CACV 150/2011

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF APPEAL
CIVIL APPEAL NO. 150 OF 2011
(ON APPEAL FROM HCIA 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 Kwan, Fok and Lam JJA in Court
Dates of Hearing: 13 and 14 November 2012
Date of Judgment: 4 December 2012

J U D G M E N T

Hon Kwan JA:

1. This is an appeal by the Commissioner of Inland Revenue against the judgment of Barma J on 8 July 2011. The judge allowed an appeal by the taxpayer, Aviation

Fuel Supply Company ("AFSC") from a determination of the Deputy Commissioner of Inland Revenue made on 11 February 2009. By that determination, the Deputy Commissioner confirmed the profits tax assessment for the year of assessment 2003/04 which, inter alia, charged AFSC to profits tax of a payment of US$449,043,000 ("the Sum"), received by AFSC from the Airport Authority ("the Authority"). The Sum was received by AFSC from the Authority as part of the "Accelerated Facility Cost Payment" under a Franchise Agreement between them.

2. The assessor and the Deputy Commissioner took the view that the Sum was chargeable to profits tax either on the basis it should be regarded as a revenue receipt to be taken into account in arriving at the profits earned by AFSC from its business under section 14 of the Inland Revenue Ordinance, Cap 112 ("the Ordinance"), or it should be taxable by virtue of section 15(1)(m), by which 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 was chargeable to profits tax under section 14.

3. AFSC's appeal against the assessment was transferred to and heard by the Court of First Instance instead of the Board of Review pursuant to section 67 of the Ordinance.

4. The judge found against the Commissioner on both bases. He held in favour of AFSC that the Sum was not a receipt from AFSC's business and was not chargeable to tax under section 14. Even if the receipt were derived from the business of AFSC, it was capital in nature and was outside the scope of profits tax. Nor was the Sum caught by sections 15(1)(m) and 15A(1). Even though AFSC had a right to receive income from property, such a right was not transferred by AFSC to the Authority. And even if there were transfer of such a right, AFSC was able to bring itself within the exception in section 15A(3) in that at the time the right to receive income was transferred, AFSC also transferred to the Authority its legal and equitable interest in the property from which its right to receive income was derived.

5. How the questions raised in this dispute should be resolved would depend to a large extent on the correct analysis of the trade or business of AFSC, which, as the judge recognised, was of key importance.

The facts

6. The underlying facts in the Agreed Statement of Facts and relevant documents were set out in the judgment. I extract the following narrative from the Agreed Statement of Facts and summarise the material provisions in the relevant contractual documents below.

The Agreed Statement of Facts

7. The Agreed Statement of Facts gave this narrative of events in chronological sequence:

> "
> "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. … 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 [i.e. "the Facility" in the Franchise Agreement eventually entered into] 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]. …

"8) The partners in the Partnership entered into a Limited Partnership Agreement dated 14 August 1995 … under which the Franchisee [i.e. AFSC] was constituted. It stated at clause 2.1 that

"The Partners shall carry on in limited partnership from the date of this Agreement, 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 Airport Authority of Hong Kong."

This was restated at clause 2.1 of the Restate (sic) Limited Partnership Agreement dated 20 December 1995 … as follows:

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

"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 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[1]	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]."

[1] AFSC had offered the amount in para 18 (a)(ii) for tax, but not the Sum in para 18(a)(i)

8. I turn to some of the pertinent documents referred to above.

The Business Plan Specification Brief

9. This document dated 12 August 1994 specified the basis of and the requirements to be observed in the business plan to be submitted to the Authority by a party bidding for the right to provide the Facility. It contained these material provisions.

10. The Franchise Agreement[2] and the Operating Agreement were 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[3]. These agreements would be in the form appropriate to meet the commercial objectives and principles of the Authority[4], one of which was to "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."[5]

11. The Franchise Agreement would require the Franchisee (which eventually proved to be AFSC) to develop the Facility and to enter into an Operating Agreement for the provision of the services to operate and maintain the Facility[6]. The drafting approach of these agreements assumed it would be more flexible for the Franchisee to have separate agreements. The Franchisee was required to indicate in the Business Plan whether itself or other separate legal entities would enter into the Operating Agreement[7].

12. The Airport System Payment (later called "Facility Payments") would enable the Franchisee to recover its Facility Cost, which essentially consisted of the costs of constructing the Facility, with a reasonable rate of return not exceeding 15% assuming a payment period of 20 years[8]. The Facility Payments would be funded with the revenue from the Facility[9].

13. Revenue from the Facility was the aggregate of all fees and charges, including the Throughput Fee, levied on the users of the Facility[10]. The Throughput Fee was the major source of revenue and was the fee charged to the users for each gallon of aviation fuel delivered into an aircraft. It would be calculated by the Operator and submitted to the

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2 Called the "Licence Agreement" in the Business Plan Specification Brief
3 Business Plan Specification Brief, section 3.1.1
4 Business Plan Specification Brief, section 3.1.1 and Appendix C
5 Business Plan Specification Brief, Appendix C, para 2
6 Business Plan Specification Brief, section 3.1.2
7 Business Plan Specification Brief, sections 3.1.3, 3.4.1 and 7.1.1. AFSC did not become the Operator but chose to have its nominee, AFSC Operations Limited, to be the Operator, see Agreed Statement of Facts para 11.
8 Business Plan Specification Brief, sections 6.4.4 and 6.5.2 and Appendix F, para 3.5(a)
9 Business Plan Specification Brief, section 6.5.5
10 Business Plan Specification Brief, section 7.4.1

Authority for approval and would be based on a formula so as to recover the costs of developing, financing, managing, operating and maintaining the Facility[11].

