FACV 14/2013

IN THE COURT OF FINAL APPEAL OF THE HONG KONG SPECIAL ADMINISTRATIVE REGION

FINAL APPEAL NO. 14 OF 2013 (CIVIL)
(ON APPEAL FROM CACV NO. 150 OF 2011)

Between:

AVIATION FUEL SUPPLY COMPANY Respondent

and

COMMISSIONER OF INLAND REVENUE Appellant

Before: Chief Justice Ma, Mr Justice Ribeiro PJ, Mr Justice Tang PJ, Mr Justice Stock NPJ, Lord Hoffmann NPJ

Dates of Hearing: 24 November 2014

Date of Judgment: 15 December 2014

J U D G M E N T

Chief Justice Ma:

1. I agree with the judgment of Lord Hoffmann NPJ.

Mr Justice Ribeiro PJ:

2. I agree with the judgment of Lord Hoffmann NPJ.

Mr Justice Tang PJ:

3. I agree with the judgment of Lord Hoffmann NPJ.

Mr Justice Stock NPJ:

4. I agree with the judgment of Lord Hoffmann NPJ.

Lord Hoffmann NPJ:

5. On 22 December 1995 the Airport Authority ("the Authority"), which had been set up to oversee the planning, design and construction of the new airport at Chek Lap Kok, granted to Aviation Fuel Supply Company ("the taxpayer") a franchise to design and construct a Facility for the supply of aviation fuel. On the same date and pursuant to the terms of the Franchise Agreement, the Authority granted the taxpayer a lease of the Facility for a term of 20 years and the right to nominate an Operator who would have the exclusive right to operate and maintain the aviation fuel Facility at the airport. Out of the income derived from supplying fuel to the airlines, the Operator was to pay the taxpayer periodic Facility Payments calculated to enable it to recover the cost of constructing the Facility and a reasonable return on its investment.

6. The airport opened on 6 July 1998. By clause 11.1 of the Franchise Agreement the Authority was given the right, at any time after the 5th anniversary of the opening date, to terminate the franchise and lease by electing to pay the taxpayer an Accelerated Facility Cost Payment, calculated according to a formula intended to reflect the net present value of the right to future Facility Payments. Thereafter the Operator would continue to operate the Facility on behalf of the Authority, which would receive the Facility Payments.

7. On 23 October 2002 the Authority gave notice of its election to terminate the taxpayer's franchise by making an Accelerated Facility Cost Payment on 7 July 2003. On that date it paid the taxpayer US$449,043,000 ("the payment").

8. In its profits tax returns for the year 2003-4, the taxpayer treated the payment as a capital receipt in return for the transfer of its entire assets and undertaking at the airport to the Authority. The Assessor, on the other hand, took the view that the payment was income chargeable to profits tax. The Deputy Commissioner upheld her assessment.

9. The taxpayer appealed and pursuant to section 67 of the Inland Revenue Ordinance Cap 112 ("the Ordinance") the appeal was transferred to the Court of First Instance and came before Barma J. In a judgment delivered on 8 July 2011 he accepted that the payment was of a capital nature and discharged the assessment. The Commissioner appealed to the Court of Appeal, which dismissed the appeal on 4 December 2012. There is no appeal against that decision.

10. A few weeks before the hearing in the Court of Appeal, the Commissioner decided that she needed a second string to her bow. On 22 October 2012 she amended her notice of appeal to allege that if the decision of Barma J was affirmed, the assessment should be varied to take into account that the taxpayer's Facility at the airport had consisted of industrial buildings, plant and machinery for which capital allowances had been claimed and the disposal of which gave rise to balancing charges.

11. In principle, capital expenditure is not deductible for the purposes of computing taxable profits. But the Ordinance recognises that capital assets may be wasting or depreciating and that it would not be fair to compute the taxpayer's profits without taking into account the fact that, year by year, such assets are declining in value and may eventually have to be replaced. The Ordinance therefore provides under various heads for initial or annual allowances to take depreciation into account.

