HCIA 6/2009

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE
INLAND REVENUE APPEAL NO. 6 OF 2009

IN THE MATTER of Section 66 and Section 67 of the Inland Revenue Ordinance (Cap. 112)

BETWEEN

AVIATION FUEL SUPPLY COMPANY Appellant

and

COMMISSIONER OF INLAND REVENUE Respondent

Before: Hon Barma J in Court
Dates of Hearing: 5 and 6 May 2010
Date of Judgment: 8 July 2011

J U D G M E N T

A. BACKGROUND, FACTS AND RELEVANT DOCUMENTS

A.1 Introduction

1. This is an appeal by the Aviation Fuel Supply Company ("AFSC") from a Determination of the Deputy Commissioner of Inland Revenue, Mr Chu Yam-yuen, made

on 11 February 2009. By his determination, the Deputy Commissioner confirmed the profits tax assessment on AFSC for the year of assessment 2003/04, subject to two adjustments, neither of which is material for the purposes of this appeal. The net assessable profits of AFSC for the year of assessment in question, as so confirmed, amounted to HK$2,689,601,895, upon which the amount of tax payable was HK$470,680,331. The appeal was transferred to be heard directly by the Court of First Instance pursuant to section 67 of the Inland Revenue Ordinance ("the Ordinance").

2. The matter for determination on this appeal concerns the chargeability to profits tax of a payment of US$449,043,000 ("the Sum") received by AFSC from the Airport Authority (which I shall refer to, together with its predecessor the Provisional Airport Authority, collectively as "the Authority") in the 2003/04 year of assessment. The assessor and the Deputy Commissioner took the view that the Sum was taxable in the hands of AFSC, either on the basis that it should properly be regarded as being a revenue receipt that should be taken into account in arriving at the profits earned by AFSC from its business in the relevant year of assessment pursuant to section 14 of the Ordinance, or alternatively because it was taxable under the combined effect of sections 14, 15(1)(m) and 15A of the Ordinance. AFSC contends that the Sum was capital in nature and was thus not chargeable to profits tax, and that it is not rendered chargeable by virtue of sections 15(1)(m) and 15A.

A.2 The Agreed Facts

3. The underlying facts are not in dispute. They are set out in an agreed Statement of Facts, the relevant parts of which are as follows (I shall set out separately the relevant provisions in certain of the agreements referred to in the Statement of Facts):-

> "2) … the Hong Kong Government decided in October 1989 to build a new airport at Chek Lap Kok, Lantau Island. In April 1990, the Provisional Airport Authority was established … to oversee the planning, design and construction of the new airport. The Provisional Airport Authority was reconstituted as [the Authority] in December 1995 to enable it to provide, develop, operate and maintain the new airport at Chek Lap Kok. The Provisional Airport Authority and [the Authority] are collectively referred to hereinafter as "the Authority".
>
> "3) It was the policy of the Authority to franchise out aviation logistics business. Each franchisee (sic) was awarded on a build-operate-transfer ("BOT") basis. Prior to the award of a franchise, expressions of interest were sought followed by invitation for business plan submissions from qualified candidates, and finally negotiations took place with the few best bidders. The successful candidate financed, designed, constructed, commissioned and was entitled to operate the facility for a fixed franchise term. In turn the franchisee got the right to commercially run the relevant business. The aviation logistics business franchised out included … aviation fuel.

"4) The Aviation Fuel Supply Consortium ("the Consortium") was a group of aviation fuel suppliers … and airline companies. Six of the fuel suppliers … had 30 years of experience in supplying fuel to airline companies at the Kai Tak airport. After some initial discussions, the Authority in August 1994 invited the Consortium to prepare and submit a business plan for the provision of an aviation fuel service system [which I shall hereafter refer to as "the Facility" as that was how it came to be described in the Franchise Agreement that was eventually entered into between AFSC and the Authority] at the new airport. …

"5) The Consortium submitted a Business Plan for [the Facility] at the Chek Lap Kok Airport to the Authority.

"6) In or before August 1995, the Consortium won the bid.

"7) By a Limited Partnership Agreement dated 14 August 1995, [AFSC] was formed by the members of the Consortium. It was registered on 18 August 1995 under the Limited Partnership Ordinance (Cap. 37). A Supplemental Agreement was entered into on 15 December 1995 for the admission of a new limited partner and a Restated Limited Partnership Agreement was entered into on 20 December 1995 to restate the terms governing the partners of [AFSC]. AFSC Management Limited was the general partner of [AFSC] whereas … seven oil companies and two airline companies were its limited partners …

…

"9) On 22 December 1995, the Authority and [AFSC] entered into a Franchise Agreement. …

"10) On 22 December 1995, the Authority and [AFSC] entered into a Lease as contemplated in the Franchise Agreement. …

"11) On 22 December 1995, the Authority entered into an Operating Agreement with [AFSC]'s nominee, AFSC Operations Limited ("the Operator"). The Operator was owned by the limited partners of [AFSC] … or their related companies. …

…

"13) On 20 May 1996, [AFSC] pursuant to Clause 3.4 of the Franchise Agreement granted a licence to the Operator.

"14) [The Facility] provided the aviation fuel service for the airport and the Operator was responsible for the operation and maintenance of the

system. The operating cycle of the system was illustrated in Annex I and was described below:

a) Fuel was received at the Sha Chau Receipt Jetty, from which it was pumped to the storage tanks,

b) then fed through the hydrant system to the hydrant pits, and

c) from which the service vehicles carried out the into-plane fuelling operations.

…

"15) Pursuant to the Franchise Agreement, [AFSC] financed, designed, constructed and commissioned the Facility, which was completed and in operation when the new airport at Chek Lap Kok opened on 6 July 1998.

…

"17) By a notice dated 23 October 2002, the Authority notified [AFSC] of its election, pursuant to Clause 11 of the Franchise Agreement, to accelerate [AFSC]'s recovery of the Facility Cost and to make the Accelerated Payment on 7 July 2003 ("the Accelerated Payment Date").

"18) The Accelerated Payment made by the Authority to [AFSC]:

a) comprised the following

		US$
(i)	Discounted Facility Payments Payable after the Accelerated Payment Date ["the Sum"]	449,043,000
(ii)	Shortfall of Facility Payments prior to the Accelerated Payment Date	3,283,000
(iii)	Additional financing costs	4,230,871
(iv)	Additional expenses	372,719
		456,929,590

b) was paid on the following dates:

		US$
(i)	7 July 2003	449,643,000
(ii)	9 September 2003	4,003,590
(iii)	18 September 2003	3,283,000
		456,929,590

…

"20) The Lease was terminated on the Accelerated Payment Date pursuant to Clause 11 of the Franchise Agreement.

"21) The Operating Agreement subsisted notwithstanding the payment of the Accelerated Payment by the Authority to [AFSC]."

A.3 The Documents

4. Each of the documents referred to in the Statement of Agreed Facts was annexed to it. I set out in the following paragraphs relevant extracts and provisions from such documents, and from the Business Plan Specification Brief prepared by the Authority in respect of the aviation fuel service system to be provided at the new airport. In such extracts, I have generally referred to defined items by the names used for them in the Franchise Agreement for consistency and to avoid confusion.

A.3.1 The Business Plan Specification Brief

5. The Business Plan Specification Brief was provided to AFSC on 12 August 1994. It specified the basis of, and requirements to be observed in, business plans to be submitted to the Authority by parties interested in bidding for the right to provide the aviation fuel service system. Relevant parts of this included:-

(1) Section 3.1, headed "Nature of the Licence Agreement [which was to become the Franchise Agreement] and the Operating Agreement". This was in the following terms:-

"3.1.1 The [Franchise Agreement] and the Operating Agreement are the proposed formal legal documents to be entered into by the Authority for the development of the Airport System [i.e. the Facility] and the provision of the associated services. They will be in the form appropriate to meet the commercial objectives and principles of the Authority (Appendix C).

"3.1.2 The [Franchise Agreement] in general:

(a) requires the [Franchisee] [which eventually proved to be AFSC] to develop the [Facility] pursuant to the terms and conditions set out therein;

(b) requires the [Franchisee] to enter into an Operating Agreement for the provision of the Services to operate and maintain the [Facility]; and

(c) …

"3.1.3 The drafting approach of these agreements assumes that it will be more flexible for the [Franchisee] to have separate agreements. However, the [Franchisee] is required to indicate in the Business Plan whether itself or other separate legal entities will enter into the Operating Agreement …"

(2) Section 3.3, which was headed "Development of the [Facility]", and provided:

"3.3.1 The [Franchisee] will be responsible for the development of the [Facility], including the design, construction, financing and commissioning works, except any portion of works undertaken by the Authority as described in Section 6.2."

