

CACV 45/2012

**IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF APPEAL
CIVIL APPEAL NO. 45 OF 2012
(ON APPEAL FROM BOARD OF REVIEW CASE NO B/R 97/09)**

BETWEEN

BRAITRIM (FAR EAST) LIMITED

Appellant

and

COMMISSIONER OF INLAND REVENUE

Respondent

Before: Hon Kwan JA, Fok JA and Barma JA in Court

Date of Hearing: 30 November 2012

Date of Judgment: 30 November 2012

Date of handing down Reasons for Judgment: 6 December 2012

REASONS FOR JUDGMENT

Hon Kwan JA:

1. I agree with the Reasons for Judgment of Barma JA.

Hon Fok JA:

2. I agree with the Reasons for Judgment of Barma JA.

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Hon Barma JA:

3. This is an appeal by the Appellant taxpayer, Braitrim (Far East) Limited (“the Taxpayer”), by Case Stated against the Decision of the Inland Revenue Board of Review (“the Board”) dated 23 August 2011. The appeal is made directly to the Court of Appeal under section 69A of the Inland Revenue Ordinance, Cap 112 (“the Ordinance”), pursuant to the Order of Tang V-P (as he then was) dated 2 February 2012.

4. The appeal turns on a single point of law involving the construction of section 16G of the Ordinance. At issue is the question whether, as the Commissioner of Inland Revenue (“the Commissioner”) contends, the word “lease” in section 16G(6) bears the meaning given to it by its definition in section 2(1) of the Ordinance (which is wider than the commonly understood legal definition of a lease), or whether, as the Taxpayer suggests, the context requires that the statutory definition should not apply, and the word given its commonly understood legal meaning. If the Commissioner is correct, the items of expenditure sought to be deducted by the Taxpayer would not be deductible when arriving at the amount of the assessable profits of the Taxpayer for the three years of assessment which are the subject of this appeal. On the other hand, if the Taxpayer is correct, such expenditure would be deductible.

5. The Board answered this question in favour of the Commissioner, concluding that the extended definition of lease contained in section 2(1) applied to the word “lease” as used in section 16G(6), so that certain moulds owned by the Taxpayer which it permitted its Mainland manufacturers to use were “excluded fixed assets”, and thus not “prescribed fixed assets”, within the meaning of section 16G(6), so that the capital expenditure incurred by the Taxpayer in producing them could not be deducted pursuant to section 16G(1) or (2).

6. At the conclusion of the hearing, we dismissed the appeal, with costs to the Respondent, the Commissioner of Inland Revenue (“the CIR”). These are our reasons for doing so.

7. The underlying facts in relation to this matter were not disputed. The agreed facts were set out in paragraph 3 of the Board’s Decision, while the (unchallenged) evidence of two witnesses called by the Taxpayer was summarised in paragraphs 4 to 20 of the Decision. The facts can be summarised as follows:-

- (1) The Taxpayer, which was incorporated in Hong Kong in 1988, carried on the business of supplying plastic garment hangers and related packaging materials until it ceased business in 2002. It was a subsidiary of a United Kingdom company which supplied plastic hangers to a range of United Kingdom retailers. The hangers were customised, and were designed by the parent company in conjunction with its customers.

