

Taxability of profits: the importance of correctly identifying what a person's trade or business consists of

The recent Court of First Instance decision in *Aviation Fuel Supply Company v Commissioner of Inland Revenue* (HCIA 6/2009, 8 July 2011) illustrates how important it is in correctly identifying what a person's business consists of when determining the taxability of his or her profits under section 14 of the Inland Revenue Ordinance (Cap. 112) (the **IRO**). The decision also contains a useful discussion on the rarely-invoked sections 15(1)(m) and 15A of the IRO, which provide for the chargeability to profits tax in respect of the amount paid in return for the transfer of a right to receive income from property.

Key issues

Chargeability to profits tax under section 14 of the IRO

Chargeability to profits tax under sections 15(1)(m) and 15A of the IRO

Background

The material facts in *Aviation Fuel Supply Company* are as follows:

1. In 1989, the Hong Kong Government decided to build a new airport at Chek Lap Kok in place of the Kai Tak airport. As part of the implementation of this plan, the Airport Authority (the **Authority**) invited tenders for the provision of various types of aviation logistics services. One particular type of such services was the provision of an aviation fuel service system, in respect of which the taxpayer won the bid in or before August 1995.
2. As a result of the taxpayer winning the bid:
 - a. the Authority and the taxpayer entered into a Franchise Agreement (the **FA**), pursuant to which the taxpayer was responsible for financing, designing, constructing and commissioning the aviation fuel service system (the **Facility**);
 - b. the Authority and a nominee company of the taxpayer (the **Operator**) entered into an Operating Agreement (the **OA**), pursuant to which the Operator was responsible for operating and maintaining the Facility;
 - c. the Authority and the taxpayer also entered into a Lease (the Lease) in respect of certain premises (known as the Facility Area) as contemplated in the FA in order to enable the taxpayer to execute its work in respect of the Facility; and
 - d. the taxpayer further granted a Licence (the **Licence**) to the Operator to use the Facility Area for the purposes of observing and performing its obligations under the OA.

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3. In consideration of the obligations undertaken by the taxpayer pursuant to the FA, the Authority was obliged to procure the Operator (who was responsible for collecting all the revenue generated from the usage of the Facility) to make periodic Facility Payments to the taxpayer (over a period of 20 years). Nevertheless, the FA provided that after the fifth anniversary of the Airport Opening Date (which was 6 July 1998), the Authority had the option of making the Accelerated Payment (which payment shall include a lump sum representing the Facility Payments payable after the date of the Accelerated Payment as calculated based on a discount rate of 12% per annum (the **Sum**)) to the taxpayer, following which the Lease shall terminate forthwith, whilst the OA shall continue to subsist. In such event, the Facility, being a fixture on the Facility Area, shall automatically vest in the Authority, and the Operator shall make facility payments to the Authority instead (although the basis of calculating such facility payments payable to the Authority shall be different from that of calculating the Facility Payments payable to the taxpayer).
4. By a notice dated 23 October 2002, the Authority notified the taxpayer of its election to make the Accelerated Payment to the taxpayer on 7 July 2003. The Accelerated Payment was duly made, and accordingly the Lease was terminated (whilst the OA continued to subsist).
5. The question before the Court was whether the Sum (in the amount of US\$449,043,000) was chargeable to profits tax under sections 14, 15(1)(m) and 15A of the IRO.

Issues, arguments and the judgment

Issue 1: Whether the Sum was chargeable to profits tax under section 14 of the IRO

Section 14(1) of the IRO provides that: "*Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.*"

Both the taxpayer and the Commissioner agreed that in resolving Issue 1, the following three questions had to be considered:

1. What did the taxpayer's trade or business consist of?
2. Did the Sum represent a profit arising from the taxpayer's trade or business?
3. Was the Sum capital or income in nature?

Regarding the first question (i.e. what the taxpayer's trade or business was):

1. The taxpayer contended that its business consisted of designing, constructing and commissioning the Facility, and exploiting its interests in the Facility under the FA and the Lease in order to derive revenue in the form of the Facility Payments payable by the Operator over a period of 20 years. In other words, the taxpayer was developing the Facility for itself, in order to put it to profitable use, albeit that the period of such use was limited by the terms of the FA to 20 years (or less, in the event that, as in fact happened, the Authority exercised its option to make the Accelerated Payment under the FA).
2. On the other hand, the Commissioner contended that the taxpayer's business was designing, constructing and commissioning the Facility for the Authority for profit, and it was paid by the Authority for doing so, the payment being either in the form of the Authority's agreement to procure that the Operator made the Facility Payments as were payable to the taxpayer, or alternatively in the form of the Accelerated Payment.
3. Having carefully examined the terms of the FA, the OA, the Lease and the other relevant documents, Barma J found this question in favour of the taxpayer. In coming to this conclusion, Barma J placed particular emphasis on the fact that as a matter of both legal obligation and fact, the Facility Payments were made by the Operator to the taxpayer (for the Operator's right to use the Facility), as opposed to by the Authority to the taxpayer (for the taxpayer's provision of services in respect of the Facility). In the view of Barma J, this was consistent with the position that the taxpayer, and not the Authority, was the owner of the Facility.