(3) Section 3.4, which was headed "Management and Operation of the [Facility]", and provided:

"3.4.1 The [Franchise Agreement] will require the [Franchisee] or its nominee to enter into an Operating Agreement for the provision of the Services for the [Facility]."

(4) Section 6.5, headed "Airport System Payment [later called the Facility Payments] to [Franchisee]", provided:

"6.5.1 The [Franchisee] will be entitled to annual [Facility Payments] over the term of the [Franchise Agreement].

"6.5.2 The [Facility Payments] will enable the [Franchisee] to recover its [Facility Costs] (as described in section 6.4.4 [these essentially consisted of the costs of constructing the Facility]) with a reasonable rate of return.

"6.5.3 The mechanism for determining the annual [Facility Payments] will be described in Schedule A of the [Franchise Agreement]. The [Franchisee] is required to propose the rate of return in its Business Plan and to set out a formula for determining the [Facility Payments], both of which will be agreed between the [Franchisee] and the Authority.

"…

"6.5.5 The [Facility Payments] will be funded with the revenue from the [Facility] (Section 7.4)."

(5) Section 7.4, headed "Revenue and Payments of the [Facility]", which provided:

"7.4.1 Revenue from the [Facility] is the aggregate of all fees and charges, including the Throughput Fee, levied on the users of the [Facility].

"7.4.2 The Throughput Fee is the major source of revenue generated from the [Facility]. It is the fee charged to the users of the [Facility] for each gallon of aviation fuel delivered into an aircraft. It will be calculated by the Operator, prior to the start of each year, and submitted to the Authority for approval. It will be based on a formula (Section 6.1 of Appendix B) so as to recover the costs of developing, financing, managing, operating and maintaining the [Facility].

"…

"7.4.4 All revenue from the [Facility] will be used to discharge the costs of provisioning the [Facility] in order of priority listed below:

(a) reimbursement to the Operator for all Operating Costs incurred in managing, operating and maintaining the [Facility];

(b) the [Facility Payment] to the Licensee;

(c) Authority Fee to the Authority;

(d) Operating Fee to the Operator; and

(e) any reserve for future capital expenditure or major maintenance programmes.

Any surplus of revenue over expenditure at the end of any year shall also be transferred to a reserve account, to be used for the benefit of the users of the [Facility] at the direction of the Authority.

"7.4.5 The Operator will be responsible for collecting all revenue and making disbursements to the appropriate parties."

6. Appendix C and Appendix H to the Business Plan Specification Brief are also relevant. Paragraph 2 of Appendix C was in the following terms:

> "2. The Authority will provide opportunities for Service Providers to finance, design, construct and operate the required Ground Handling Service facilities whenever appropriate, and in a manner that is efficient and profitable for the users of the Airport and the community it serves.",

while Appendix H indicated that depreciation allowances in respect of the Facility would be claimable by the Franchisee.

A.3.2 The Limited Partnership Agreement

7. The Limited Partnership Agreement dated 14 August 1995 provided in Clause 2.1 that:

> "The Partners shall carry on in limited partnership … directly or indirectly, the business, with a view to profit, of designing, financing and constructing an aviation fuel service system at Chek Lap Kok Airport, Hong Kong pursuant to a franchise agreement with [the Authority."

A.3.3 The Restated Limited Partnership Agreement

8. Clause 2.1 of the Restated Limited Partnership Agreement dated 20 December 1995 stated that:

> "The Partners shall continue to carry on the business, with a view to profit, of designing, constructing and commissioning and financing the Facility."

A.3.4 The Franchise Agreement

9. The Franchise Agreement is perhaps the most important of the documents that fall to be considered in this appeal. Its key terms, for present purposes, consisted of the following:-

(1) Clause 3, headed "Scope of Agreement", which provided:-

> "3.1 <u>Grant</u>
>
> The Authority grants to [AFSC], to the full extent that it lies within the power of the Authority so to grant, the following rights, subject to and in accordance with this Agreement:
>
> 3.1.1 Construction and Commissioning
> The right to carry out and complete the design, construction and testing of the Franchisee Works and to commission the Facility;

3.1.2 Operation
The right by its nominee, the Operator, to enter into the Operating Agreement and the exclusive right to operate and maintain the aviation fuel service facility at the Airport subject to and in accordance with the Operating Agreement;

3.1.3 Payment
The right to recover the Facility Cost pursuant to Clause 10; and

3.1.4 Lease
The right (subject to Clauses 3.4 and 11.6) from the Airport Opening Date until the expiry of the Payment Term [defined at paragraph B3 of Schedule B to the Franchise Agreement as 20 years] to occupy the Facility Area as tenant and, subject to the terms of this Agreement and the performance and observance by the Operator of its obligations under the Operating Agreement, to have quiet, uninterrupted and exclusive possession and enjoyment of the Facility Area for the purposes of enabling [AFSC] to execute the Works and the Operator to exercise its rights and to observe and perform its obligations and liabilities under the Operating Agreement.

"…

"3.4 Licence to Operator

3.4.1 [AFSC] shall, as from the date of issue of the Certificate of Operational Readiness until the expiry of the Payment

Term or, if earlier, the termination of the Operating Agreement:

(a) grant a licence to the Operator and its employees to enter upon and occupy the Facility Area and permit its contractors, agents, customers and suppliers all such access to the Facility Area as may for the time being be necessary for the purposes of enabling the Operator to operate and maintain the aviation fuel service facility at the Airport subject to and in accordance with the Operating Agreement.

(b) permit the Operator, its employees, contractors and agents to use the Facility Capital Assets for the said purposes; and

(c) upon request by the Operator, transfer the Facility Capital Assets [these were various assets such as vehicles used in the operation of the Facility] to the Operator at nil value."

(2) Clause 4, headed "Design, Construction and Commissioning", which provided:

"4.1 The Facility

[AFSC] shall in accordance with the Construction Schedule:

4.1.1 carry out and complete the design, construction and testing of the Franchisee Works;

4.1.2 monitor and inspect the construction and testing of the Authority Works; and

4.1.3 commission the Facility."

(3) Clause 10, headed "Recovery of Facility Cost", which provided:

"10.1 [AFSC] shall be entitled to recover the Facility Cost [which consisted of its costs of carrying out the Franchisee Works, and the sums reimbursed by it to the Authority in respect of the Authority Works] as follows:

10.1.1 The Authority shall procure the payment by the Operator to [AFSC] of the Facility Payments subject to and in accordance with Schedule A and the Operating Agreement.

…"

(4) Clause 11, headed "Accelerated Facility Cost Payment", which provided:

"11.1 Notwithstanding the provisions of Clause 10, the Authority may at any time after the fifth anniversary of the Airport Opening Date, elect to accelerate recovery of the Facility Cost by the [AFSC] by payment to [AFSC] of the Accelerated Facility Cost Payment provided that:

11.1.1 the Authority gives not less than 3 months' notice of such election to the Franchisee, expiring on or at any time after the fifth anniversary of the Airport Opening Date, specifying the date on which the Accelerated Facility Cost Payment is to be made; and

11.1.2 the Facility Payments which would thereafter be payable to the Authority to recover the Accelerated Facility Cost Payment as notified by the Authority to the Operator pursuant to clause 3.3 of the Operating Agreement shall be lower than the Facility Payments which otherwise would have been due to [AFSC] in accordance with this Agreement save that this proviso shall not apply if at the time of making such election the Authority has entered into the Permanent Supply Facility Agreement.

"11.2 The Accelerated Facility Cost Payment shall be the aggregate of :

11.2.1 such amount as will ensure that [AFSC] recovers the Facility Payments based on the Updated Financial Model as of the date of notice from the Authority under Clause 11.1 and discounted to the date of such notice based on a rate of 12% per annum;

11.2.2 any unrecovered shortfalls in any instalments of the Facility Payment(s) due to [AFSC] during the period from the date of such notice to the Accelerated Payment Date;

11.2.3 any additional financing costs payable by [AFSC] as a direct result of the early repayment of any Borrowings obtained by [AFSC]; and

11.2.4 any additional expenses incurred by [AFSC] arising out of the accelerated recovery of the Facility Cost.