14. All revenue from the Facility would be used to discharge the costs of provisioning the Facility in this order of priority: (a) reimbursement to the Operator for all Operating Costs in managing, operating and maintaining the Facility; (b) the Facility Payments to the Franchisee; (c) the Authority Fee to the Authority; (d) the 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 would 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[12]. The Operator would be responsible for collecting all revenue and making disbursements to the appropriate parties[13].

15. Depreciation allowances in respect of the Facility would be claimable by the Franchisee[14].

The Franchise Agreement

16. The Franchise Agreement was entered into between the Authority and AFSC on 22 December 1995. By this agreement, AFSC acquired from the Authority:

(1) the right to carry out and complete the design, construction and testing of the Facility and to commission it[15];

(2) the right by its nominee, the Operator, to enter into the Operating Agreement and the exclusive right to operate and maintain the Facility for 20 years from the Airport Opening Date, subject to and in accordance with the Operating Agreement[16];

(3) the right to a lease of the Facility Area[17] ("the Lease"), for 20 years from the Airport Opening Date, giving it quiet uninterrupted and exclusive possession of the Facility Area, subject to an obligation to, and so that it could, grant a licence ("the Licence") to the Operator to operate the Facility[18]; and

(4) the obligation of the Authority to procure the payment, by the Operator to AFSC, of the Facility Payments, payable out of the results of operating

[11] Business Plan Specification Brief, section 7.4.2
[12] Business Plan Specification Brief, section 7.4.4
[13] Business Plan Specification Brief, section 7.4.5
[14] Business Plan Specification Brief, Appendix H, para 7
[15] Franchise Agreement, clause 3.1.1
[16] Franchise Agreement, clause 3.1.2; Operating Agreement, clause 4.1
[17] The Facility Area is described and marked out in the Appendix to the Lease
[18] Franchise Agreement, clauses 3.1.4 and 3.4.1; "Payment Term" in clause 3.1.4 was defined in clause 1 and in Schedule B as 20 years from the Airport Opening Date

> the Facility, in accordance with Schedule A and the Operating Agreement[19].

17. In return, AFSC undertook to carry out and complete the design, construction and testing of the Franchisee Works, to monitor and inspect the construction and testing of the Authority Works, and to commission the Facility[20]. AFSC was set up with the sole purpose of exercising the rights and observing its obligations and liabilities under the Franchise Agreement[21].

18. If the Operating Agreement was terminated for any reason, the Authority would appoint a replacement operator, which may be a subsidiary or a division of the Authority, to continue to operate the Facility and was to ensure that the replacement operator would be subject to the same obligations to make the Facility Payments as the Operator under the Operating Agreement[22]. And if the Authority should notify AFSC of the termination of the Operating Agreement for any reason, AFSC should grant to the Authority, or to such replacement operator as notified by the Authority, a similar licence to operate the Facility for the remainder of the term[23].

19. AFSC was to recover the Facility Cost[24] (which consisted of its costs of carrying out the Franchisee Works, and the sums reimbursed to it by the Authority in respect of the Authority Works) by the Authority's procurement of the Facility Payments to be paid by the Operator to AFSC[25]. All the Facility Payments to AFSC would be made without set-off, deduction or counterclaim[26]. The Facility Payments were based on a cash flow model, which may be amended from time to time, designed to ensure that AFSC would recover the Facility Cost over a period of 20 years with a rate of return of 15% per annum[27]. Monthly Facility Payments were to be computed by a formula[28].

20. Clause 11.1 gave the Authority the option, at any time after the fifth anniversary of the Airport Opening Date, to "elect to accelerate recovery of the Facility Cost by [AFSC] by payment to [AFSC] of the Accelerated Facility Cost Payment". The Accelerated Facility Cost Payment included the Sum, which was to be calculated under a formula provided as would ensure that AFSC recovered the Facility Payments based on a financial model and discounted to the date of the Authority's notice of election based on a rate of 12% per annum[29].

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19 Franchise Agreement, clauses 3.1.3, 10.1.1 and Schedule A
20 Franchise Agreement, clause 4.1
21 Franchise Agreement, clause 14
22 Franchise Agreement, clause 10.1.2
23 Franchise Agreement, clause 3.4.2
24 Defined in Franchise Agreement, clause 1 and in Schedule A
25 Franchise Agreement, clause 10.1.1 and Schedule A
26 Franchise Agreement, clause 10.2
27 Franchise Agreement, Schedule A, paras A5 to A7, A10, A11 and A19, and appendices to Schedule A
28 Operating Agreement, Annex M, para M2
29 Franchise Agreement, clause 11.2.1

21. On payment of the Accelerated Facility Cost Payment,

(1) the obligation of the Authority to procure the payment by the Operator to AFSC of the Facility Payments would be fully satisfied[30] and the Facility Payments would no longer be made by the Operator to AFSC[31];

(2) the Lease granted by the Authority to AFSC would terminate[32];

(3) the Licence granted by AFSC to the Operator would also terminate and the Operator would be entitled to be granted a new licence by the Authority to operate the Facility[33]; and

(4) thereafter, the Operator would become liable to make Facility Payments to the Authority as notified by the Authority, which would be lower than the Facility Payments that would otherwise have been due to AFSC[34].

