary of Court Decisions

Court of First Instance (CFI)	
Date	8 July 2011
Issue	Whether the Sum received by the Taxpayer upon termination of the Franchise Agreement is subject to profits tax
Decision	The CFI ruled in favor of the Taxpayer, concluding that the Sum was not subject to profits tax for the following reasons: • The Sum received was not derived from the Taxpayer's business • The Sum was of a capital nature • The Sum was not received for the transfer of a right to receive income

Court of Appeal (CA)	
Date	4 December 2012
Issue	1. Whether the Sum received by the Taxpayer upon termination of the Franchise Agreement is subject to profits tax 2. Whether the disposal of the Facility for which capital allowances had been claimed gave rise to balancing charges (this point was raised by the Commissioner of Inland Revenue (CIR) shortly before the hearing before the CA)
Decision	The CA upheld the decision of the CFI and concluded that the Sum was not subject to profits tax and that no balancing charge arose because the business was passed to the Airport Authority by succession

Court of Final Appeal (CFA)	
Date	15 December 2014
Issue	Whether the disposal of the Facility for which capital allowances had been claimed gave rise to balancing charges.
Decision	The CA should not have allowed the CIR to raise the question of a balancing charge at the last minute before the hearing in the CA, so it was unnecessary to decide whether a balancing charge would arise

Comments

The decisions of the three courts provide analysis and comments on several topics that could serve as valuable guidance for taxpayers.

Business scope

It was held that the Taxpayer was developing the Facility for itself in order to derive revenue in the form of Facility Payments from the Operator over a period of 20 years, instead of developing the Facility as a service for the Airport Authority. The Sum received from the Airport Authority was of a different nature to the Facility Payments to be received from the Operator and did not represent a discounted present value of the future income. Based on such business scope, both the CFI and the CA considered that the Sum was not a receipt derived from the operation of the Facility, i.e. the Taxpayer's business. Therefore, it was held that the Sum was not chargeable to profits tax under section 14 of the IRO.

The result of the case could have been dramatically different had the business scope of the Taxpayer been considered to be the provision of services to the Airport Authority. Therefore, it is important to ascertain the business scope. Depending on the specific facts and circumstances of each case, certain receipts could be considered as not being derived from a taxpayer's business and, hence, not fall under the general charging provision of the IRO.

Capital vs revenue receipt

As it was held that the Sum was not a receipt derived from the Taxpayer's business and, hence, not chargeable to profits tax under section 14 of the IRO, it was not necessary for the courts to consider whether the Sum was of a capital or revenue nature. Nevertheless, the CFI judge analyzed various factors and concluded that the Sum was capital in nature. This analysis contains useful guidance to taxpayers in determining whether a receipt is of a capital or revenue nature. The following factors were considered:

- Whether the receipt was a payment to bring about a termination of the Taxpayer's business;
- Whether the receipt was a substitute or compensation for the loss of future income;
- Whether the receipt would result in a transfer of risk;
- Whether the receipt would result in a change of ownership of the Facility (evidenced by the Taxpayer's entitlement to depreciation allowances);
- The duration of the loss to the Taxpayer; and
- The accounting treatment.

The court placed considerable weight on the results and purposes of making the payment as determining factors. The judge commented that the tax treatment adopted, which might not necessarily be correct, was not relevant in determining the nature of the receipt.

Transfer of right to receive income

The CFI considered that, although the Taxpayer had a right to receive income from the Facility, that right was not transferred to the Airport Authority as a result of the Accelerated Payment. It was because the Facility Payments received by the Taxpayer from the Operator were different from the payments received by the Airport Authority from the Operator after the Accelerated Payment. Therefore, the Sum should not be taxable under section 15(1)(m) of the IRO (section 15(1)(m) and 15A provide that amounts received/receivable in respect of the transfer of a right to receive income are taxable).

The judge went on to state that, even if there was a transfer of the right to receive income, the Sum would be excluded under section 15A(3) because the property from which the right to receive income was derived (i.e. the Facility) was considered to have been transferred to the Airport Authority after the Accelerated Payment.