"11.3 The Accelerated Facility Cost Payment shall be payable on the Accelerated Payment Date. The payment of the Accelerated Facility Cost Payment shall be in full and final satisfaction of the Authority's obligations under Clause 10. For the avoidance of doubt, an election by the Authority under Clause 11.1 or the payment of the Accelerated Facility Cost Payment shall not give any right to the Authority to terminate the Operating Agreement.

"…

"11.6 The Lease constituted by Clause 3.1.4 shall terminate on the Accelerated Payment Date."

(5) Clause 14, headed "Sole Purpose of [AFSC]", which provided:

"[AFSC] having been set up with the sole purpose of exercising the Rights and observing and performing its obligations and liabilities under this Agreement, [AFSC] shall not except with the previous written consent of the Authority be or become directly or indirectly engaged, concerned or interested in any business (whether at the Airport or elsewhere and whether within Hong Kong or elsewhere) other than that for which the Rights are granted."

(6) Schedule A to the Franchise Agreement is also relevant, in particular paragraphs A10 and A11. These are in the following terms:

"A10. The Base Case Financial Model includes a stream of Facility Payments that provides:

(a) a forecast Project IRR to [AFSC] of 15%; and

(b) a constant forecast cost to the users of the Facility when measured on a per unit basis, in real US Dollar terms.

"A11. In the preparation of any proposed Updated Financial Model [AFSC] shall amend the stream of Facility Payments to take account of any changes in the Facility Cost in accordance with Paragraph A5 or, as the case may be any reductions in instalments of Facility Payments as described in Paragraph A7. Such amendments shall be made as to:

(a) provide a forecast Project IRR of 15% and

(b) ensure that the annual increases in the Facility Payment, in percentage terms, are the same as those set out in the Base Case Financial Model."

The Appendices to Schedule A provided forecast monthly payments for a period of 20 years.

A.3.5 The Lease

10. The Lease contemplated by the Franchise Agreement was entered into on the same day, 22 December 1995. It contained the following terms:-

(1) Clause 2, headed "Grant of Lease", which provided:

"2.1 In consideration of the Rental and subject to the provisions of the Franchise Agreement and this Lease, the Authority grants to [AFSC] the Facility Area to hold the same as tenant for the Lease Term.

"…"

(2) Clause 3, headed "Lease Term", which provided:

"The Lease Term shall commence on the Airport Opening Date and shall end on the expiry of 20 years thereafter or, if earlier, the termination of the Franchise Agreement."

(3) Clause 4, headed "Rental", which provided:

"[AFSC] shall pay the Authority an annual rental of one hundred Hong Kong Dollars (HK$100) throughout the Lease Term."

(4) Clause 5, headed "Franchisee's Covenants", which provided:

"[AFSC] to the intent that the obligations shall continue throughout the Lease Term covenants with the Authority:

"5.1 to pay the Rental in the manner specified in the Franchise Agreement;

"5.2 to use the Facility Area only for the purposes and in the manner set out in the Franchise Agreement;

"5.3 to perform and observe all obligations and liabilities of [AFSC] under the terms and conditions of the Franchise Agreement."

A.3.6 The Operating Agreement

11. Also on 22 December 1995, the Authority entered into the Operating Agreement with the Operator. The following provisions in the Operating Agreement are to be noted:

(1) Clause 3.1, headed "Grant" by which the Authority granted to the Operator, to the full extent that it lay within the Authority's power so to grant, the following rights, subject to and in accordance with the Operating Agreement:

"3.1.1 Licence

"the right to be granted a Licence:

(a) by [AFSC] in accordance with Clause 3.4.1 of the Franchise Agreement from the Operator's Commencement Date until the expiry or earlier termination for any reason of this Agreement or, if earlier, the Accelerated Payment Date; and

(b) if the Accelerated Payment Date occurs, by the Authority from that date until the expiry or earlier termination for any reason of this Agreement

to occupy the structures and buildings within the Facility Area as licensee and to use the Facility Capital Assets supplied by [AFSC] for the purpose of enabling the Operator to operate the Facility pursuant to the terms of this Agreement;

"3.1.2 Operation

"the exclusive right to operate the Facility and to enter into User Agreements with Users during the Term;

"3.1.3 Access

"the right for the Operator and its employees, and for its contractors, sub-contractors, consultants, agents, suppliers, customers, invitees and visitors and their respective employees, to have from the date of execution of this Agreement until the expiry or earlier termination for any reason of this Agreement all such access to the Facility Area, to those parts of the Facility which are located outside the Facility Area and to all other parts of the Airport as may for the time being be necessary for the observance and performance of its obligations and liabilities hereunder and the operation of the Facility;

"3.1.4…"

(2) Clause 3.3, headed "Accelerated Payment Election", which provided:

"In the event that the Authority makes the Accelerated Payment Election:

"3.3.1 subject to proviso (b) to clause 11.1 of the Franchise Agreement, the Authority shall notify the Operator of the Facility Payments to be made to the Authority in accordance with Clause 14.1.2; and

"3.3.2 the Operator shall make all such payments to the Authority and take such sums into account as Facility Payments in the calculation of the Throughput Fee over the relevant period."

(3) Clause 4.1, headed "Term", which provided:

"Subject to Clause 29.2, the Term shall be 20 years from the Airport Opening Date unless terminated for any reason in accordance with the terms of this Agreement."

(4) Clause 13.1, headed "Throughput Fees", which provided:

"13.1.1 The Operator shall charge Throughput Fees to Suppliers calculated from time to time in accordance with Annex M.

"13.1.2 The Throughput Fees shall be collected in accordance with the Supplier Agreements provided always that the Operator shall implement a charging policy which is fair and non-discriminatory between Suppliers regardless of the volume of aviation fuel supplied."

(5) Clause 14.1, headed "Facility Payments", which provided:

"14.1.1 The Operator shall pay to [AFSC] the Facility Payments due in accordance with the Franchise Agreement by monthly instalments, such instalments to be calculated in accordance with Annex M, within 10 Business Days after the expiry of the month to which each such instalment relates.

"14.1.2 In the event that the Authority makes the Accelerated Payment Election the Operator shall pay in accordance with Clause 3.3.2 the Facility Payments notified pursuant to Clause 3.3.1.

"14.1.3…"

(6) Annex M, which provided for the calculation of the Throughput Fees and Facility Payments.

(7) Annex N, which required the Operator to maintain various bank accounts, including (under paragraph N1(a)) a United States Dollar bank account, with all funds in that account (which were to derive from the Throughput Fees) being held by the Operator on trust for, among others, AFSC.

A.3.7 The Licence

12. The Licence granted by AFSC to the Operator on 20 May 1996 pursuant to clause 3.4 of the Franchise Agreement contained the following relevant terms:

(1) Clause 2.1, which stated:

> "To Operator: As from the date of issue of the Certificate of Operational Readiness until the expiry of the Payment Term or, if earlier, the date of termination of the Operating Agreement, [AFSC] grants a licence to the Operator and its employees to enter upon and occupy the Facility Area and consents to its contractors, agents, customers and suppliers having all such access to the Facility Area as may for the time being be necessary for the purposes of enabling the Operator to operate and maintain the aviation fuel service facility at the Airport subject to and in accordance with the terms of the Operating Agreement provided that for the avoidance of doubt there shall be excepted from and reserved out of such licence the airspace over the Facility Area above the height of the Facility save as may be required for any Further Construction Work carried out in accordance with the Operating Agreement."

(2) Clause 2.3, which stated:

> "Facility Capital Assets: As from the date of issue of the Certificate of Occupational Readiness until the expiry of the Payment Term, or if earlier, the date of termination of the Operating Agreement, [AFSC] shall permit the Operator, its employees, contractors and agents to use the Facility Capital Assets for the purposes described in Clause 2.1 and, upon request by the Operator at any time during such period, [AFSC] shall transfer, by delivery, the Facility Capital Assets to the Operator at nil value."

