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HONG KONG TAX ALERT

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Application for leave to appeal to the Court of Final Appeal: *Aviation Fuel Supply Company v CIR* and *Braitrim (Far East) Limited v CIR*

On 16 August 2013, the Court of Appeal granted the Commissioner of Inland Revenue leave to appeal to the Court of Final Appeal on whether a balancing charge should be imposed on Aviation Fuel Supply Company (AFSC) on the sale of plant and machinery.

Subsequently, on 19 August 2013 the Court of Final Appeal dismissed the application for leave to appeal by Braitrim (Far East) Limited on whether Braitrim's arrangement with mainland factories for the provision of moulds came within the statutory definition of a "lease".

Aviation Fuel Supply Company

On 4 December 2012, the Court of Appeal dismissed the appeal by the Commissioner of Inland Revenue against the judgment of the Court of First Instance that the payment of a sum of USD 449 million (the Sum) received by AFSC from the Airport Authority was not chargeable to profits tax under section 14 of the Inland Revenue Ordinance (IRO) nor taxable by virtue of sections 15(1)(m) and 15A(1). The Commissioner of Inland Revenue did not seek leave to appeal from this part of the judgement. For the background to this case, please refer to Hong Kong Tax Alert Issue 2 – January 2013.

The Commissioner only sought leave to appeal on whether "balancing charges" should be imposed on AFSC on the sale of the assets. This issue was not argued in the Court of First Instance and was only raised before the Court of Appeal. In lodging his application for leave to appeal, the Commissioner put forward two questions: (1) whether, for the purpose of imposing a balancing charge on the sale of plant and machinery giving rise to sale moneys, the imposition of a balancing charge is avoided by virtue of section 39D in circumstances where the assets pass by way of succession by reason of a sale; and (2) whether the "succession defence" in section 39D(3) is available against a charge on proceeds of sale of prescribed fixed assets under section 16G(3) and, a balancing charge on the sale of industrial buildings under section 35(1)(a) giving rise to sale moneys.

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These questions were premised on the Commissioner's contention that there was a clear finding in the Court of Appeal's judgment that there was a sale of the business of AFSC, including the Facility (being the plant and machinery, prescribed fixed assets and industrial buildings for the purpose of the balancing charges), with the sale value of each item of the assets to be apportioned when the matter is to be remitted back to the Commissioner.

It was argued for the Commissioner that it followed from there that the payment of the Sum was a sale of the prescribed fixed assets for the purpose of section 16G(3); a sale of AFSC's relevant interest in the industrial building or structure for the purpose of section 35(1)(a) giving rise to sale moneys; and a cessation of trade of AFSC within section 39D(2) giving rise to sale moneys.

The Commissioner argued that the Court of Appeal was wrong to hold that a balancing charge would not be made by the "succession" defence of AFSC by virtue of sections 39B(7) and 39D(3). This was because of the finding that there was a sale of the assets, and sections 39D(3) and 39B(7) only apply to a succession to a trade otherwise than by the sale of the relevant plant and machinery. Section 39D(3) does not apply to a charge on proceeds of sale of prescribed fixed assets under section 16G(3) or a balancing charge on the sale of industrial buildings or structures under section 35(1)(a) giving rise to sale moneys.

After the Court of Appeal handed down its judgement, the question of whether it had found there was a sale of the assets was the subject of some correspondence of the parties to the Court. The Commissioner had applied to the Court to vary its judgment with regard to the question of balancing charges or to hold a further hearing to deal with the matter. AFSC had responded that the proper remedy of the Commissioner was to seek leave to appeal. The Court declined to vary the judgment or entertain further submissions.

While the Court of Appeal exercised its discretion and granted leave to appeal it stated that it was not appropriate to say anything further about what was meant in its judgement.

Regardless of the outcome of this appeal, the judgement of the Court of First Instance and Court of Appeal that the Sum received by AFSC was on capital account and that the sum was not otherwise taxable under sections 15(1)(m) and 15A(1) remains authoritative.

Braitrim (Far East) Limited

For the background to this case, please refer to Hong Kong Tax Alert Issue 5 – February 2013. Braitrim sought unsuccessfully in the Board of Review and in the Court of Appeal to challenge the Commissioner's assessment that it was not entitled to a deduction of expenditure on certain moulds used in the production of plastic garment hangers. The Court of Appeal refused leave to appeal to the Court of Final Appeal and Braitrim sought leave to appeal.

The taxpayer, a subsidiary of a UK company, was in the business of supplying plastic garment hangers ultimately used by UK retail companies. The hangers, which were made according to the customers' requirements, were manufactured by two mainland factories. The taxpayer provided those factories with the product designs and the factories designed, constructed and operated the moulds used in the manufacture of the hangers. The moulds, while situated in the premises of the factories, remained the property of the taxpayer which had authorised them to be used by the factories exclusively for the manufacture of the hangers to be supplied to its customers.

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Section 2(1) of the IRO provides "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 ...". This definition is a wider concept of a "lease" than that under the general law. Accordingly, the legislature's definition gives an extended meaning to the word "lease".

The Court of Appeal held that it was bound to apply the extended meaning unless something in the Ordinance required the contrary. It was argued that where a statutory definition provides that a certain meaning is "included" in a definition, the Court is bound to consider whether contextually, the commonly understood meaning rather than the extended meaning is intended to apply. The Court of Final Appeal did not accept this interpretation. Rather, the Court noted that the opening words of section 2(1) emphasises the importance of context in deciding whether, as accepted by the Court of Appeal, the statutory definition applies.

The Court of Final Appeal also stated that it was also common ground that on its face, the language of the definition caught Braitrim's arrangement with the Mainland factories. Braitrim endeavoured to argue that the extended meaning should nevertheless be discarded as inapplicable because viewed purposively, it cannot have been the legislative intention to create such a narrow exception, confining the deduction to cases where a taxpayer itself uses the machinery or plant and does not enter into an arrangement granting some other person the right to use it. Further, the extended meaning was only intended to take effect in relation to anti-avoidance provisions in the Ordinance.

The Court considered that the reasoning of the Court of Appeal rejecting the above arguments was unassailable. There was nothing in the context of the Ordinance to require adoption of a meaning other than the legislature's extended meaning even if this results in a relatively narrow class of taxpayers being eligible for the deduction. There was also nothing to suggest that the extended meaning is intended only to operate in relation to anti-avoidance provisions. The closing words of section 2(1) give anti-avoidance powers to the Commissioner in respect of hire-purchase arrangements but, as the Court of Appeal held, the legislative history strongly indicated that the extended meaning was intended to apply to section 16G and was not intended to be confined in the manner suggested.

Accordingly, the Court of Final Appeal did not consider the proposed appeal reasonably arguable and leave was refused.

With this decision, the IRD's position has been confirmed that no deduction or depreciation allowances are allowable where plant and equipment is made available by Hong Kong taxpayers to factories outside Hong Kong to manufacture its products.

As noted in Hong Kong Tax Alert Issue 5 – February 2013, the only remaining remedy lies in an amendment of the IRO. However, there has been no indication from the Government that it is prepared to amend the law.

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