The Lease

22. By the Lease, the Authority granted to AFSC the Facility Area to hold as tenant at an annual rent of $100[35]. 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[36]. AFSC covenanted to use the Facility Area only for the purposes and in the manner set out in the Franchise Agreement and to perform and observe all its obligations and liabilities under the Franchise Agreement[37]. The Authority covenanted with AFSC to perform and observe the obligations and liabilities of the Authority under the Franchise Agreement[38]. On the expiry of the lease term, the provisions on the consequences of termination of the Franchise Agreement would extend to the Lease and take effect accordingly[39].

The Operating Agreement

23. The Operating Agreement between the Authority and the Operator was made on the same date as the Franchise Agreement and it was mentioned in the recitals that pursuant to the Franchise Agreement, the Operator was willing to exercise the right to enter into the Operating Agreement[40]. By this agreement, the Operator was granted the exclusive

30 Franchise Agreement, clause 11.3
31 Franchise Agreement, clause 11.1.2
32 Franchise Agreement, clause 11.6
33 Operating Agreement, clause 3.1.1
34 Franchise Agreement, clause 11.1.2; Operating Agreement, clauses 3.3 and 14.1.2; although the Franchise Agreement would not be formally terminated, there would be no further obligation of any party to make payment to AFSC under this agreement.
35 The Lease, clauses 2.1 and 4.1
36 The Lease, clause 3
37 The Lease, clauses 5.2 and 5.3
38 The Lease, clause 6.2
39 The Lease, clause 7
40 Operating Agreement, Recitals para (B)

right to operate the Facility for 20 years from the Airport Opening Date[41] and it acquired from the Authority the right to be granted a licence to operate the Facility. The Licence was to be granted by AFSC in accordance with the Franchise Agreement and by the Authority in the event of payment of the Accelerated Facility Cost Payment[42]. There was provision for early termination by the Authority of the Operating Agreement and appointment of a replacement operator[43].

24. In exercising the rights and performing its obligations and liabilities under the Operating Agreement, the Operator agreed and confirmed that it would be acting as an independent contractor for its own account and not as agent or partner of the Authority[44].

25. The Operator was to charge Throughput Fees to Suppliers, the preliminary calculation of which was based upon the projected Operating Costs, the Facility Payments due in accordance with the Franchise Agreement, the Operating Fee, the Authority Fee and the Reserve Appropriations[45]. The Operator would review the preliminary calculation in mid year and the Authority would approve the calculation in consultation with the Operator subject to any appropriate revision[46].

26. The Operator was to pay AFSC the Facility Payments by monthly instalments, the amount of each instalment would equal the Facility Payment for the relevant calendar year divided by the projected yearly throughput multiplied by the projected monthly throughput for that month[47].

27. The Operator was to pay the Authority the Authority Fee, the rate of which was to be notified by the Authority, by monthly instalments[48].

28. The Operator was entitled to be paid the Operating Fee by monthly instalments, calculated according to a base amount and adjusted each year by a formula[49].

29. In the event that the net revenues were less than the sum of the Facility Payments, the Operating Fee, the Authority Fee and the Reserve Appropriations payable in respect of any month, the shortfall was to be dealt with by reductions to the aforesaid sums to the extent necessary to meet such shortfall in an order of priority with the instalments of any Facility Payments due to AFSC the second last amount to be reduced[50].

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[41] Operating Agreement, clauses 3.1.2 and 4.1
[42] Operating Agreement, clause 3.1.1
[43] Operating Agreement, clause 4.2
[44] Operating Agreement, clause 3.2.3
[45] Operating Agreement, clause 13.1 and Annex M, para M7.2
[46] Operating Agreement, Annex M, para M8.2
[47] Operating Agreement, clause 14.1.1 and Annex M, para M2
[48] Operating Agreement, clause 14.2 and Annex M, para M6
[49] Operating Agreement, clause 14.3 and Annex M, para M1
[50] Operating Agreement, clause 14.7.1

30. The Operator was to open a US dollar bank account into which the US dollar denominated segment of the Throughput Fee would be paid and the Facility Payments to AFSC payable in US dollars would be made out of this account[51]. A Hong Kong dollar bank account ("the Operating Account") was to be opened by the Operator into which the Hong Kong dollar denominated segment of the Throughput Fee would be paid and out of which all Operating Costs, the Operating Fees, the Authority Fees, all Reserve Appropriations and any Facility Payment payable in Hong Kong dollars would be made[52]. All funds maintained in the US dollar account were to be held by the Operator on trust for AFSC and other persons entitled to them[53] and all funds in the Operating Account were to be held on trust for the Authority and the Operator and any other person entitled thereto to the extent of their respective interests[54].