12. In theory, these allowances should match the actual decline in value of the capital asset. In practice, of course, there seldom is an exact correlation and the taxpayer may sell the asset for more or less than its original cost less the allowances he has received. As Lord Reid explained in *Inland Revenue Commissioners v. Wood Brothers (Birkenhead) Ltd* [1959] AC 487, 505 in relation to the corresponding U.K. legislation:

> "If one assumes values in money remaining stable, the amount of the allowances on any item ought to be such that, when the trader comes to sell it, the price which he receives is equal to the price which he paid for it less the aggregate amount of the allowances which he has received in respect of it. If on selling the item he receives more than that amount, then, neglecting the effect of inflation, it could be said that the allowances made to him had been too large, and, as these allowances had been deducted year by year before assessment of his trading profits, he had therefore paid too little in income tax…[I]n the Finance Act 1945…"[b]alancing charges" were introduced to meet the case where the trader had received too large allowances…"

13. The Commissioner says that the taxpayer received the following allowances and is therefore liable for the corresponding balancing charges:

(a) Capital expenditure on the provision of a prescribed fixed asset.

Section 16G provides for a 100% allowance on certain "prescribed fixed assets" such as computer hardware and software which depreciate rapidly. If they are subsequently sold, subsection 3(a) creates a balancing charge by requiring the proceeds of sale to be treated as income subject to profits tax.

(b) Commercial buildings and structures

Section 33A provides for an "annual allowance" (4% a year) for wear and tear on the capital expenditure incurred in the construction of a commercial building or structure. By section 35(1), if the building or structure is sold, a balancing charge is made on the excess of the sale moneys over the capital expenditure reduced by the allowances.

(c) Plant and machinery

For the years of assessment up to and including 1979-80, section 37 provides for an initial allowance on capital expenditure incurred in the provision of machinery or plant and an annual allowance calculated on the reducing value of the asset, that is, the cost less the initial allowance and previous allowances. By section 38, if the plant or machinery is sold for more than the expenditure less the allowances, a balancing charge is made in the amount of the excess. For the tax years 1980-81 and thereafter, there are similar provisions in sections 39B (granting the allowances) and 39D (creating the balancing charge). The difference between the two sets of provisions is that under the older ones, allowances were granted separately on each item of plant or machinery and under the new "pooling" system, they are granted in respect of classes of plant or machinery. The difference is not relevant to anything in this appeal and I shall treat the two regimes as interchangeable.

14. There is no dispute that the taxpayer received these allowances and therefore, in principle, if the termination of the franchise and lease can be regarded as a sale of the buildings and structures, prescribed fixed assets and plant and machinery to the Authority and the consideration for each of those assets exceeded the residual value after allowances, a balancing charge should be added to the taxpayer's profits for that year of assessment: see section 18F(1).

15. The taxpayer submitted to the Court of Appeal that the Commissioner should not at that stage be allowed to put forward a claim that the taxpayer was liable to be assessed on balancing charges. It was an entirely new basis for assessment. The Court of Appeal, in a judgment delivered by Kwan JA, with which Fok and Lam JJA concurred, rejected this objection. She said that the Court could deal with the case "on the existing materials…without the need for further evidence." Her view was that the Commissioner's case failed because, for reasons to which I shall in due course return, the Ordinance excluded a balancing charge in the circumstances in which the franchise and lease had come to an end.

16. The Commissioner appeals against this decision on the merits and I shall have something to say about it later. But the chief question, in my opinion, is whether the Commissioner should have been allowed to raise the question of a balancing charge at the last minute before the hearing in the Court of Appeal.