This analysis illustrates the importance of comparing the nature of income before and after the transaction to determine whether there is a "transfer" of a right to receive income.

Raising a new basis for assessment

Subsequent to the CFI's decision, which was in favor of the Taxpayer, the CIR appealed to the CA. A few weeks before the hearing before the CA, the CIR amended his notice of appeal to raise a new point that if the Sum was affirmed to be not subject to profits tax, the assessment should be revised to take into account balancing charges arising from the disposal of the Facility for which capital allowances had been claimed. The CA decided that no balancing charge would arise because the business was passed to the Airport Authority by succession.

The CIR made the same balancing charge argument in his appeal to the CFA. Instead of determining whether a balancing charge should arise, the CFA analyzed whether the CIR should have been allowed to raise the new basis for assessment at the last minute before the CA hearing.

The CFA considered that the question of whether the amount chargeable to profits tax was liable to be increased by a balancing charge was part of the assessment to profits tax; it was irrelevant that it was on an entirely different basis from the original assessment of the payment as income, so there was jurisdiction for the CA to make an assessment on a different basis.

However, he had to consider whether it was fair for the CA to entertain the CIR's submission that the Taxpayer should be assessed on a new basis (i.e. a balancing charge). By the time the CA was invited to make the assessment, the six-year statute of limitations period for making an additional assessment had expired, although such an assessment by the CA under section 67(7) of the IRO is not restricted by the limitations period. The main purpose of the limitation period is to protect a taxpayer from having to investigate transactions that took place more than six years ago. The balancing charge claim would require evidence to form an appropriate calculation basis. The CFA considered that it would not be fair to the Taxpayer to require it to investigate these matters after expiration of the statute of limitations, so it held that the CA should not have entertained the CIR's application and the dismissed the appeal.

If the Inland Revenue Department (IRD) did not originally issue an assessment on a certain basis and subsequently raise a new basis for the assessment before the CA, technically speaking, there was jurisdiction for the court to make an assessment on a different basis. However, if it is unfair to the taxpayer, the court should not entertain the IRD's submission. To determine the question of fairness, two factors are taken into account: (1) whether the statute of limitations period has expired; and (2) whether the new basis will require any further investigation of the facts.

It is believed that the IRD will issue various protective assessments on all possible bases for tax disputes to avoid similar issues in the future.

<u>Balancing charge</u>

Although it was not necessary for the CFA to decide whether a balancing charge should be assessed for the reasons set out above, the CFA expressed its views at the request of the CIR because the CIR considered that the CA's decision was wrong and would negatively affect IRD practice.

In the CA, it was held that no balancing charge would arise by virtue of sections 39B(7) and 39D(3) of the IRO because the business was passed to the Airport Authority by succession. While the CFA judge agreed that the Airport Authority succeeded to the Taxpayer's business, it considered that there was a sale of the plant and machinery. Therefore, it should not fall under sections 39B(7) and 39D(3) and a balancing charge could arise.

In addition, the CFA pointed out that the CA erred in determining all the CIR's claims to balancing charges under sections 39B(7) and 39D(3). There is no equivalent in the provisions for prescribed fixed assets or industrial buildings and structures. In other words, a balancing charge could arise for prescribed fixed assets or industrial buildings and structures even if they were passed to the Airport Authority by succession other than by sale.

Concluding Remarks

Although the decisions of the three courts seem to be consistent, i.e. the Taxpayer prevailed before all three courts, it is interesting to note that the CFA disagreed with the CA on the issue of balancing charges.

The Aviation Fuel Supply case is a useful reference on the taxability of a termination payment, whether a payment arises from the taxpayer's business, whether it is capital or revenue in nature and the application of section 15A (the transfer of a right). However the issue of balancing charges and, in particular, whether there is a succession when plant and machinery pass to the successor other than by sale (under which no balancing adjustment should arise) is very fact dependent, and each case should be decided based on its own merits.

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