A.4 AFSC's tax returns

13. AFSC filed profits tax returns, together with its financial statements and profits tax computations for the years of assessment 1997/98 through to 2003/04. In each of these tax returns, the Facility Payments received from the Operator were recognised as being chargeable to profits tax and were offered for profits tax assessment. The amounts of such Facility Payments ranged from US$11,369,624 in the 1997/98 year of assessment to US$33,377,234 in the 2002/03 year of assessment, increasing each year. In the 2003/04 year of assessment, with which this appeal is concerned, the amount of Facility Payments offered for assessment was US$17,837,764, which included the sum of US$3,283,000 mentioned in fact 18(a)(ii) of the Statement of Agreed Facts in respect of the shortfall of Facility Payments prior to the Accelerated Payment Date. The Sum was not offered for profits tax assessment on the basis that it was, according to AFSC, to be regarded as compensation for the surrender of its business, being a payment made by the Authority to acquire AFSC's business, and as such was capital in nature and not taxable under section 14 of the Ordinance.

A.5 AFSC's audited accounts

14. AFSC's audited accounts, throughout the period from completion of the Facility until the year of assessment with which we are concerned, treated the Facility as a fixed asset of ASFC, and treated the Facility Payments as its income, adopting a policy of recognising the Facility Payments as income in the period in which AFSC rendered services (such services being the provision of the Facility to the Operator for use by the Operator).

A.6 The view taken by the Inland Revenue Department

15. The Assessor took the view that the Sum was not compensation for loss of business, and was not capital in nature. She took the view that the receipt of a lump sum payment in lieu of the monthly Facility Payments (which were accepted to be taxable) did not change the income nature of the payment. She also expressed the view that the Sum was deemed to be a trading receipt chargeable to profits tax pursuant to section 15(1)(m) of the Ordinance.

16. The Deputy Commissioner upheld the assessment (subject to the two minor adjustments which I have mentioned in paragraph 1 above). His reasoning (set out at paragraphs 3(7) to 3(10) of the Determination) was that:

(1) There was no distinction between the Facility Payments and the Sum for tax purposes, so that both were to be regarded as income receipts of AFSC's business; or alternatively,

(2) The Sum could be regarded as being in substitution for the Facility Payments, so that it should be taxable as income, taking the character of the payments for which it was substituted; or

(3) The Sum was consideration for the transfer of a right to receive income from Property, so that it is taxable as income in accordance with sections 14, 15(1)(m) and 15A of the Ordinance.

B. WHETHER THE SUM IS CHARGEABLE UNDER SECTION 14

17. I shall deal first with whether or not the Sum is taxable under section 14 of the Ordinance. Section 14(1) is the relevant subsection, and is in the following terms:

> "(1) 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."

B.1 The issues for consideration

18. Mr Goldberg, Q.C. appearing for AFSC submitted that as section 14(1) provides for profits tax to be charged on assessable profits arising from a trade, profession or business, three questions had to be considered:

(1) It was first necessary to identify what, in this case, AFSC's trade or business consisted of.

(2) Having done so, one should then go on to consider whether or not the profit in question arose *from* that trade or business.

(3) If so, it was then necessary to go on to consider the nature of the profit in question – i.e. whether it was capital in nature (in which case it would not be chargeable to tax) or of an income nature (in which case it would be so chargeable).

19. Mr Furness, Q.C., appearing for the Commissioner, did not dissent from this approach.

B.2 The first question: What was AFSC's trade or business?

20. It became apparent during the course of argument that the first question was of key importance, as the way in which it is answered has a substantial impact upon the answers to be given to the second and third questions. The parties took very different views as to what AFSC's business consisted of. For AFSC, Mr Goldberg contended that its business consisted of designing, constructing and commissioning the Facility, and exploiting its interests in the Facility and under the Franchise Agreement and the Lease in order to derive revenue in the form of the Facility Payments payable by the Operator over a period of 20 years. For the Commissioner, Mr Furness argued that this was not the case, and that AFSC's business was, relevantly, the design construction and commissioning of the Facility for the Authority for profit. Put another way, AFSC's case was that it was developing the Facility for itself, in order to put it to profitable use, albeit that the period of such use was limited by the terms of the Franchise Agreement to 20 years (or less, in the event that, as in fact happened, the Authority exercised its option to make the Accelerated Facility Cost Payment under clause 11 of the Franchise Agreement), whereas the Commissioner's case was that AFSC was doing this for the Authority, and was to be paid by the Authority for doing so, the payment being either in the form of the Authority's agreement to procure that the Operator made such Facility Payments as were payable to AFSC, or alternatively to make the Accelerated Facility Cost Payment.

21. To decide this question, it is necessary to consider the arrangements constituted by the various agreements and to come to a view as to what their effect was in commercial

terms. In my view, when this is done, the conclusion must be that the description of its business contended for by AFSC is the correct description as a matter of commercial reality.

B.2.1 The Authority's commercial objectives and principles

22. To start with, it is instructive to note the way in which the Authority described its commercial objectives and principles in paragraph 2 of Annex C to the Business Plan Specification Brief. So far as the provision of ground handling services, of which the provision of an aviation fuel supply system and service was one, was concerned, the approach was to provide opportunities for licensees to finance, design, construct and operate such services. As mentioned in section 3.1.1 of the Business Plan Specification Brief, the agreements to be entered into would be drafted with these commercial objectives and principles in mind. This does not indicate an intention on the part of the Authority to develop the infrastructure necessary for the provision of the various ground handling services itself, by employing contractors or specialist contractors to do so for it. On the contrary, what was envisaged was that operators would be given the opportunity to do so with a view to operating the facilities for profit – in other words, that they would be developing the relevant infrastructure (in this case the Facility) for their own benefit.

23. This view of things is, I think, supported by the description of the policy of the Authority in relation to the franchising out of the aviation logistics (or ground handling) services in paragraph 3 of the Statement of Agreed Facts as essentially consisting of a Build-Operate-Transfer model, by which the successful franchisee for a particular ground handling service would be given a licence by which he would be entitled (and required) to design and develop the necessary facilities for the service, and thereafter be given the right to operate it for a stated term, at the end of which it would be transferred to the Authority. It seems to me that in principle, in such a model, during the period of operation by the franchisee concerned, the franchisee will be undertaking a business of its own. Although the infrastructure would eventually be transferred to (or vest in) the Authority, until that happened, it would be right to describe the relevant franchisee as carrying on a business of its own in exploiting or (if it were the case) operating the infrastructure in question with a view to profit.

B.2.2 Relevance of a specified Internal Rate of Return

24. In this context, I do not think that the fact that the return to a franchisee might be capped at a particular rate (in this case an Internal Rate of Return of 15%) negates this way of looking at the business reality. It is clear that one of the objectives of the Authority was to ensure that the franchised services were provided in a manner and at a cost that was reasonable, with a view to having the new airport operate in an efficient and successful way. Having regard to this, the agreement by a franchisee to design, build and operate the infrastructure necessary for the services to be provided in return for the right to generate revenue on the basis that such revenue would provide it with a particular rate of return would appear to be a commercial decision for the franchisee in question. If the franchisee in question were to be satisfied with a particular rate of return, and was prepared to agree that its rate of return should not exceed a particular level, such agreement would not indicate that

it was not making use of the infrastructure for its own purposes, as opposed to building it as a service for the Authority.

B.2.3 The source of the Facility Payments

25. On the other hand, it is, I think, important to have regard to the source from which the Facility Payments were to be made, both in terms of legal obligation and in terms of where, as a matter of fact, the Facility Payments came from.

26. In terms of legal obligation, the obligation to make Facility Payments to AFSC lay with the Operator. Although the Operator did not owe this obligation to AFSC, as there was no contract between them under which the Operator was required to pay the Facility Payments to AFSC, it was, nonetheless obliged to make the Facility Payments to AFSC pursuant to its obligations to the Authority under the Operating Agreement. On the other hand, the Authority was under no obligation to make the Facility Payments to AFSC. Its obligations to AFSC under the Franchise Agreement was only to procure that the Facility Payments would be made to AFSC by the Operator – this obligation it met by imposing an obligation on the Operator under the Operating Agreement whereby the Operator was required to make the Facility Payments to AFSC. Although the Authority would be liable in damages to AFSC if Facility Payments which had become due were not paid to AFSC by the Operator, and thus was under a liability to compensate AFSC in the event that Facility Payments to which AFSC was entitled were not paid to it, this does not, in my view, amount to an obligation on the part of the Authority to itself make payment of the Facility Payments to AFSC.