17. In the case of an appeal transferred from the Board of Review to the Court of First Instance, section 67(7) of the Ordinance provides:

> "In determining an appeal under this section, the Court of First Instance may –
>
> (a) confirm, reduce, increase or annul the assessment determined by the Commissioner;
>
> (b) 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, in which case an assessment shall be made by the Commissioner so as to conform to that direction…"

18. By section 13(4) of the High Court Ordinance Cap 4, the Court of Appeal has all the authority and jurisdiction of the court from which the appeal was brought. Accordingly, the Court of Appeal had the power to make any assessment which the Deputy Commissioner was empowered to make when he determined the assessment on 11 February 2009.

19. For the purposes of deciding whether the Court of Appeal had jurisdiction to grant the order sought by the Commissioner, the question is therefore whether the Commissioner could have done so.

20. The jurisdiction of the Commissioner is conferred by section 64(2) of the Ordinance. By section 64(1), a person aggrieved by an assessment may serve on the Commissioner a notice of objection. Section 64(2) then provides:

> "On receipt of a valid notice of objection under subsection (1) the Commissioner shall consider the same and within a reasonable time may confirm, reduce, increase or annul the assessment objected to…"

21. The nature of the powers and duties of the Commissioner under section 64(2) of the Ordinance has been settled since the decision in *Mok Tsze Fung v Commissioner of Inland Revenue* [1962] HKLR 258, in which Mills-Owen J said:

> "His duty is to review and revise the assessment and this, in my view, requires him to perform an original and administrative, not an appellate and judicial, function, of considering what the proper assessment should be. He acts de novo, putting

himself in the place of the assessor, and forms, as it were, a second opinion in substitution for the opinion of the assessor."

22. These principles were recently reaffirmed by the Court of Final Appeal in *Shui On Credit Co Ltd v Commissioner of Inland Revenue* (2009) 12 HKCFAR 392. The taxpayer had entered into a complicated scheme of pre-arranged transactions with a view to avoiding tax. It was assessed to profits tax under the anti-avoidance provisions of section 61A of the Ordinance, which requires that the transaction "has, or would have had, but for this section" the effect of conferring a tax benefit on a person. The Commissioner took the view that there was no need to resort to section 61A because, despite the scheme, the sums in question were chargeable to profits tax under the ordinary provisions of sections 16 and 17 of the Ordinance. He therefore made an assessment under those sections. The taxpayer objected that he was not entitled in dealing with an objection to make an assessment upon an entirely different basis. But Lord Walker of Gestingthorpe, citing the *Mok Tsze Fung* case, said that the Commissioner's duty was to consider de novo whether, and if so in what amount, the taxpayer should be assessed to profits tax. He was not confined to deciding whether the assessment had been made on the right basis.

23. Likewise in this case, I consider that the question of whether the amount chargeable to profits tax was liable to be increased by a balancing charge was all part of the assessment to profits tax. It did not matter that it was on a wholly different basis from the original assessment of the payment as income. A taxpayer who gives a notice of objection takes his chance on whether the outcome will be to annul, reduce or increase the assessment or the basis upon which the Commissioner will assess him. I therefore agree with the Court of Appeal that there was jurisdiction to make the assessment.

24. However, section 67(7)(b) says that the Court may make any assessment which the Commissioner had power to make and thereby confers a discretion. As Lord Walker of Gestingthorpe emphasised in the *Shui On Credit Co* case, the Commissioner (and in its turn the Court) is under a duty to act fairly. So the question is whether it was fair for the Court of Appeal to entertain the Commissioner's submission that the taxpayer should be assessed on the basis of a balancing charge.

25. There are in my view two important questions relevant to the question of fairness. The first is that, by the time the Court of Appeal was invited to make the assessment, the period of limitation for making an additional assessment under section 60(1) had expired. Under that section, an additional assessment must be made within six years of the expiration of the year of assessment. That was 2003-4. An assessment under section 67(7)(b) is not of course an additional assessment within the meaning of section 60(1). The power of the Court is backdated to the date on which the Commissioner made the assessment under appeal. But the effect is to deprive the taxpayer of the protection of the limitation period against what may be in substance an entirely new claim.