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- (2) The hangers themselves were supplied by the Taxpayer, and were manufactured by one of two Mainland factories, both of which were unrelated to the Taxpayer or its parent company.
- (3) The hangers were manufactured using moulds which were made by the factories to designs provided by the Taxpayer, under the guidance of the Taxpayer's staff. Although produced by the factories, the moulds were the property of the Taxpayer, which authorised the factories to use them for the purposes of production of hangers. The moulds were used only to manufacture hangers to be supplied to the Taxpayer, for onward supply to its parent company and the ultimate customers, the United Kingdom retailers.
- (4) In its Profits Tax returns for the years of assessment 2000/01, 2001/02 and 2002/03 (the years of assessment with which we are concerned), the Taxpayer reported assessable profits of HK\$33,457,609, HK\$59,113,981 and HK\$43,037,506 respectively. The Taxpayer also claimed as a deductible expense (pursuant to section 16G of the Ordinance) the expenditure on what it contended were "prescribed fixed assets" – namely moulds used in the manufacturing process described above – in the following respective amounts: HK\$11,082,700 in 2000/01, HK\$3,292,183 in 2001/02 and HK\$4,270,470 in 2002/03, while offering for assessment sales proceeds in respect of such moulds of HK\$517,500 in 2001/02 and HK\$204,000 in 2002/03.
- (5) Initially, the assessor accepted the returns as submitted. However, in March 2007, the Assessor decided that the expenditures in relation to the moulds were not deductible under section 16G, and raised additional assessments on the Taxpayer, which were later revised in May 2008. The revised additional assessments had the effect of increasing the assessable profits of the Taxpayer for the years of assessment in question. The increase was attributable principally to the disallowance of the deductions claimed in respect of the moulds under section 16G of the Ordinance, but also (in smaller part) to the inclusion of certain royalty income which was initially not offered for assessment. The increase attributable to the royalty income is not now in issue, as the Taxpayer did not pursue its appeal in relation to it before the Board. However, in relation to the moulds, the additional profits assessed amounted to HK\$11,084,850 for 2000/01, HK\$2,809,741 for 2001/02 and HK\$4,066,470 for 2002/03.
- (6) The Taxpayer's objections to these additional assessments having been rejected by an Acting Deputy Commissioner of Inland Revenue by Determinations dated 12 February 2010, the Taxpayer appealed against

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those Determinations to the Board. As I have noted, the Board dismissed the Taxpayer's appeal.

8. It is convenient now to set out the relevant statutory provisions. These are as follows:-

(1) Section 2(1) of the Ordinance, which relevantly provides:-

“(1) In this Ordinance, unless the context otherwise requires –

...

lease, in relation to any machinery or plant, includes –

- (a) any arrangement under which a right to use the machinery or plant is granted by the owner of the machinery or plant to another person; and
- (b) any arrangement under which a right to use the machinery or plant, being a right derived directly or indirectly from a right referred to in paragraph (a), is granted by a person to another person,

but does not include a hire-purchase agreement or a conditional sale agreement unless, in the opinion of the Commissioner, the right under the agreement to purchase or obtain the property in the goods would reasonably be expected not to be exercised.

...”

(2) Section 16(1) of the Ordinance, which relevantly provides:-

“(1) In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period, including –

...

- (ga) the payments and expenditure specified in sections ... 16G ... as provided in those sections;

...”

(3) Section 16G of the Ordinance, which relevantly provides:-

“(1) Notwithstanding anything in section 17, in ascertaining the profits of a person from any trade, profession or business in respect of which the person is chargeable to tax under this Part for any year of assessment, there shall, subject to subsections (2) and (3), be deducted any specified capital expenditure incurred by the person during the basis period for that year of assessment.

...

(6) In this section –

excluded fixed asset means a fixed asset in which any person holds rights as a lessee under a lease;

prescribed fixed asset means –

(a) such of the machinery or plant specified in items ... 26 ... of the First Part of the Table annexed to rule 2 of the Inland Revenue Rules (Cap 112 sub leg A) as is used specifically and directly for any manufacturing process;

...

but does not include an excluded fixed asset;

specified capital expenditure, in relation to a person, means any capital expenditure incurred by the person on the provision of a prescribed fixed asset....”

(4) Section 17 of the Ordinance, which relevantly provides –

“(1) For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of –

...

(c) any expenditure of a capital nature or any loss or withdrawal of capital;

...”

- (5) Item 26 of the First Part of the Table annexed to Rule 2 of the Inland Revenue Rules, which refers to:-

“Plastic manufacturing machinery and plant including moulds.”

9. Applying those provisions to the present case, the moulds in respect of which the deductions were claimed fall within item 26 of the First Part of the Table annexed to Rule 2 of the Inland Revenue Rules. As the moulds were used directly for a manufacturing process, they would be prescribed fixed assets as long as they were not excluded fixed assets, and the capital expenditure incurred on their provision would be specified capital expenditure, which would (notwithstanding section 17(1)(c)) be a deductible expense by virtue of section 16(1)(ga). However, if the moulds in question were the subject of a lease, they would be excluded fixed assets, in respect of the cost of provision of which no deduction could be claimed.