27. Moreover, when one looks to see what, in terms of the source of funds, is the source of the Facility Payments, it is clear from the structure that was set up that the funds out of which the Facility Payments were to be made by the Operator to AFSC came from the Throughput Fees to be charged by the Operator to the suppliers of aviation fuel. This is clear from Section 7.4 of the Business Plan Specification Brief. The Throughput Fees, which represented the major element of the revenue to be generated from the Facility (Section 7.4.1), were to be fixed by the Operator (subject to the Authority's approval) at a level that would enable the costs of developing, financing, managing, operating and maintaining the Facility to be recovered (Section 7.4.2), and would be applied first to reimburse the Operator for its operating costs, then to make the Facility Payments, followed by the Authority Fee payable by the Operator to the Authority under the Operating Agreement, and thereafter an Operating Fee and reserves.

28. Further, Annex N to the Operating Agreement required the Operator to maintain various bank accounts, including (under paragraph N1(a)) a United States Dollar bank account, for the US Dollar portion of the Throughput Fees, with all funds in that account being held by the Operator on trust for AFSC and other persons entitled to them.

29. This structure is one under which the Facility Payments cannot be regarded as being, in any real or practical sense, payments by anyone other than the Operator, out of

revenues generated from the operation of the Facility. In particular, the Facility Payments cannot be regarded as payments by the Authority, or payments made out of funds that would otherwise have gone to the Authority, as the Authority was only to be entitled to receive the Authority Fee out of such revenues, and any surplus was not to be held for the account of the Authority but for the benefit of the users of the Facility. Pertinently, the fact that the portion of the Throughput Fees held in the Operator's US Dollar account were to be held on trust for (among others, but principally) AFSC and would be the source of the Facility Payments means that the Facility Payments were never intended to go to the Authority at all.

30. In these circumstances, I do not think that the Facility Payments can be regarded as being in any sense a payment to AFSC by the Authority for services rendered to the Authority. Nor can the Authority's obligation to procure the making of the Facility Payments by the Operator be so regarded. On this basis, I do not consider that the Authority can be regarded, by virtue of its obligations under Clause 10.1.1 of the Franchise Agreement as making a payment to AFSC, still less that it can be regarded as making a payment to AFSC for services rendered by AFSC to it. On the contrary, the nature of the arrangements suggests strongly that AFSC was always intended to derive income out of which it would recoup its costs of developing the Facility by permitting the Facility to be put to use by the Operator, and that AFSC's business was one of developing the Facility for this purpose, rather than one of developing the Facility as a service to the Authority.

B.2.4 Payment of Facility Payments to the Authority after the Accelerated Facility Cost Payment was paid to AFSC

31. In addition, the fact that Facility Payments (although not, as we shall see, the *same* Facility Payments as were payable to AFSC) were to be paid by the Operator to the Authority by virtue of clause 14.1.2 and 3.3.1 of the Operating Agreement in the event that the Authority elected to make the Accelerated Facility Cost Payment of itself suggests that the business of AFSC involved the receipt of such payments from the Operator for allowing the Operator to make use of the Facility. Following the making of the Accelerated Facility Cost Payment, the Facility would vest in the Authority by reason of the termination of the Lease granted by the Authority to AFSC, as the Facility was a fixture upon the leased land. The Authority would thereafter be the person permitting the Operator to make use of the Facility (as it had promised to do under clause 3.1.1(b) of the Operating Agreement). This demonstrates, in my view, that the Facility Payments were to be paid by the Operator for the right to use the Facility, to the person for the time being the owner of the Facility, and is entirely consistent with regarding the business of AFSC, so long as it remained the owner of the Facility, as being the generation of income from the Facility in which it had invested its capital, rather than the provision of a service to the Authority of designing and constructing the Facility for income to be paid to it by the Authority.

B.2.5 AFSC's ownership of the Facility

32. A further factor that supports the view that the business of AFSC was as described by Mr Goldberg is the fact that AFSC was, until the termination of the Lease, the owner of the Facility. That this is so is demonstrated by the fact that from the outset, as

envisaged by Appendix H of the Business Plan Specification Brief, it was intended that as between AFSC and the Authority, it was to be AFSC that would be entitled to claim depreciation allowances in respect of the Facility, allowances which could only be claimed by it if it were the owner of the Facility.

33. AFSC's ownership of the Facility until the termination of the lease on the making of the Accelerated Facility Cost payment is also evidenced by its own audited accounts, which consistently treated the Facility as a fixed asset belonging to AFSC, the value of which was written down by depreciating it at a rate that reflected its anticipated useful life from AFSC's point of view.

34. In my view, the fact that AFSC remained the owner of the Facility after its construction and commissioning is not consistent with it having had a business of developing the Facility for the Authority, as opposed to doing so with the aim of owning it and turning it to account in the manner suggested by Mr Goldberg.

B.2.6 AFSC's audited accounts

35. Similarly, the consistent treatment in AFSC's audited accounts of the Facility Payments as its income, recognising them as income at the time that the service of making the Facility available for use by the Operator so as to enable the Operator to charge Throughput Fees, is also, I think, wholly consistent with this view of AFSC's business, but not with the view contended for by Mr Furness.

B.2.7 AFSC's obligation to pay for the Authority Works

36. It may also be noted that under the arrangements set out in the Franchise Agreement, AFSC was obliged to make payment to the Authority for the Authority Works (i.e., the work that had been done on the land to be leased to AFSC by way of preliminary works to enable the Facility to be constructed on such land). The fact that AFSC was obliged to make such payment, which would then be factored in to the Facility Cost to be recovered by AFSC under Clause 3.1.3 of the Franchise Agreement is not consistent with the suggestion that AFSC had a business of constructing the Facility as a service for the Authority – had this been the case, there would seem to be little reason for requiring AFSC to pay for the Authority Works, as the effect of this would be to result in the Authority recovering the costs of the works that it had carried out only to have to pay them out again.

B.2.8 Whether the Authority is to be regarded as having paid AFSC for the Facility

37. Mr Furness submitted that the obligation of the Authority pursuant to Clause 10.1.1 of the Franchise Agreement, coupled with the right on the Authority's part to accelerate recovery of the Facility Cost in the manner provided for in Clause 11, were both means by which the Authority was to pay AFSC for the service of developing the Facility for the Authority. For the reasons which I have explained in paragraphs 25 to 30 above, I do not think that this is the correct analysis of the nature of the Authority's obligation under

Clause 10.1.1. The position was, I think, aptly put by Mr Goldberg when he suggested that Clauses 3 and 10 of the Franchise Agreement constituted the structure by which AFSC would be able to derive its income, and did not themselves constitute the income that it was to receive for designing, financing, constructing and commissioning the facility.

B.2.9 The descriptions of AFSC's business by AFSC

38. Mr Furness also relied on the descriptions of AFSC's business in the Partnership Agreement and Restated Partnership Agreement, in terms which did not expressly refer to it being part of AFSC's business to exploit the Facility in the manner suggested by Mr Goldberg, to suggest that AFSC's business was to develop the Facility as a service for the Authority. A similar point was made in relation to the description of AFSC's business in its audited accounts. However, I do not think that these descriptions will bear the weight that Mr Furness seeks to put on them. It was undoubtedly AFSC's business to design, construct and commission the Facility, but the question remains: did AFSC do so as a service for the Authority, or as a means to put itself in a position to earn income through the arrangements contained in the Franchise Agreement? For the reasons which I have given, I am of the view that it was the latter.

39. Thus, for all of these reasons, I am satisfied that the nature of AFSC's business was as described by Mr Goldberg, and was one that involved deriving income from the Facility Payments that it hoped to receive over a period of 20 years through the arrangements embodied in the Franchise Agreement.

B.3 Second question: Was the Sum a receipt from AFSC's business?

40. Having come to this conclusion, it is then necessary to consider whether or not the Sum represents a profit that derives from this business. In my view, it was not. The Sum was part of the Accelerated Facility Cost Payment which the Authority had an option to make under clause 11 of the Franchise Agreement. But it was of a different nature to the Facility Payments, and did not serve as a substitute for them.

B.3.1 The source of the Accelerated Facility Cost Payment

41. First, the Sum (and the Accelerated Facility Cost Payment of which it formed part) does not derive from the same source as the Facility Payments. The point here is not simply that the party making the payment was different (i.e. the Authority as opposed to the Operator). Rather, it is that the Sum, unlike the Facility Payments, did not arise from the operation of the Facility. As I have explained above (see paragraphs 25 to 30), the Facility Payments had their source in the Throughput Fees charged by the Operator to suppliers of aviation fuel. By contrast, the Sum was part of the Accelerated Facility Cost Payment payable to AFSC by the Authority, presumably out of its own resources, and certainly not wholly (if at all) from sums paid by reason of the operation of the Facility.