26. In Commissioner of *Inland Revenue v V H Farnsworth Ltd* [1984] NZLR 428 a majority of the New Zealand Court of Appeal decided that a provision in the New

Zealand Income Tax Act 1976, which gave the court hearing an appeal a power to make or direct an assessment in terms virtually identical to section 67(7)(b) of the Ordinance, impliedly excluded a power to make an assessment on a different basis from that under objection. That decision was based upon provisions in the New Zealand Act which are not present in the Ordinance and which would have put the taxpayer at a procedural disadvantage. As the courts of Hong Kong have, since the *Mok Tsze Fung* case, taken the contrary view, the majority decision is less helpful than the dissenting opinion of Cooke J, which proceeded on the assumption that, as in Hong Kong, there was jurisdiction to make an assessment on a different basis. He was however emphatic in saying that it would not be fair to exercise the jurisdiction after the limitation period had expired:

> "In my opinion, when the taxpayer has made returns and been assessed, and putting aside cases of fraud etcetera, it would not be right to allow the Commissioner to support an increased assessment by taking an entirely new point for the first time after the four years."

27. I am not sure that I would put the matter quite so dogmatically. I think that there may be cases in which, even after expiry of the limitation period, it would not be unfair to exercise the power to make an assessment on a different basis. But this will largely depend upon the second factor which I suggest should be taken into account, namely whether the new basis will require any further investigation of the facts. The main purpose of the limitation period is, after all, to protect the taxpayer from having to investigate transactions that have receded more than six years into the past. In my view, it is for the Commissioner to satisfy the Court that the taxpayer will not be deprived of this protection. There is possibly an analogy in RHC Ord 20, r.5(5), which permits an amendment to raise a new cause of action after expiry of the limitation period if it is based upon "the same or substantially the same facts" as the original claim.

28. The taxpayer puts forward a number of reasons, both substantive and procedural as to why the assessment should not be made. First, it says most of the relevant assets were not the subjects of a sale. The buildings, structures, plant and machinery were affixed to the land and formed part of the realty in which the taxpayer had only a leasehold interest. On the expiry of that interest, they passed to the Authority by operation of law and not by virtue of a sale.

29. The finding of Barma J, upheld by the Court of Appeal, was that the taxpayer disposed of the assets and undertaking of its business of supplying (through the Operator) aviation fuel at the airport, including its leasehold interest in the Facility, to the Authority for a consideration determined according to the formula in the Franchise Agreement. Because the Authority happened to hold the reversionary interest on the lease, the effect was to bring it to an end and merge it in the reversionary interest. It would also be the case that any chattels that had become part of the realty would pass with the lease. But I do not think that these special facts detract from the fact that there was a disposal of the business including the lease and chattels. I do not think that it is necessary to decide the point, but it would seem to me reasonable to describe this transaction as a sale for the purposes of the Ordinance:

compare the definition from Benjamin on Sale cited by Viscount Simonds in *Littlewoods Mail Order Stores Ltd v. Inland Revenue Commissioners* [1963] AC 135, 152.

30. The taxpayer also says that perhaps it was not entitled to some of the allowances. Only the owner of plant and machinery qualifies for annual allowances under section 39B(2), so that the taxpayer would not have qualified in respect of plant and machinery fixed to the realty. In that case, even if the Commissioner mistakenly gave the allowances, the taxpayer should not be liable for a balancing charge.

31. The Franchise Agreement recited that the Franchisee's bid had been based upon a Business Plan Specification Brief issued by the (then) Provisional Airport Authority. This had invited the submission of a Financial Plan (Appendix H) which assumed that the bidder would be claiming the allowances. In fact the taxpayer duly claimed and received them. So the argument that they were not entitled to do so is not particularly attractive. However, it is again in my view not necessary to decide the point.