Regarding the second question (i.e. whether the Sum represented a profit derived from the taxpayer's trade or business), again, Barma J found this question in favour of the taxpayer, and held that the Sum was not paid to compensate for unpaid Facility Payments. Essentially, Barma J's reasoning was, *inter alia*, that by finding that the taxpayer's business

was to develop the Facility for itself and to put it to profitable use, it would follow that the payment of the Sum (which was made for the purposes of preventing future Facility Payments from being made to the taxpayer, terminating the Lease, vesting the Facility in the Authority and triggering the obligation of the Operator to make facility payments from that point onwards to the Authority instead) should not be regarded as profits arising from the operation of the Facility.

Regarding the third question (i.e. whether the Sum was capital or income), Barma J held that Sum was capital in nature on, *inter alia*, the basis that the Sum was paid to prevent future Facility Payments from being made to the taxpayer and to bring about the termination of the Lease (and hence the taxpayer's ownership of the Facility).

Given the above, Barma J held that the Sum was not chargeable to profits tax pursuant to section 14 of the IRO.

Issue 2: Whether the Sum was chargeable to profits tax under sections 15(1)(m) and 15A of the IRO

Section 15(1)(m) of the IRO provides that for the purposes of the IRO, 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 hence chargeable to profits tax).

Section 15A of the IRO provides:

"(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."

The Commissioner's argument, based on the terms of sections 15(1)(m) and 15A, was essentially that the effect of the Accelerated Payment was that the taxpayer's right to receive Facility Payments from the Operator was transferred to the Authority, that the Sum was paid as consideration for that transfer, and that no property in which the taxpayer had a legal or equitable interest was transferred prior to or at the same time as the transfer of that right.

Barma J agreed with the Commissioner's argument that the taxpayer had a right to receive income (in the form of the Facility Payments) from the Operator, and that such right arose from the Facility / the Lease. However, he did not agree that the effect of the Accelerated Payment was to transfer such right from the taxpayer to the Authority, by virtue of the fact that the basis of calculating the facility payments payable to the Authority was different from that of calculating the Facility Payments payable to the taxpayer. Further, since Barma J found that the effect of the Accelerated Payment was to terminate the Lease and thereby vesting the Facility (being a fixture attached to the property under the Lease) in the Authority, the exception as provided under section 15A(3) shall apply, and therefore the Sum was not chargeable to profits tax by virtue of section 15(1)(m) and section 15A.

Conclusion

The decision in *Aviation Fuel Supply Company* demonstrates that in determining the taxability of one's profits under section 14 of the IRO, it is important to correctly identify what the person's trade and business consists of, as this can have a substantial impact on the answers to the other two essential questions: i.e. whether the profit in question arises from that person's trade or business; and whether the profit is capital or income in nature.

This case also provides a practical example as to how an assessment of profits tax made pursuant to the rarely-invoked sections 15(1)(m) and 15A of the IRO may be successfully challenged.

Another point which is noteworthy is that this case was a tax appeal transferred from the Board of Review to be heard directly by the Court of First Instance pursuant to section 67 of the IRO (under which the consent of both the taxpayer and the Commissioner is required). It was noted in the Court of First Instance decision in *Lee Yee Shing Jacky and*

Another v Board of Review (Inland Revenue Ordinance) and *Another* (HCAL 40/2008, 22 February 2011) that the section 67 procedure has been rarely used. As expressed by the Commissioner in that case, the Commissioner would take the view that it is appropriate for the procedure to be invoked in two types of cases: (1) where there is no dispute of facts and the issues are complex legal issues; or (2) where the parties expect at the outset that the case will proceed all the way to the Court of Final Appeal and a direct appeal to the Court of First Instance would save one tier of appeal, thus saving costs and time. This particular case does obviously seem to fall within type (1). As to whether it will proceed all the way to the Court of Final Appeal, we shall wait and see.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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