10. It is common ground that the moulds were not the subject of a lease as that term is commonly legally defined. However, it is equally common ground that, on the undisputed evidence, and as the Board found, they were the subject of an arrangement under which a right to use the moulds was granted by the Taxpayer to the Mainland manufacturers, and thus were the subject of a lease as defined in section 2(1) of the Ordinance. If, therefore, that definition of lease applied for the purposes of section 16G, the capital expenditure incurred on the moulds would not be deductible, and the Determination of the Acting Commissioner, and the Decision of the Board, would be correct.

11. As section 2(1) provides that the definitions enacted in it are to apply unless the context otherwise requires, it is necessary for the Taxpayer to show that the context in which the term lease is used in section 16G(6) requires the statutorily defined meaning not to apply. This was made clear by Ma CJ in *Cathay Pacific Airways Ltd v Kwan Siu Wa Becky et al* (unreported, CFA, FACV 5/2012, 26 September 2012), where he said (at paragraph 31 of the judgment), when dealing with the equivalent definition provision in the Employment Ordinance, Cap 57:-

“I take this opportunity to stress that, in my view, these qualifying words in section 2(1) [of the Employment Ordinance, Cap 57] can only refer to the context of the Ordinance; in other words, the definitions contained in the definition section will apply to the other provisions in the Ordinance unless in the context of the Ordinance itself, a different meaning should be given.”

12. Mr Barlow SC, appearing for the Taxpayer, submitted that on a proper understanding of the context and purpose of section 16G, the word “lease” as used in the definition of an excluded fixed asset could not have been intended to be understood in the sense required by the extended definition contained in section 2(1) of the Ordinance. He argued that:-

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- (1) The definition of “lease” now appearing in section 2(1) of the Ordinance was first enacted in the context of section 39E of the Ordinance, when that section was introduced in 1986 as part of general anti-avoidance measures. By contrast, section 16G of the Ordinance (which was introduced by amendments to the Ordinance made in 1998) is not concerned with anti-avoidance measures, but with the provision of a form of depreciation allowance which enables the full cost of certain types of plant and machinery to be written off in the year in which the expenditure was incurred. The purpose and context of section 16G therefore does not require the use of the extended definition of “lease”, so that the statutory definition should not apply.
- (2) In support of this contention, he referred to certain legislative materials, including the Explanatory Memorandum to the Inland Revenue (Amendment) (No. 2) Bill 1998 (“the Bill”) (by which section 16G was introduced into the Ordinance) and the Hansard report of the Secretary for the Treasury moving the Bill before the Legislative Council on 7 April 1998.
- (3) He suggested that to apply the section 2(1) definition of “lease” in the context of section 16G(6) would render section 16G unworkable or absurd and undermined its purpose, as it would mean that the deduction for specified capital expenditure on a prescribed fixed asset could rarely be taken advantage of, thereby defeating the purpose of section 16G, whereas the adoption of the narrower, commonly understood legal definition of the term would give the deduction wider application, which would be consonant with the provision’s purpose.
- (4) He also contended that the full meaning of “lease” in the Ordinance involved two meanings – its ordinary meaning in some contexts, and its extended meaning in others, and that the Board’s decision had the effect of cutting down that full meaning.

13. I do not agree with Mr Barlow’s suggested construction of “lease” as the word is used in section 16G. In my view, Mr Fung SC, who appears for the Commissioner, was right when he submitted that the legislative history of section 16G makes it clear that the extended definition of “lease” provided by section 2(1) was intended by the legislature to apply in the context of section 16G(6). That history is as follows:-

- (1) The extended statutory definition of “lease” was first introduced in 1986 when section 39E was introduced. It was contained in section 39E(5), which made it clear that the extended definition only applied to section 39E itself.

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- (2) Section 16G was added to the Ordinance in 1998. The definition of “lease” in section 39E(5) was repealed (see clause 24 of the Bill), but the same definition of “lease” was then inserted into the existing section 2(1) (see clause 3 of the Bill).