The Licence

31. By the Licence, AFSC granted to the Operator a licence to enter upon and occupy the Facility Area for the purpose of enabling the Operator to operate and maintain the Facility subject to and in accordance with the Operating Agreement[55]. AFSC was to permit the Operator to use the Facility Capital Assets (i.e. plant, vessels, vehicles and equipment, whether affixed to the Facility or not) to operate the Facility and, upon request by the Operator, was to transfer by delivery the Facility Capital Assets to the Operator at nil value[56].

The audited accounts of AFSC

32. In the audited accounts of AFSC, the Facility Payments received from the Operator each year were recognised as income in the period in which AFSC rendered services, being the provision of the Facility to the Operator for use by the Operator and were offered for profits tax assessment. The Facility was treated as a fixed asset in the audited accounts and the expenditure on the Facility was treated as capital expenditure. It was stated in the accounts for each year for the year ending 31 December 1998 to the year ending 31 December 2003 that the Facility "is depreciated over its estimated useful life of 20 years in proportion to the expected facility payments to be received during the period". Depreciation allowances had been claimed in the earlier years of assessment by AFSC on plant and machinery, industrial building and prescribed fixed assets, as envisaged in the Business Plan Specification Brief.

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51 Operating Agreement, Annex N, para N1(a)
52 Operating Agreement, Annex N, para N1(b)
53 Operating Agreement, Annex N, para N2
54 Operating Agreement, Annex N, para N3
55 The Licence, clause 2.1
56 The Licence, clause 2.3

The nature of AFSC's business, the Facility Payments and the Accelerated Facility Cost Payment

33. At the heart of this case lies the question of how the business of AFSC, the Facility Payments and the Accelerated Facility Cost Payment should be characterised. The Commissioner contended that this was a business of AFSC constructing the Facility and selling its construction expertise for reward, with the Facility Payments and the Accelerated Facility Cost Payment paid in return for building the Facility. AFSC argued that its business was to acquire a long term interest in the Facility and to exploit this interest by using it to get part of the operating results of the Facility in the form of the Facility Payments, and that the Accelerated Facility Cost Payment was not earned from the business of exploiting the Facility but was paid by the Authority to acquire AFSC's rights to the Facility.

34. Mr Furness, QC[57] for the Commissioner made these submissions about the contractual arrangements and other pertinent documents:

(1) In the description of the business of AFSC in the Limited Partnership Agreement and the Restated Limited Partnership Agreement, no mention was made of any business to acquire any interest in the Facility after its construction and to exploit the Facility. Likewise, in all the tax returns of AFSC, its principal business activity was simply stated as "development of the aviation fuel supply system" at Chek Lap Kok or the Hong Kong International Airport.

(2) Although it was envisaged when bids were sought by the Authority that the services of building the Facility and operating the Facility after it was built could be provided by the same party, this did not happen eventually. In having regard to the way in which the Authority described its commercial objectives and principles in Appendix C to the Business Plan Specification Brief and the policy of the build-operate-transfer model in the Agreed Statement of Facts[58], the judge had started on the wrong footing. It was more pertinent to have regard to the fact that AFSC had chosen instead to nominate a related entity to operate the Facility. In the Franchise Agreement, AFSC only undertook to carry out and complete the construction of the Facility. It did not get the right to operate the Facility. The separate activity of operating the Facility was undertaken by its nominee, the Operator. AFSC had no obligation in this respect beyond granting a licence to the Operator to operate and maintain the Facility.

(3) For the separate activity of operating and maintaining the Facility, The Operator was remunerated by the Operating Fee. No fee was payable to AFSC under the Licence for granting a licence to the Operator to enter

[57] Appearing with Mr Stewart Wong, SC
[58] Judgment of Barma J, paras 22 and 23

and occupy the Facility Area to operate the Facility. The Operator had assumed no legal obligation to pay AFSC. It was the Authority that had agreed with AFSC to procure the Operator to pay the Facility Payments to AFSC. The Facility Payments paid to AFSC were designed to recover the Facility Cost for building the Facility, as stated in clause 10 and Schedule A to the Franchise Agreement. It was not an arrangement for AFSC to share in the operating results of the Facility.

(4) After the Airport was opened for business, all that AFSC had was the Lease granted by the Authority, which produced no income, and a promise given by the Authority to procure the Operator to pay the Facility Payments to enable AFSC to recover the Facility Cost. The Lease was granted to AFSC as part of the overall package to provide it with some security as the Facility Payments were to be paid over 20 years. Any business AFSC might have in exploiting the Facility was illusory.

(5) The Accelerated Facility Cost Payment in clause 11 of the Franchise Agreement, which is to "accelerate recovery of the Facility Cost by [AFSC]", performs the same function as the provision made in clause 10 for the recovery of Facility Cost in the form of the Facility Payments. The Accelerated Facility Cost Payment merely provides for AFSC's recovery of the Facility Cost in an alternative way in that payment was to be made by the Authority instead and it would be in a lump sum discounted to 12% per annum instead of spread over 20 years. Although the Authority was not directly indebted to AFSC for the Facility Cost, the Authority had in substance an obligation to repay, either by its covenant under clause 10.1.1 to procure the Operator to pay the Facility Payments, or at its election to pay the Accelerated Facility Cost Payment itself under clause 11.1, so the latter was just another means of serving the same end and was merely a form of pre-payment. Hence, the Accelerated Facility Cost Payment took on the same character as the Facility Payments which it replaced and both are revenue receipts of AFSC.