32. The real difficulty for the Commissioner is the question of what part of the purchase price should be attributed to the various assets that have attracted allowances. The Commissioner says that the whole payment should count as consideration for the buildings, plant, machinery and so on. The Accelerated Facility Cost Payment was calculated by reference to the Facility Payments to which the taxpayer would have been entitled during the remainder of the term and those payments had been calculated to allow the taxpayer to recover the cost of its investment in constructing the Facility together with a reasonable rate of return. Therefore the payment was in return for what the taxpayer had spent in the construction of the Facility and that consisted of buildings, plant, machinery etc.

33. I do not accept this submission. It is true that the payment was calculated by reference to what the taxpayer had spent. But that does not mean that he was selling only those assets which had been constructed or acquired for the purposes of the Facility. He was also selling the business: the right to occupy the land on which the Facility was built and the monopoly right to supply aviation fuel and receive Facility Payments for the remainder of the term. If one had to apportion part of the payment to the Facility hardware, one would have to take into account that on any view it had depreciated in value from the time it was installed. That was why the allowances had been granted. The payment, on the other hand, was calculated by reference to what the taxpayer had originally spent. So there is plainly a mismatch between this sum and the part of the Accelerated Payment that can be attributed to the buildings, machinery and plant.

34. I do not think that an apportionment of the payment would be an easy matter. It would require evidence about the value of these items in 2003. The Commissioner accepts that the Court of Appeal had no material upon which it could form a view about their value and asks that he be directed pursuant to section 67(7)(b) to consider the question and make an appropriate assessment. Section 38A of the Ordinance confers upon the Commissioner a power, when assets which qualify for allowances are "sold together or with other assets in pursuance of one bargain", to "allocate a purchase price to each individual

asset". But in my opinion, it would not be fair to the taxpayer to require it to investigate these matters after the limitation period for a fresh assessment has expired. These are entirely new facts upon which the Commissioner needs to rely in order to sustain the assessment. It would have been possible for the assessor or the Commissioner to have originally made alternative assessments, one treating the whole payment as income and the other claiming a balancing charge: see *Commissioner of Inland Revenue v Nina T.H. Wang* [1993] 1 HKLR 7; [1994] 1 WLR 1286. But I think it is too late to invoke section 67(7)(b) to achieve the same result at the very last minute. The Court of Appeal should not have entertained the application.

35. For these reasons I would dismiss the appeal. It is therefore unnecessary to decide whether the Court of Appeal was right to say that no balancing charge was payable. The Commissioner, however, has invited the Court to express a view because he considers that the decision of the Court of Appeal was wrong and will disturb the practice of his office. I shall therefore express a view.

36. For this purpose it is necessary to assume that the items on which allowances had been granted did in fact answer to the descriptions in the Ordinance and in particular that the machinery and plant were at all times rightly described as machinery and plant and were not part of the premises of the Facility. This, as I have said, is a contested matter.

37. As I explained earlier, section 37 provides for initial and annual allowances on machinery and plant in the tax years up to and including the tax year 1979-80 and section 39B provides for them in the years 1980-81 and thereafter. As there is no relevant difference between them, I shall discuss the matter by reference to the later system.

38. Section 39B(7) provides:

> "If a person succeeds to any trade, profession or business which immediately before the succession –
>
> (a) was carried on by another person; and
>
> (b) the machinery or plant that was used at any time by that other person for the purpose of producing profits chargeable to tax under Part 4 is not sold to the successor,
>
> the reducing value of such machinery or plant shall, for the purpose of computing annual allowances under subsection (3), be taken to be the reducing value thereof still unallowed to that other person as at the time of succession."

39. Ordinarily, if a person buys a business together with its plant and machinery, the price he pays for the plant and machinery will be capital expenditure which he has incurred for the purpose of producing profits and he will receive allowances based upon that

price: section 39B(1). The depreciation clock is started running anew. If the whole assets and undertaking have been sold for a single sum, the Commissioner may determine the sum attributable to the plant and machinery under section 38A.