14. Mr Fung submitted that this shows that it was clearly the decision of the legislature that the extended definition of lease was intended to apply to section 16G as well as to section 39E. I agree. If this had not been the intention, there would have been no need to move the definition out of section 39E (where it was confined to that section), particularly as the word “lease” does not appear elsewhere in the amendments introduced by the Bill. Moreover, the only other definitions that were moved from section 39E to section 2(1) at this time were the definitions of “arrangement” and “conditional sale agreement”, both of which appear in the definition of “lease”. By contrast, a substantial number of other definitions which appeared in section 39E were simply left there. Had it not been intended that the word “lease” in section 16G should be understood in the extended sense defined by the statutory definition, it would have been sufficient simply to enact section 16G in its present form. If that had been done, it would have been clear that the extended definition could not apply to section 16G. The only purpose of moving the definition would seem to have been to ensure that it applied to the word “lease” as used in both section 16G and section 39E.

15. I do not agree with Mr Barlow’s response that this approach involves ignoring the opening words of section 2(1). Those words were always there. They were not enacted together with the introduction of the definition of “lease” into the definition section. This submission is, in fact, the argument which I have described in paragraph 12(4) above, which is itself fallacious, as it involves a non sequitur. It does not follow that, simply because the definition section provides for definitions within it not to apply where the context requires otherwise, there are necessarily contexts within the statute to which the definition should not apply. All that the words “unless the context otherwise requires” import is an obligation to consider whether or not the definition is appropriate in the particular context. They say nothing about whether any context requiring a definition to be ignored actually exists. I therefore also disagree with Mr Barlow’s suggestion that to fail to find a context in which the statutory definition of lease should be disapplied is somehow to give the interpretation section less than its full meaning.

16. Further, I think that Mr Fung was also right in saying that there is, viewed objectively, nothing in the context of section 16G that requires the disapplication of the statutory definition of “lease”. On the contrary, he rightly pointed out that that definition is concerned with plant and machinery, which is the very subject matter of section 16G.

17. I also agree with Mr Fung that it is not possible to read more into the purpose of section 16G than to conclude that it was the intention of the legislature to afford a deduction to capital expenditure on fixed assets falling within the statutory definition of “prescribed fixed assets”. There does not appear to be anything, whether in the terms of the provision itself, or in the legislative materials referred to by Mr Barlow, to show the extent

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to which it was intended that this deduction should be available. It is true that to limit the availability of the deduction to taxpayers who use the plant and machinery themselves, but not to those who permit others to use them under some arrangement, will mean that fewer taxpayers will be able to take advantage of the deduction. But that does not mean that this is something other than what the legislature intended. Having regard to the legislative history to which I have already referred, it seems to me to be quite clear that the legislative intention was to limit the scope of the deduction so that it was not available in cases where the fixed asset in question was the subject of an arrangement by which a person other than its owner was granted a right to use it.

18. So far as the legislative materials are concerned, even if regard is had to them, they do not assist the Taxpayer:-

- (1) The Explanatory Memorandum to the Bill simply states that the purpose of clause 9 of the Bill (which was to become section 16G) was to add a new head of deduction of expenditure on a “prescribed fixed asset”, going on to give a general explanation of what this covered. However, that general explanation is in broad terms, and cannot be regarded as somehow overriding the specific terms of the legislation that was in fact enacted. It says nothing about leased fixed assets, and thus throws no light on what meaning should be given to “lease” in section 16G(6).
- (2) The extracts from Hansard dealing with clause 9 of the Bill deal only with amendments to the clause that were unrelated to the issues in this appeal, and therefore do not take matters any further.

19. It follows from the foregoing that I would not agree with Mr Barlow’s suggestion that the interpretation of section 16G advanced by the Commissioner, and adopted by the Board, is unworkable, or absurd, or would be likely to defeat the purpose of the provision.

20. For all of these reasons, I am satisfied that the word “lease” in section 16G(6) of the Ordinance is to be understood in accordance with the definition in section 2(1). It follows that the expenditures on the moulds by the Taxpayer were not deductible, that the decision of the Board was correct, and that this appeal should be dismissed.

(Susan Kwan)
Justice of Appeal

(Joseph Fok)
Justice of Appeal

(Aarif Barma)
Justice of Appeal

Mr Barrie Barlow SC, instructed by Baker & McKenzie, for the appellant

Mr Eugene Fung SC, instructed by Department of Justice, for the respondent