(6) As for AFSC's contention that it had bought rights giving it a long term interest in the Facility and its operating results, the correct analysis should be that AFSC had earned rights to be paid the Facility Payments by building the Facility. After the Facility was constructed, the business of AFSC was merely to collect payments for what it had earned.

(7) Although the payment by instalments could be reduced if the revenue was not sufficient, and its earnings were therefore linked to the commercial success of the Facility, this was not fatal to the Commissioner's contention that the business of AFSC was a

> construction business. Legally, the only basis for AFSC's right to be paid the Facility Payments was its relationship with the Authority, in that the Authority had agreed to procure the Operator to make these payments.

35. I am not persuaded by the submissions of Mr Furness on the proper characterisation of the business of AFSC, the Facility Payments and the Accelerated Facility Cost Payment. The judge had considered the whole contractual arrangement between AFSC, the Authority and the Operator and analysed it from different angles and came to the view that the description contended for by AFSC is correct and accords with the commercial reality[59]. I agree with his reasoning and conclusion.

36. Much of Mr Furness' submission hinged on there being a departure from the Business Plan Specification Brief in that the operation of the Facility was actually carried out by a separate entity, not by the successful bidder that undertook the construction and commissioning of the Facility. If the services of building and operating the Facility had been provided by the same entity, the argument that AFSC was in the business of building the Facility and not exploiting the Facility would have fallen away.

37. The separation of the services of building and operating the Facility should be looked at in the proper context so as not to lose sight of the commercial reality – that it was the policy of the Authority to award the franchise on a build-operate-transfer basis; that the successful candidate, who was to finance, design, construct and commission the Facility, was entitled to operate the Facility for a fixed franchise term; and that it was envisaged by the Authority in seeking bids for the franchise that the franchisee might choose to nominate a separate entity related to it to operate the Facility instead of operating the Facility itself. The matter of having a Franchise Agreement between AFSC and the Authority, and a separate Operating Agreement between the Operator and the Authority, did not mean there was a departure from the basic policy and commercial objectives of the parties. It is pertinent to bear in mind that notwithstanding there being two separate agreements, frequent references were made in one agreement to the terms of the other regarding the obligations undertaken and the rights that were granted in this triangular relationship between AFSC, the Authority and the Operator. Once the web of that intricate contractual arrangement is disentangled, one can readily see there was no change in substance of the business undertaking and that all along AFSC's business was to build and exploit the Facility, earning fees from the operation of the Facility. I agree with Mr Goldberg, QC[60] that if the Commissioner's description of AFSC's business was right, the agreement between the Authority and AFSC should have been a straightforward construction contract instead of a Franchise Agreement with complex contractual arrangements involving the Operating Agreement, the Lease and the Licence.

38. Furthermore, if AFSC's business was just constructing the Facility, it is difficult to see how that business, which must have ceased in 1998, could still produce a

[59] Judgment of Barma J, paras 22 to 46

[60] Appearing with Ms Yvonne Cheng for AFSC

revenue receipt for 2003/04. The Commissioner sought to contend that such a business could continue so long as it was receiving the fruits of its labour being the Facility Payments, citing South Behar Railway Co Ltd v Commissioners of Inland Revenue [1925] AC 476 at 483 to 484 and Commissioner of Inland Revenue v Bartica (1996) 4 HKTC 129 at 159 to 160, and that the business remained subsisting for the receiving and discharging of the Facility Payments. This appeared to me to be a highly artificial argument, and was an attempt to escape from the difficulties which the Commissioner created by characterising AFSC's business in that way. Besides, I do not think the businesses in the cases cited are comparable to a business for the construction of a single facility which has been completed for some years and in which the builder holds no real interest of any kind, as asserted by the Commissioner to be the situation here. The relatively low level of activity in those cases that were held to constitute a continuing business was consistent with the nature of business in those cases.

39. I think Mr Goldberg has a valid criticism that the Commissioner has not come up with a description of AFSC's business that is coherent and consistent with the documentation and commercial reality.

40. The judge rightly had regard to the source from which the Facility Payments were made, which provided a good indicator as to what they were paid for. This is what he said in the pertinent parts of the judgment:

> "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."

41. Mr Furness did not disagree with Mr Goldberg that AFSC had no right to get any amount at all from the Authority, and, in particular, had no right to get the Facility Cost. Further, as pointed out by Mr Goldberg, the Facility Payments were derived from and payable out of the Throughout Fees and in the event the Throughout Fees were not adequate to meet the Facility Payments, the Facility Payments would be reduced to the extent necessary in the order of priority as provided for in the Operating Agreement. The Authority had no obligation to make good any shortfall in the Facility Payments.

42. For all the above reasons, I reject the contention of the Commissioner that the Facility Payments were consideration given to AFSC by the Authority for building the Facility for the Authority. As Mr Goldberg had put it aptly, this is the reverse of what happened. AFSC was not selling building services to the Authority, it was buying an interest in the Facility and its operating results. AFSC's obligation to build the Facility was the consideration it gave to acquire its rights, not a service it sold to the Authority. The Facility Payments were the share of the operating results which AFSC had purchased, not the consideration received by it.