B.3.2 The nature of the Sum

42. Second, the nature of the Accelerated Facility Cost Payment was, I think, fundamentally different from any payments that might be made by the Authority in discharge of its obligations to AFSC under clause 10.1.1 of the Franchise Agreement. If circumstances arose in which Facility Payments had become payable by the Operator to AFSC, but the Operator for some reason did not pay them, the Authority might well have been liable to AFSC in damages pursuant to clause 10.1.1. However, any such damages paid by the Authority would have been paid to put AFSC in the position that it would have been in had the Authority procured the Operator to make the Facility Payments – in other words, such damages would have compensated AFSC for Facility Payments which it ought to have, but did not, receive. Such damages would therefore have been a true substitute for the Facility Payments. By contrast, the Sum and the rest of the Accelerated Facility Cost Payment were paid not to compensate for unpaid Facility Payments, but to prevent Facility Payments payable to AFSC arising in future, by bringing into effect a termination of the Lease, the vesting of the Facility in the Authority and triggering the obligation of the Operator to make payment of Facility Payments from that point onwards to the Authority instead of AFSC. The Sum was therefore fundamentally different in nature to the Facility Payments, and cannot be regarded as a mere substitute for them.

B.3.3 The difference between Facility Payments payable to AFSC and Facility Payments payable to the Authority

43. Third, when one looks at the Facility Payments to be paid by the Operator to AFSC and the Authority respectively, it would not appear that they are intended to be in the same amounts, or even calculated in the same way. The Facility Payments to be paid to AFSC were to be calculated by reference to the Facility Cost. By contrast, it would appear from Clause 3.1.4 of the Franchise Agreement that when it came to the Facility Payments that would become payable to the Authority in the event that it exercised its option to make the Accelerated Facility Cost Payment, such Facility Payments would be calculated by reference to the Accelerated Facility Cost Payment (rather than the Facility Cost) so as to enable the Authority to recover that amount. For this reason also, I do not think that the Sum can be regarded as a substitute for the Facility Payments payable to AFSC.

B.3.4 The Sum did not represent the discounted present value of the Facility Payments

44. Fourth, although the Sum was calculated by reference to the Facility Payments that were expected to become due over the remaining term of the Franchise Agreement, the use of a fixed discount rate of 12% per annum for the accelerated payment meant that whether or not the Sum would truly represent the amount that AFSC could expect to earn over the remaining term of the Franchise Agreement discounted for early receipt would depend on what return AFSC could expect to earn on the Sum over that period of time, something which would be likely depend on the level of interest rates that could be earned at the time that the Accelerated Facility Cost Payment was made. This return may or may not have been as much as 12%, and it would therefore be a matter of fortuity whether or not the

Accelerated Facility Cost Payment accurately represented the present value to AFSC of the Facility Payments that it would otherwise have been entitled to receive.

45. In these circumstances, it seems to me to be clear that the Sum was different in nature to the Facility Payments, and cannot be regarded as deriving from the business of AFSC as I have found it to be.

46. If this is right, it would follow that the Sum is not chargeable to tax under section 14 of the Ordinance. However, in case I am wrong as to this, I shall go on to consider whether, assuming that the Sum represents a profit earned by AFSC from its business as described by Mr Goldberg, it is capital or income in nature.

B.4 Third question: Was the Sum capital or income?

B.4.1 The Law

47. Whether a particular receipt is to be regarded as capital or income in nature is a question that has been considered in a number of authorities.

48. In *C.I.R v Wattie* [1999] 1 WLR 873, Lord Nolan, delivering the judgment of the Privy Council in an appeal concerning the correct classification (as income or capital) of a payment made to a taxpayer to induce it to enter into a lease at above market rental, confirmed (at p. 880 of the judgment) that the approach to be adopted when considering whether a particular item of receipt or expenditure is of a capital or revenue nature is that described by Dixon J in *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634 at 648, where he said that the answer to the question "depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process." The same approach was also endorsed by Dyson LJ (as he then was) in *IRC v John Lewis Properties plc* [2003] STC 117, in which the English Court of Appeal considered the correct classification of a payment received for an assignment of rentals, at paragraph 73 of his judgment.

B.4.2 The position in this case

49. In this case, there are a number of factors that point to the Sum being a receipt of a capital rather than an income or revenue nature, and so not chargeable to profits tax pursuant to section 14 of the Ordinance.

B.4.2(a) A payment to bring about a termination of AFSC's business

50. First, as I explained in paragraph 42 above, the Sum is properly to be regarded as being a payment made in order to bring about a termination of AFSC's business, as I have found it to be. It is well established that payments made to bring about the termination or destruction of a business are to be regarded as capital in nature.

51. That this is so appears from *Glenboig Union Fireclay Company Ltd v IRC* (1922) 12 TC 427, where the question was whether a payment of compensation made for requiring a company whose business was the working of certain fireclay fields of which it was the lessee to leave part of such fields unworked was of a receipt of a capital or income nature. The company contended that it was income, since that would produce a more favourable outcome to it in terms of its tax liabilities, and relied on the fact that the compensation was worked out by reference to the profit which would have been earned over a period of some two and a half years.

52. Rejecting this contention, and concluding that this payment was capital in nature, Lord Buckmaster said (at p.463) that:-

> "… I regard that argument as fallacious. In truth, the sum of money is the sum paid to prevent the Fireclay Company obtaining the full benefit of the capital value of that part of the mines which they are prevented from working by the Railway Company. It appears to me to make no difference whether it be regarded as a sale of the asset out and out, or whether it be treated merely as a means of preventing the acquisition of profit that would otherwise be gained. In either case, the capital asset of the Company to that extent has been sterilised and destroyed, and it is in respect of that action that the sum … was paid. It is unsound to consider the fact that the measure, adopted for the purpose of seeing what the total amount should be, was based on considering what are the profits that would have been earned. That, no doubt, is a perfectly exact and accurate way of determining the compensation … But there is no relation between the measure that is used for the purpose of calculating a particular result and the quality of the figure that is arrived at by means of the application of that test. I am unable to regard this sum of money as anything but capital money …"

53. Lord Wrenbury, delivering the other judgment in the House of Lords, expressed the same view, saying (at p. 465):

> "… Was that compensation profit? The answer may be supplied, I think, by the answer to the following question: Is a sum profit which is paid to an owner of property on the terms that he shall not use his property so as to make a profit? The answer must be in the negative. The whole point is that he is not to make a profit and is paid for abstaining from seeking to make a profit. The matter may be regarded from another point of view: the right to work the area in which the working was to be abandoned was part of the capital asset consisting of the right to work the whole area demised. Had the abandonment extended to the whole area all subsequent profit by working would, of course, have been impossible, but it would be impossible to contend that the compensation would be other than capital. It was the price paid for sterilising the asset from which profit might otherwise have been obtained. …"

54. In the present case, the effect of the payment by the Authority of the Accelerated Facility Cost Payment was to prevent AFSC from earning further Facility Payments in the future. This occurred both because thereafter the Operator was required under the Operating Agreement to make Facility Payments to the Authority instead of to AFSC and because under the terms of Clause 3.4 of the Franchise Agreement, the Lease would terminate, with the effect that AFSC would no longer be in a position to permit the Operator to continue to operate the Facility and would no longer be the owner of the Facility (which would, being a fixture, pass into the ownership of the Authority). In the circumstances, AFSC's ability to continue to derive income by way of the Facility Payments was sterilised, and it is therefore to be regarded as receiving the Sum in order to prevent it from earning income in the future. That being so, I am satisfied that the Sum is a receipt that is capital in nature, notwithstanding that it was calculated by reference to the Facility Payments that it was expected would be received over the remaining period during which they would otherwise have been made.

B.4.2(b) The Accelerated Facility Cost Payment was not a substitute for the Facility Payments

55. Further, for the reasons I have explained above, I do not consider that the Accelerated Facility Cost Payment can be regarded as representing the accelerated receipt of the Facility Payments that the Operator was to pay AFSC, or as being in any real economic sense a substitute for the Facility Payments so as to take on their nature as an income receipt.

