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HONG KONG TAX ALERT

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Aviation Fuel Supply Company prevails on grounds of "fairness"

The Court of Final Appeal rules that taxpayer is entitled to protection against Commissioner of Inland Revenue taking a new point after the period for making additional assessments had expired.

Summary

- *The Court of Final Appeal (CFA) handed down its judgement on 15 December 2014 dismissing the Commissioner of Inland Revenue's ("the Commissioner") appeal on the issue of balancing charges against Aviation Fuel Supply Company ("the taxpayer").*
- *The CFA held that it would be unfair to deprive the taxpayer of the protection of the six-year limitation period as the new basis of assessment would require extensive further investigation by the taxpayer.*

The Court of Final Appeal (CFA) recently published its judgement in the case between Aviation Fuel Supply Company ("the taxpayer") and Commissioner of Inland Revenue ("the Commissioner") that originated from the Commissioner seeking to tax a sum received by the taxpayer in the 2003/4 year of assessment from the Airport Authority ("the Authority") which was intended to compensate it for the cost of a facility it had constructed under a franchise and lease agreement entered into with the Authority.

Background

The detailed facts of the case can be found in *Hong Kong Tax Alert – January 2013*.

The matter came before the Court of First Instance in 2010 as a question of capital versus revenue which was resolved in the taxpayer's favour with a similar outcome on appeal to the Court of Appeal (CA) in 2012. It was at the CA where the Commissioner sought to introduce a new argument, namely that if the receipt from the Authority was indeed a capital receipt (as contended by the taxpayer), then the taxpayer's assessment should be revised (by the court) to take into account capital allowances which taxpayer had claimed so that balancing charges could be imposed.

The taxpayer argued before the CA that the Commissioner should not, at that late stage, be allowed to put forward a claim that the taxpayer was liable to be assessed on balancing charges[1] as it was an entirely new basis for assessment.

Despite the taxpayer's objection, the CA allowed the Commissioner to raise this new issue but then found against him on the merits, namely that the Inland Revenue Ordinance (IRO) excluded a balancing charge in the circumstances where a franchise and lease had come to an end.

[1] *The amount by which the sale price of an asset exceeds its written down value. If the termination of the franchise and lease can be regarded as a sale of the buildings and structures, 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: Section 18F(1) Inland Revenue Ordinance ("IRO").*

Timeline

- *Appeal leapfrogged to the Court of First Instance (CFI) under Section 67 of the Inland Revenue Ordinance (IRO). By a judgement dated 8 July 2011, the CFI allowed the taxpayer's appeal.*
- *The Commissioner of Inland Revenue (CIR) appealed to the Court of Appeal (CA) on two alternative grounds:*
  (1) the payment was of revenue nature; or
  (2) balancing charges be brought into account if the payment were a capital receipt.
- *The CA allowed the Commissioner to raise the issue regarding balancing charges but dismissed the appeal on 4 December 2012.*
- *The Commissioner appealed to the CFA on the issue of balancing charges.*
- *On 15 December 2014, the CFA handed down its judgement dismissing the Commissioner's appeal.*

The Commissioner appealed to the CFA, having dispensed with the argument that the sum in question was revenue in nature and therefore subject to taxation (for further background information regarding the appeal see *Hong Kong Tax Alert – September 2013*). The CFA was called upon, therefore, to consider just two issues:

1. Should the Commissioner have been allowed to raise the issue of a balancing charge in the CA having not raised it previously?
2. Whether the sum received from the Authority attracted balancing charges?

The decision

1. The CA had jurisdiction to make revised assessments but was under a duty to act fairly. The question was, therefore, whether it was fair for the CA to entertain the Commissioner's submission and the Commissioner would need to demonstrate that this was the case.

   The CFA held that it would be unfair to deprive the taxpayer of the protection of the six-year limitation period as the new basis of assessment would require extensive further investigation by the taxpayer. Consequently the CA should not have entertained the Commissioner's application for a variance of assessment and the appeal was therefore dismissed on this procedural ground.

2. It was unnecessary, in light of the above, for the CFA to decide whether the CA was correct in asserting that no balancing charge was payable. The Commissioner had, however, invited the court to express an opinion as he considered the CA's decision to be incorrect with consequent ramifications for the assessing practice of the Inland Revenue Department.

The CFA then opined that the CA had been wrong in law with the application of the rules relating to the *clawback* of capital allowances in two respects:

- The rules preventing a *clawback* from applying on a succession to a business could only apply where the succession occurred other than through a sale;
- The succession rules in any case only applied to plant and machinery allowances, and could not apply to commercial buildings or prescribed fixed assets.

Discussion: Right to introduce new arguments

Section 67(7) of the IRO gives the courts the right 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."

In *Mok Tsze Fung v CIR* [1962] HKLR 258, it was held that the Commissioners duty "*is to review and revise the assessment and this... 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.*"

Consequently, the court was able to take on new arguments where it was appropriate to do so, but in doing so it had to act fairly. Following the guidance in *CIR v V H Farnsworth Ltd* [1984] NZLR 428, the court considered whether it would be fair to allow a new line of argument to be put where the standard time limit for issuing a new assessment had elapsed. The Court considered that the main purpose of the protection was to prevent the taxpayer from needing to investigate records that had receded more than six years into the past. It was for the Commissioner to satisfy the Court that the taxpayer would not be deprived of this protection.

In the case of the capital allowances under contention, the CFA considered that further investigation would be needed on the assumption that some depreciation had taken place and that some of the consideration would need to be allocated to the value of the lease and the monopoly business. For this reason they dismissed the appeal.

Although the ruling certainly restricts the ability of the Commissioner to introduce late arguments, it appears that revised submissions may still be allowed where the argument only concerns a point of law. It had been argued before the Court that this would place the taxpayer at a disadvantage since the arguments they could place before the Court were restricted to their grounds of appeal under sections 66(3) or 67(5)(c) of the IRO as the case may be. However, the Court does not appear to have accepted this argument, and presumably would allow the taxpayer to extend its case as required to rebut any new arguments advanced by the CIR.

Discussion: Rejection of Court of Appeal's findings on succession

The findings of the CA were contrary to the IRO and it was no surprise that they were rejected, albeit *obiter dictum*, by the Court of Final Appeal. Interestingly, the comments of the court imply that if the Commissioner had followed correct process they would have been right to seek a balancing charge, although possibly not for the whole amount claimed.

The CA had held that no *clawback* of capital allowances was due as there had been a succession by the Authority to the taxpayer's business under section 39B(7) of the IRO. As the CFA noted, even if they had been right on this point, it would only have been relevant to plant and machinery allowances, not other allowances such as commercial buildings allowances or prescribed fixed assets.

However, the CFA also rejected the CA's reasoning that the rules of succession only apply where the transfer does not take place by way of sale and that a sale had not taken place because the relevant assets had reverted to the head leaseholder who already had an interest in them, and that the consideration given was all for the business. The CFA rejected this argument and held that a sale had in fact taken place.

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