43. In contrast to the Facility Payments, the source from which the Accelerated Facility Cost Payment was made and the nature of this payment was very different. The judge had this to say in the judgment:

> "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 …, 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.
>
> 42. … 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."

44. Thus analysed, the Sum did not represent the discounted present value of the Facility Payments, nor was it a receipt derived from AFSC's business. It was not earned from the carrying on of business but arose outside the course of the business activity (Commissioner of Inland Revenue v Hang Seng Bank Ltd [1991] 1 AC 306 at 318E). It was a payment made by the Authority at its election to acquire that business. It was not something AFSC could choose to receive or not receive. For this reason, it is not chargeable to tax under section 14.

If the Sum was a capital or income receipt

45. Having come to the view the Sum was not a receipt from the business of AFSC, the question whether the Sum was a capital or income receipt is not relevant. But as this issue was considered by the judge[61], and as submissions were made to us, I would deal with it succinctly.

46. Assuming that the Sum was from the business of AFSC, it should be brought into account for the purpose of profits tax only if it had the character of income but not if it had the character of capital. The distinction here is between payments made to compensate for loss of profits (which would have the character of income and are taxable) and payments made on the destruction of a business (which are inherently capital in character and not taxable).

47. The judge made a thorough analysis of the relevant factors in arriving at the conclusion that the Sum was a capital receipt. He took into account the purpose of the Accelerated Facility Cost Payment (which was to bring about a termination of AFSC's business, and not a substitute for the Facility Payments), the risk of not receiving sufficient Facility Payments had moved from AFSC to the Authority, the length of the right that was brought to an end as a result, the entitlement of AFSC to claim depreciation allowances arising in relation to the Facility, and the consistent treatment of the Facility and the Lease as capital in the accounts of AFSC. I agree entirely with his analysis and conclusion.

48. Mr Furness argued before us that even if AFSC's business was to acquire the Facility as a capital asset and to exploit the Facility, the Sum should still be regarded as an income receipt, for one of three reasons.

49. His first reason and primary case is that the Sum was a form of pre-payment by the debtor for a future stream of income. Even though the Authority was not a debtor to AFSC, it was akin to one. Had the Franchise Agreement run its full course of 20 years, all receipts of the Facility Payments under clause 10 would be taxable as income. Clause 11

[61] Judgment of Barma J, paras 47 to 62

allowed the Authority, after the fifth anniversary of the Airport Opening Date, to elect to pay the Accelerated Facility Cost Payment in lieu, so that the term for payment of the Facility Payments would not run for 20 years. From a fiscal, business and practical point of view, payment under clause 11 produced the same outcome as payment under clause 10. Alternatively, the Sum was paid as compensation for taking away AFSC's business and the Sum was compensation for the loss of income, not of a capital asset, and so should be treated as an income receipt. In the further alternative, there was a sale of business being the right to receive income. As the payment of the Sum gave rise to the right to receive income, it should be treated as income.

50. In support of his primary case that the Sum was received in exchange for and as the present value of a future stream of income and should be regarded as income receipt, Mr Furness prayed in aid the Australian cases of Commissioner of Taxation (Cth) v Myer Emporium Ltd (1987) 163 CLR 199 and Henry Jones (IXL) Ltd v Commissioner of Taxation (1991) 31 FCR 64. These cases established that, except in the case of the assignment of an annuity where the income arises from the very contract assigned, an assignment of income from property without an assignment of the underlying property right will bring about the result that the consideration for the assignment is merely a substitution for the future income to be derived and will have the character of income. In other words, the taxpayer is simply converting future income into present income. Mr Furness submitted that these cases were not his preferred basis for analysing the facts of the present case but they were indicative of what was the consistent approach.

51. The Australian cases are not analogous to the present situation. This was not an assignment of the right of income on its own. And the source of the payment of the Sum was not an assignment of income. As the judge pointed out, the Facility Payment payable to the Authority after the payment of the Sum was not the same as the Facility Payments payable to AFSC before such payment. It is not necessary to be drawn into the further discussion as to whether the Australian decisions are wrong or should be followed in Hong Kong.

52. I reject the primary case of Mr Furness. For the reasons given by the judge, the Sum was properly to be regarded as being a payment to bring about a termination of AFSC's business, and not as a substitute or compensation for the loss of the Facility Payments[62]. When the relevant factors of the indicia of a capital payment (IRC v John Lewis Properties plc [2003] Ch 513 at paras 80 to 87) were considered in the factual matrix in this case, as the judge had done, one can see the cumulative effect is that the present case falls clearly within the line of cases where payment was made for the destruction of a capital asset (Glenboig Union Fireclay Co Ltd v IRC (1922) 12 TC 427; Van Den Berghs Ltd v Clark (1935) TC 390; and Barr Crombie & Co v IRC (1945) TC 406), not where payment was made to compensate for the loss of income (The Burmah Steam Ship Co Ltd v IRC (1931) 16 TC 67; London and Thames Haven Oil Wharves Ltd v Attwooll [1967] 1 Ch 772).