B.4.2(c) Movement of risk from AFSC to the Authority

56. In addition, it should be noted that that AFSC was not certain to receive Facility Payments over the course of 20 years to enable it to recover the Facility Cost with the stipulated Internal Rate of Return of 15% per annum. Although this was the expectation, it was not one which was certain to be met. It is possible to envisage circumstances in which it would not be. An extreme example given by Mr Goldberg in the course of argument was the possibility that the new airport might be destroyed or otherwise rendered unusable by some catastrophic event. In such a case, the Facility (assuming it had survived unscathed) could not be put to use, as there would be no need for it, since the airport was not operating. A less dramatic possibility would be that demand for the new airport might not meet expectations, with the consequence that the quantities of fuel supplied might not result in sufficient Throughput Fees being paid to enable Facility Payments to be made to AFSC in amounts sufficient to achieve the desired rate of return. While it was envisaged that Throughput Fees in future years would be adjusted to make up for such shortfalls, there could be no certainty that this would result in Facility Payments being received in the amounts necessary to achieve the 15% rate of return overall. If this were to happen, the Operator would be under no obligation to make up the shortfall, and the Authority would not be liable to do so either, since its obligation was only to ensure that Facility Payments that were in fact due were paid to AFSC. Where no Facility Payments were due, or where the Facility Payments due and paid were insufficient, no further liability attached to the Authority to make up the difference. The risk of such shortfalls therefore lay with AFSC.

Upon the making of the Accelerated Facility Cost Payment, AFSC ceased to be entitled to receive Facility Payments from the Operator, which was required instead to make Facility Payments to the Authority. If the Facility Payments to be made to the Authority were insufficient to recoup to the Authority its costs of making the Accelerated Facility Cost Payment, this was the Authority's problem. The risk of not receiving sufficient Facility Payments to earn a profit therefore shifted from AFSC to the Authority. Such a movement of risk tends to suggest that the sum paid which brings it about is capital in nature (see MacNiven v Westmoreland Investments Ltd [2001] STC 237, per Lord Hoffman at para 54 of his judgment).

B.4.2(d) The duration of what was lost to AFSC

57. I would also accept, as Mr Goldberg submitted, that the length of the right that was brought to an end as a result of the payment is a relevant factor in considering whether the payment is capital or income in nature. In the present case, the length of the unexpired portion of the Franchise Agreement and Lease was some 15 years. This in itself tends to suggest that the Sum was capital in nature.

B.4.2(e) AFSC's entitlement to Depreciation Allowances

58. Further, the fact that it was envisaged that there would be depreciation allowances arising in relation to the Facility, and that it was agreed that such depreciation allowances should be for the benefit of AFSC (see Appendix H of the Business Plan Specification Brief), suggests that the Sum, payment of which resulted in a change of the ownership of the Facility, should be regarded as being capital in nature.

B.4.2(f) AFSC's accounting treatment

59. Likewise, the consistent manner in which the Facility and the Lease were treated in AFSC's accounts as being of a capital nature (although of less weight) also points, I think, to the same conclusion.

B.4.2(g) Was the purpose of the Accelerated Facility Cost Payment to discharge the Authority from its obligation under Clause 10.1.1 of the Franchise Agreement?

60. As will be apparent from the foregoing, I do not accept the contentions of Mr Furness as to the nature of the Accelerated Facility Cost Payment. While it is true that the purpose of the Facility Payments was (as indicated by clauses 3.1.3 and 10.1.1 of the Franchise Agreement) to enable AFSC to recover the Facility Cost, and the making of the Accelerated Facility Cost Payment by the Authority involved accelerated recovery of the Facility Cost, it does not follow that the two payments are similar in nature. In my view, the correct understanding of the arrangements embodied in the Franchise Agreement is that AFSC was to recover the Facility Cost (together with the desired return on its investment) through the Facility Payments, which were to derive from revenue generated by the

Operator's use of the Facility and would be income in AFSC's hands, but that it was open to the Authority, at its election, to cause AFSC to recover its investment by making the Accelerated Facility Cost payment and thereby to prevent AFSC from earning future Facility Payments, which would thereafter be collected by the Authority itself (apparently to be calculated on a different basis, as I have already noted). The difference is, in my view, between two modes by which capital can be recovered. First, it is possible for someone who has laid out capital on a project (say, the construction of a building) to recoup his outlay through rentals or charges for the use of that on which the capital was expended (such receipts being income in nature). Alternatively, it is possible to recoup the investment by disposing of that which was produced by the expenditure of capital (such a receipt being capital in nature, provided that the intention was, up until the time of disposal, still to retain the asset for the purpose of generating income). In this context, I do not think that, even if the Franchise Agreement had provided for the Authority's option to make the Accelerated Facility Cost Payment as early as from the Airport Opening Date, the analysis would be any different. Having regard to the structure that was set up, and the conclusion that AFSC's intention was to exploit the Facility by allowing the Operator to use it for the stipulated 20 year period, the Sum would remain a capital receipt, received on the sterilisation of AFSC's business.

61. Similarly, I do not think that it can be said that the Accelerated Facility Cost Payment had as its purpose the full and final settlement of the Authority's obligation under Clause 10.1.1 of the Franchise Agreement to procure the payment of the Facility Payments by the Operator to AFSC. It is true that the making of the Accelerated Facility Cost Payment was (by virtue of Clause 11.3) to have this effect, but in my view, the purpose of making it was in substance to enable the Authority to receive Facility Payments from the Operator in place of AFSC. Once the payment was made, there would no longer be Facility Payments payable by the Operator to AFSC, and in consequence, the Authority's obligation under section 10.1.1 of the Franchise Agreement would no longer be necessary. Thus, it seems to me that the fact that the Authority was no longer to be under any obligation to procure payments of Facility Payments by the Operator to AFSC was the necessary consequence of, rather than the reason for, the payment of the Accelerated Facility Cost Payment.

62. For all of these reasons, I am satisfied that the Sum should be regarded as being capital and not income in nature, and that it is not therefore chargeable to profits tax under section 14 of the Ordinance.

B.4.2(h) Other points

63. In coming to this conclusion, I have not found it necessary to place any weight on the fact that in all previous years of assessment, AFSC offered its income from the Facility Payments for assessment and claimed depreciation allowances in respect of the Facility, and that assessments had been made and confirmed on this basis. As both parties agreed, the tax treatment adopted in previous years was not binding on either the Commissioner or the court.

64. I have also not found it necessary to place reliance on what Mr Goldberg submitted were difficulties in the way of seeking to characterise AFSC's business in the way that the Commissioner now does – in particular the suggestion that the business would have ceased well before the year of assessment now under consideration, as I am satisfied, for the reasons that I have explained above, that the proper characterisation of AFSC's business is, as a matter of business practicality, as contended for by AFSC, namely, to develop and exploit the Facility on its own behalf.

65. If, however, I am wrong as to the view that I have taken as to the nature of AFSC's business – i.e. that it was one of developing the Facility and making it available to the Operator in return for the Facility Payments, and that the correct view of AFSC's business is that it was developing the Facility as a service for the Authority, and was paid for that service over a period of time by way of a combination of the Facility Payments and the Accelerated Facility Cost Payments, it would not follow that the assessment in this case should stand unaltered. On this view of AFSC's business, it would be necessary for its accounts to be recast so as to treat both the expenses of developing the Facility and the payments received by it as being income in nature, from the commencement of the business onwards. Only after this is done would it be possible to ascertain the profits on which tax would properly be chargeable. In this connection, I do not think that it would be right to treat AFSC as having, in effect, obtained the appropriate deductions (or having substantially done so) by virtue of having made claims for depreciation allowances in previous tax years. The fact that previous assessments (which are now no longer open to challenge due to the lapse of time since they were made) would on this view of things have been incorrect does not justify a failure to seek to properly ascertain the amount of the profits of AFSC that should be subject to profits tax for the year of assessment now under consideration.

C. WHETHER THE SUM IS CHARGEABLE BY VIRTUE OF SECTIONS 15(1)(M) AND 15A

66. Although I have concluded that the Sum is not chargeable to profits tax by virtue of the provisions of section 14 of the Ordinance alone, it is necessary to go on to consider whether or not it is nonetheless so chargeable as a result of sections 15(1)(m) and 15A of the Ordinance.