40. Subsection 39B (7) deals with the case in which the plant and machinery has passed to him otherwise than by sale ("the machinery or plant is not sold to the successor"). An example is *Commissioner of Inland Revenue v The Hong Kong Bottlers Ltd* [1970] HKLR 581, in which the successor was the owner of the whole issued share capital in the company which had been carrying on the business, and received the assets by a distribution in specie.

41. In the case of a succession otherwise than by way of sale, the clock is not started again. The successor's entitlement to allowances simply takes on where his predecessor left off. He obtains no initial allowance (subsection (8)) and the reducing value for calculating his annual allowances is taken to be "the reducing value thereof still unallowed to that other person as at the time of the succession". And because, for the purposes of calculating allowances on the assets in question, the change of ownership on succession is treated as having made no difference, there is no balancing charge: section 39D(3).

42. The question for the Court of Appeal was therefore whether this was a succession in which there had been no sale of the plant and machinery to the Authority. But the Court of Appeal appears to have treated the matter as depending simply upon whether the Authority succeeded to the taxpayer's business: see paragraphs 71 and 72 of the judgment. They cited *Bell v National Provincial Bank of England Ltd* [1904] 1 KB 149, which decides that a bank which buys the assets and undertaking of another bank and carries on its business as part of its own has succeeded to that business for the purposes of an altogether different provision of the U.K. income tax legislation. I have no difficulty with the proposition that the Authority succeeded to the taxpayer's business. But the question with which the Court of Appeal should have been concerned was whether this happened without the plant and machinery being sold to the authority.

43. It seems to me that it clearly was. The consideration obtained by the Authority in return for the Accelerated Facility Cost Payment was the whole of the taxpayer's assets and undertaking at the airport, including the plant and machinery. The price may have had to be apportioned to determine precisely what they were sold for, but in my opinion the Authority did not get them for nothing. The taxpayer submits that as some or all of them were fixtures, they could not be sold to the Authority because, as reversioner on the taxpayer's lease, it owned them already. Alternatively it says that they did not pass on sale but by operation of law when the lease was terminated. However, as between the Authority, the taxpayer and the Commissioner, they had been treated as owned by the taxpayer and I think that the Commissioner would have been entitled to make an assessment on that basis. Indeed, I doubt whether, if they had been part of the site, they would have qualified as plant and machinery at all. As for the submission that there was a transfer by operation of law, the termination of the lease was just as much a sale of the taxpayer's

residual interest as a surrender would have been. The fact that the price for the surrender had been agreed in advance and that it followed the exercise of an option by the Authority can make no difference to its commercial character.

44. There is the additional point that the Court of Appeal appears to have regarded its opinion on sections 39B(7) and 39D(3) as determinative of all the Commissioner's claims to balancing charges. But this was a mistake. There is no equivalent in the provisions for prescribed assets or industrial buildings and structures.

45. However, for the reasons given earlier. I would dismiss the appeal. As to costs, I would make an order nisi that the Commissioner pays the costs of the taxpayer, such costs to be taxed if not agreed. Should either party wish to contend for a different order for costs, written submissions should be lodged with the Registrar and exchanged within 14 days of the handing down of this judgment, with liberty on the other party to lodge and exchange written submissions within 14 days thereafter. In the absence of an application to vary, this order as to costs will become absolute at the expiry of the time limited for the lodging of submissions.

Chief Justice Ma

46. The appeal is accordingly dismissed. The Court also makes an *order nisi* as to costs as set out in para 45 above.

(Geoffrey Ma) Chief Justice	(R.A.V. Ribeiro) Permanent Judge	(Robert Tang) Permanent Judge

(Frank Stock) Non-Permanent Judge	(Lord Hoffmann) Non-Permanent Judge

Mr Michael Furness QC and Mr Stewart K.M. Wong SC, instructed by the Department of Justice, for the Appellant

Mr David Goldberg QC and Ms Yvonne Cheng SC, instructed by Baker & McKenzie, for the Respondent