[62] Judgment of Barma J, paras 42, 50 to 55

If the Sum is chargeable by virtue of sections 15(1)(m) and 15A

53. I turn to consider if the Sum is chargeable to profits tax on another basis by virtue of sections 15(1)(m) and 15A of the Ordinance.

54. Section 15(1)(m) provides as follows:

> "**15. Certain amounts deemed trading receipts**
>
> (1) For the purposes of this Ordinance, the sums described in the following paragraphs shall be deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong –
>
> …
>
> (m) 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."

55. The relevant provisions of section 15A read:

> **"15A. Transfer of right to receive income**
>
> (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."

56. Three questions arose for consideration:

(1) did AFSC have a right to receive income from property;

(2) if the answer to (1) is yes, was such right transferred to the Authority;

(3) if the answer to (2) is yes, can AFSC rely on the exception under section 15A(3).

57. The judge answered question (1) in favour of the Commissioner and held that AFSC did have a right to receive income from property[63]. He answered questions (2) and (3) in favour of AFSC. He held that there had not been a transfer of AFSC's right to receive income to the Authority in any practical or business sense[64]. If he were wrong about that, AFSC could bring itself within the exception in section 15A(3) in that the legal or equitable interest of the property from which income was derived was transferred to the Authority when the right to receive income was transferred[65].

58. In his written submission, Mr Goldberg reiterated his stance that AFSC did not have a right to receive income as under the contractual arrangements, AFSC had no right against the Operator to receive the Facility Payments and that the right against the Authority, which was to enforce the Authority's obligation to procure the Operator to pay the Facility Payments, was not a right to have income paid. I am satisfied the judge was correct to hold that from a business and practical view point, AFSC did have a right to receive income and it was a right derived from property, being its interests in the Facility or the business of exploiting the Facility. In section 15A(4), the word "property" in section 15A is defined to mean "any property whatsoever".

59. The judge held there was no transfer of the right to receive income to the Authority, as the Authority's right to receive the Facility Payments was in place as a result of the provisions of the Operating Agreement between the Authority and the Operator, well before the making of the Accelerated Facility Cost Payment. He did not consider that the triggering of the Authority's right under the existing arrangement by a process which involved the extinction of AFSC's right to receive its Facility Payments could be regarded as a transfer within the meaning of sections 15(1)(m) and 15A. Furthermore, the Facility Payments to be made by the Operator to the Authority were not the same as the Facility Payments paid by the Operator to AFSC. The extinguishing of one set of rights and the arising of a new set of rights approximates a situation giving rise to a novation, not a transfer of the rights in question.

60. Mr Furness submitted that the word "transfer" in sections 15(1)(m) and 15A is capable of a wide meaning and whilst as a matter of strict law a novation creates new legal

[63] Judgment of Barma J, para 72
[64] Judgment of Barma J, paras 73 and 74
[65] Judgment of Barma J, para 75

rights and obligations, it is recognised as a species of a transfer, citing Chitty on Contracts (30th ed) para 19-086 and Anson's Law of Contract (29th ed) page 676. But as Mr Goldberg pointed out, it is clear from para 19-088 of Chitty on Contracts that the effect of a novation "is not to assign or transfer a right or liability, but rather to extinguish the original contract and replace it by another."

61. I agree with the judge that question (2) should be answered in favour of AFSC. No matter how widely the word "transfer" is construed, the right of the Authority to receive Facility Payments after payment of the Accelerated Facility Cost Payment was an original right already in the hands of the Authority, not by virtue of something done by AFSC and did not move from AFSC.

62. Question (3) does not arise. In the event there was transfer of the right to receive income, I do not agree with Mr Furness that the only relevant property from which income was derived was the Lease and that there was no transfer of this property as it was terminated on the making of the Accelerated Facility Cost Payment. I agree with the judge that the word "transfer" in section 15A(3) should have an extended meaning, if this word were to have an extended meaning in sections 15(1)(m) and 15A(1), and that the relevant property from which income was derived must have included at least the Facility, which belonged to AFSC and was transferred to the Authority by operation of law on the termination of the Lease.

The balancing charge

63. Mr Furness argued that if the judgment is upheld and profits tax is not chargeable on the Sum, the assessment should be varied to take account of the fact that a balancing charge should be brought into account by AFSC in respect of the Facility, on which substantial depreciation allowances had been claimed in the previous years of assessment and consideration had been received on the disposal of this capital asset. The Commissioner contended that the payment of the Accelerated Facility Cost Payment was:

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

(2) either a sale of AFSC's interest in the industrial building or structure for the purpose of section 35(1)(a) giving rise to sale monies, or the termination of that interest being a leasehold interest for the purpose of section 35(1)(b) giving rise to compensation monies; and

(3) a cessation of trade of AFSC within section 39D(2) otherwise than in circumstances where the plant and machinery passes by way of succession giving rise to either sale or compensation monies.

64. The point about balancing charge was not raised before the judge. Before the substantive merits are to be considered, I would need to address the procedural objection of AFSC that the Commissioner should not be allowed to raise this on appeal to this court.