C.1 The statutory provisions

67. Section 15(1)(m) of the Ordinance provides that for the purposes of the Ordinance, 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 be deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong (and so chargeable to profits tax under section 14).

68. Section 15A provides:

> "(1) Subject to subsection (3) where –

(a) a right to receive income from property 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.

…

"(3) Subsection (1) shall not apply in relation to a transfer of a right to receive income from property where the right 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."

C.2 The arguments advanced by the parties

69. The argument for the Commissioner is that the effect of the payment of the Accelerated Facility Cost Payment was that AFSC's right to receive Facility Payments from the Operator was transferred to the Authority, that the Sum was paid as consideration for that transfer, and that no property in which AFSC had a legal or equitable interest was transferred prior to or at the same time as the transfer of that right.

70. Mr Goldberg submitted that the Sum was not caught by sections 15(1)(m) and 15A so as to become taxable notwithstanding its capital nature for three reasons:

(1) AFSC did not have a right to receive income because its right was not a right to have income paid to it. It had no right as against the Operator to receive the Facility Payments from the Operator. All it had was a right against the Authority pursuant to Clause 10.1.1 of the Franchise Agreement, under which the Authority was not obliged to pay the Facility Payments to AFSC, but was only obliged to procure the Operator to do so, or pay damages if this was not achieved. That sort of right, it was said, was very different from a right to have income paid.

(2) Even if this was not the case, and AFSC did have a right to have income paid to it within the meaning of sections 15(1)(m) and 15A, that right was not transferred to the Authority. The rights which AFSC had terminated upon the payment to it of the Accelerated Facility Cost Payment, and the Authority's right to receive Facility Payments thereafter arose pursuant to pre-existing rights between the Authority and the Operator. In other words, the Authority's right to receive

Facility Payments arose not as a result of any transfer of AFSC's right to it, but as the result of an existing arrangement that had been in place since well before the Accelerated Facility Cost Payment was paid.

(3) If contrary to the submission in (2) above, a relevant right of AFSC's was transferred to the Authority, then it was accompanied by the transfer to the Authority of AFSC's entire business, including its interests under the Lease and the Franchise Agreement. Those interests constituted property out of which the right to receive the income in question arose, so that their transfer meant that section 15A(3) would operate to prevent any charge under sections 15(1)(m) and 15A(1) from arising.

71. Mr Furness' response was that:

(1) Having regard to the substance of the matter, since AFSC could enforce the Authority's obligation to procure that the Operator paid the Facility Payments to AFSC, AFSC was in a position to compel the payment of income to it. This should be regarded from both a business and practical viewpoint as a right to receive income. It was moreover a right that derived from property, namely the Lease, and therefore came within the scope of sections 15(1)(m) and 15A.

(2) That right was transferred to the Authority, since the effect of the arrangements under the Franchise Agreement and Operating Agreement was to bring AFSC's rights to receive the Facility Payments to an end, and to activate the Authority's right to receive Facility Payments instead. "Transfer" in this context had a wider meaning than assignment, and should be interpreted so as to embrace the situation arising in the present case.

(3) The only relevant property that AFSC had was its interest in the Lease, which terminated on the making of the Accelerated Facility Cost Payment. It was therefore not transferred to the Authority. Nor could it have been transferred, since the Authority as lessor could not be a lessee of its own property. In these circumstances, there was no accompanying transfer of the property from which the right to be paid income derived, and the exception under section 15A(3) did not therefore avail AFSC, with the result that the Sum was chargeable to profits tax.

C.3 The position in this case

C.3.1 Did AFSC have a right to receive income from property?

72. In my view, Mr Furness' submission in respect of the first of these points is to be preferred. AFSC clearly had a right, as against the Authority, to require it to procure the Operator to pay the Facility Payments to AFSC. The effect of the observance of that right

was that income in the form of the Facility Payments would be paid to AFSC. Even if it became necessary for AFSC to seek damages from the Authority if the Operator failed to make the payments, thus placing the Authority in breach of its obligation to AFSC, the sums that it would receive by way of damages would be the equivalent of the Facility Payments and would represent income in AFSC's hands. Therefore, it seems to me that AFSC did have a right to have income paid to it (albeit not by the person against whom it had that right). Further, on AFSC's own case, the income derives from its property – I will consider below whether that property is limited to the Lease (as is contended for the Commissioner) or has a wider extent.

C.3.2 If so, was such right transferred to the Authority?

73. However, I am not able to agree with Mr Furness that AFSC's right to receive income was transferred to the Authority. The analysis advanced by Mr Furness approximates most closely a situation in which a novation arises. In my view, involving as it does the extinguishing of one set of rights and the arising of a set of new rights, a novation is not to be regarded as a transfer of the rights in question. In the present case, the fact is that the Authority's rights to receive Facility Payments was in place from long before the making of the Accelerated Facility Cost Payment, as a result of the provisions of the Operating Agreement made between the Authority and the Operator. I do not consider that the triggering of those rights so as to bring them into effect by a process which involved the extinction of AFSC's right to receive its Facility Payments can be regarded as a transfer within the meaning of sections 15(1)(m) and 15A.

74. It seems to me that there is a further difficulty with the approach proposed by Mr Furness. As I have explained earlier, it does not appear that the Facility Payments to be made by the Operator to the Authority after the Accelerated Facility Cost Payment was made were the same thing as the Facility Payments that were, up to then, being made by the Operator to AFSC. This is because the basis of their calculation would appear to be different – although called by the same name, and paid for the same purpose (i.e. the right to use the Facility), the Facility Payments payable to AFSC were calculated by reference to the Facility Cost, whereas those payable to the Authority were calculated by reference to the Accelerated Facility Cost Payment. In these circumstances, where the Facility Payments to be made to the Authority were different from those that were to be paid to AFSC, it does not seem to me to be possible to say that there has been in any practical or business sense a "transfer" of AFSC's right to receive income to the Authority.

C.3.3 If so, can AFSC rely on the exception under section 15A(3)?

75. The conclusion reached in the previous paragraph is sufficient to dispose of the argument that the Sum was taxable as a result of sections 15(1)(m) and 15A of the Ordinance. However, if I am wrong in my conclusion that there was no transfer of the right to receive income from AFSC to the Authority, I would nonetheless conclude that AFSC is able to bring itself within the exception contained in section 15A(3), as I am satisfied that its legal and equitable interest in the property from which its right to receive income was transferred to the Authority. I say this for two reasons. First, it seems to me that if

"transfer" is to be given an extended meaning for the purpose of sections 15(1)(m) and 15A(1), there is no reason why a similarly extended meaning should not be given to the same word in section 15A(3). Second, it is my view that the relevant property of AFSC from which it derived its right to receive income was not simply the Lease, but must also have included at least the Facility itself. This was property belonging to the AFSC (which it accounted for as such in its accounts, and the ownership of which was acknowledged by the Authority when it agreed that AFSC should be entitled to claim depreciation allowances in respect of it). Whatever may be the position in relation to the Lease, the legal and equitable interests of AFSC in the Facility would appear to have been transferred (at least by operation of law) on the termination of the Lease, as the Facility was a fixture attached to the property the subject of the Lease, and ownership of it passed from AFSC to the Authority upon termination of the Lease. That being so, it seems to me that the property from which the right to receive income was derived was indeed transferred to the Authority, along with the right to receive income from it, within the meaning of section 15A(3). Thus, for this reason also, I consider that the Sum is not taxable under sections 15(1)(m) and 15A(1) of the Ordinance.

D. DISPOSITION OF THE APPEAL AND COSTS

76. As I have concluded that the Sum is not chargeable to tax either pursuant to section 14 of the Ordinance read on its own, or in conjunction with sections 15(1)(m) and 15A, it seems to me that the revised assessment, as confirmed by the Deputy Commissioner, must be quashed insofar as it seeks to include the Sum as a taxable receipt of AFSC for the year of assessment in question, and AFSC's appeal is therefore allowed, with a costs order *nisi* that the Commissioner is to pay ASFC's costs of the appeal, to be taxed on the party and party basis if not agreed.

(Aarif Barma)
Judge of the Court of First Instance
High Court

Mr David Goldberg, QC leading Miss Yvonne Cheng instructed by Messrs Baker & McKenzie, for the Appellant
Mr Michael Furness, QC leading Mr Stewart Wong instructed by Department of Justice, for the Respondent