65. Mr Goldberg reminded us of the principle in Flywin Co Ltd v Strong & Associates Ltd (2002) 5 HKCFAR 356, that a party will be barred from taking a point on appeal where he had omitted to do so at trial, unless there is no reasonable possibility that the state of the evidence relevant to the point would have been materially more favourable to the other side if the point had been taken at trial. If the Commissioner had raised the point on balancing charge, he would have proceeded differently before the judge and would have adduced evidence on the succession of the business of AFSC as stated in its profits tax computation, it being the case of AFSC there were no sale or compensation monies attributable to the assets for which depreciation allowances were claimed, so the reducing value of those assets would be taken as the reducing value of the successor as at the time of succession pursuant to section 39B(7) and no balancing charge would be made under section 39D(3). Further, he would have led evidence to deal with the apportionment that should be made of the value of the assets for which depreciation allowances were claimed out of any sale proceeds or compensation monies.

66. The proceeding before the judge was an appeal transferred to the Court of First Instance instead of the Board of Review, under section 67 of the Ordinance. Section 67(5)(e) provides that the Court of First Instance may summon any person to give evidence at the hearing and may examine any such person as a witness on oath or otherwise. Section 67(7)(b) empowers the Court of First Instance, in determining an appeal under this provision, to make any assessment which the Commissioner was empowered to make at the time he determined the assessment, or direct the Commissioner to make such an assessment.

67. Mr Goldberg referred us to the New Zealand decision of CIR v V H Farnsworth Ltd [1984] 1 NZLR 428. The New Zealand Court of Appeal, by a majority, held that a statutory provision similar to our section 67(7) did not empower the court in the exercise of its discretion to have a new assessment made on a different and wider basis than the assessment under objection before the court. He submitted that as the six years time limit after the expiration of the year of assessment had passed, no additional assessment may now be made under section 60(1) on account of the balancing charge.

68. In seeking a variation of the assessment to take into account a balancing charge, I do not think the Commissioner is attempting to make a new assessment on a different and wider basis than the assessment under objection, unlike the situation in Farnsworth. As Mr Furness had said, the balancing charge in the present case is a plea for consistency, if the Commissioner should fail to overturn the judgment below. I would consider the making of an assessment in this case under section 67(7) as an assessment which "fairly reflect[s] the basis on which the assessment was made and the objection was made to that assessment" (Farnsworth at 435 line 55 to 436 line 2), and is within the jurisdiction of this court to make.

69. As for the exercise of discretion, although this point could and should have been taken by the Commissioner in the court below, no unfairness in procedure would be suffered by AFSC. If the matter is remitted to the Commissioner for the correct figures to be arrived at taking into account the question of a balancing charge, AFSC would be at liberty to adduce such further materials before the Commissioner as it sees fit on the succession of business and the apportionment of value to the plant and machinery. And if an additional assessment is made on account of the balancing charge, the appeal provisions in the Ordinance would apply pursuant to section 60(1). I would exercise my discretion and allow the Commissioner to raise in this appeal the issue about a balancing charge.

70. I go on to consider the substantive merits. The question here is whether the assets for which depreciation allowances were claimed had passed by way of succession so that a balancing charge would not be made by virtue of sections 39B(7) and 39D(3) of the Ordinance. I think this can be determined on the existing materials before us without the need for further evidence from AFSC.

71. Mr Furness argued that the trade or business of AFSC was not succeeded to as that business had ceased when the Lease was terminated on payment of the Accelerated Facility Cost Payment. We were referred by Mr Goldberg to two cases showing that there would be a succession to business in the situation of an acquisition by sale and purchase (Bell v National Provincial Bank of England, Ltd [1903] 1 KB 149) and a transfer of the assets and undertakings of a company on liquidation (Briton Ferry Steel Co Ltd v Barry [1940] 1 KB 463). I am inclined to agree with Mr Goldberg that the Authority had succeeded to the business of AFSC of exploiting the Facility. The goodwill and the profit-making apparatus of this business, namely, the Facility, were transferred to the Authority on payment of the Accelerated Facility Cost Payment. Thereafter business was carried on by the Authority in substantially the same way in that the Facility was exploited to receive Facility Payments from the Operator.

72. I hold that there was a succession to the business of AFSC by the Authority and that the assets for which depreciation allowances were claimed had passed by way of succession so that a balancing charge would not be made by virtue of sections 39B(7) and 39D(3). As the successor to the business, the Authority would be entitled to claim depreciation allowances on the reducing value of the capital assets as at the time of succession.

Conclusion and costs

73. I would dismiss the appeal of the Commissioner and affirm the order of Barma J quashing the assessment insofar as it included the Sum as a taxable receipt of AFSC for the year of assessment of 2003/04. I would make an order nisi that the Commissioner is to pay the costs of AFSC of this appeal, with a certificate for two counsel.

Hon Fok JA:

74. For the reasons given in the judgment of Kwan JA, I agree that the appeal stands to be dismissed and the order of Barma J affirmed. I also agree with the proposed order as to costs.

Hon Lam JA:

75. I agree with the judgment of Kwan JA.

(Susan Kwan)	(Joseph Fok)	(M H Lam)
Justice of Appeal	Justice of Appeal	Justice of Appeal

Mr David Goldberg QC and Ms Yvonne Cheng, instructed by Baker & McKenzie, for the appellant (respondent)

Mr Michael Furness QC and Mr Stewart Wong SC, instructed by the Department of Justice, for the respondent (appellant)