CLIFFORD

CHANCE

Briefing note

January 2015

The Commissioner's power to raise assessment on a new basis after the expiry of the limitation period confirmed by Court of Final Appeal in *Aviation Fuel Supply Company*

Further to the decision of the Court of Appeal (**CA**) in *Aviation Fuel Supply Company v Commissioner of Inland Revenue* [2013] 4 HKLRD 463, which we have discussed in our client briefing issued on 21 December 2012 (click here), the Court of Final Appeal (**CFA**) in its recent decision (FACV 14/2013, 15 December 2014) has confirmed that in the event a taxpayer lodges an appeal under section 67 of the Inland Revenue Ordinance (Cap. 112) (the **IRO**) to the Court of First Instance (or the appellate Court by further appeal), the Court will have the power to make any assessment which the Commissioner was empowered to make when he determined the assessment and is not confined to deciding whether the assessment that was made had been made on the right basis.

Background

On 22 December 1995, the Airport Authority (the **Authority**) was set up to oversee the planning, design and construction of the new airport at Chek Lap Kok. The Authority granted to Aviation Fuel Supply Company (the **taxpayer**) a franchise to design and construct a facility (the **Facility**) for the supply of aviation fuel and entered into a Franchise Agreement (the **FA**) with the taxpayer. The Authority also granted the taxpayer a lease (the **Lease**) of the Facility for a term of 20 years and the right to nominate an operator (the **Operator**) who would have the exclusive right to operate and maintain the Facility at the airport. The Operator was to pay the taxpayer periodic payments (the **Facility Payments**) to reimburse the costs of constructing the Facility and enable it to recover a reasonable return on its investment.

> **Key issue**
>
> - The Commissioner's power to raise assessment on a new basis under section 67 of the IRO

The FA also provided for the right of the Authority to terminate the franchise and the Lease by electing to pay the taxpayer an accelerated facility cost payment (the **Accelerated Payment**), upon which the Operator would then make periodic payment to the Authority instead of the taxpayer.

On 23 October 2002, the Authority gave notice of its election to terminate the franchise by making the Accelerated Payment on 7 July 2003 in the sum of US$449,043,000 (the **Sum**). In the taxpayer's profits tax returns, it treated the Accelerated Payment as a capital receipt in return for the transfer of its entire assets and undertaking at the airport to the Authority. The Assessor took the view that such payment was income chargeable to profits tax. The Deputy Commissioner upheld the assessment.

Procedural History

The taxpayer lodged an appeal under section 67 of the IRO, which was transferred to the Court of First Instance (**CFI**). CFI held that the payment was in capital nature and discharged the assessment. The Commissioner appealed to the Court of Appeal (**CA**), which was dismissed. No appeal was made in respect of such decision.

A few weeks before the appeal hearing before the CA, the Commissioner amended the notice of appeal to allege that if the decision of the CFI was affirmed, the assessment should be varied to take into account the capital allowances which had been given to the taxpayer as the Facility had consisted of industrial buildings, plant and machinery and the disposal of which gave rise to balancing charges.

There was no dispute that the taxpayer had received capital allowances, and if the termination of the franchise and Lease could be regarded as a sale of the buildings and structure, 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 would arise.

The taxpayer objected to the Commissioner putting forward an entirely new basis of assessment (in respect of the balancing charge) before the CA as the six years time limit for the Commissioner to raise an additional assessment had passed.

Notwithstanding the taxpayer's objection, the CA allowed the Commissioner to raise this new basis of assessment as it took the view that the Commissioner was not attempting to make a new assessment on a different and wider basis, rather it was a plea for consistency. The CA also held that the Court could deal with the case on the basis of existing materials without the need for further evidence, and that there was no unfairness in procedure to the taxpayer. Despite that, the CA ruled against the Commissioner in the appeal because the CA found that the IRO excluded a balancing charge in the circumstances in which the franchise and the Lease had come to an end. The Commissioner appealed against this aspect of the CA's decision.

CFA's Judgment

Should the Commissioner be allowed to raise the question of a balancing charge at the last minute?

Although the Commissioner appealed against the CA's decision with respect to the chargeability of balancing charge, the CFA opined that the chief question was whether the Commissioner should have been allowed to raise the question of balancing charge at the last minute before the CA.

The CFA firstly satisfied itself that the CA had jurisdiction to make an assessment of a balancing charge on the following basis:

(a) section 67(7) of the IRO provides that in determining an appeal under section 67 of the IRO, the CFI "*may make any assessment which the Commissioner was empowered to make at the time he determined the assessment …*";

(b) section 13(4) of the High Court Ordinance provides that the CA has all the authority and jurisdiction of the court from which the appeal was brought, and accordingly, the CA had the power to make any assessment which the Commissioner was empowered to make when he determined the assessment;

(c) in deciding whether the CA had jurisdiction to grant the order sought by the Commissioner, the question is whether the Commissioner could have done so;

(d) section 64(2) of the IRO provides that "*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 …*";

(e) the nature of the duties of the Commissioner under section 64(2) "*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 …* " (see <u>Mok Tsze Fung v</u>

<u>*Commissioner of Inland Revenue [1962] HKLR 258*</u>); and

(f) the Commissioner was therefore not confined to deciding whether the assessment had been made on the right basis, and 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.

Was it fair to the taxpayer for the CA to entertain the Commissioner's submission that a balancing charge should be payable?

The CFA then considered whether it was fair for the CA to entertain the Commissioner's submission that the taxpayer should be assessed on the basis of a balancing charge since the power given under section 67 of the IRO is a discretionary power, which ought to be exercised fairly. The CFA identified two questions that were relevant to the issue of fairness: (i) whether the period of limitation for making an additional assessment under section 60(1) of the IRO had expired, and (ii) whether the new basis would require any further investigation of the facts.

The CFA pointed out that there might be cases in which, even after the expiry of limitation period, it would not be unfair to exercise the power to make an assessment on a different basis. However, since the main purpose of the limitation period was to protect the taxpayer from having to revisit transactions that had occurred more than six years ago, the Commissioner must satisfy the Court that the taxpayer would not be deprived of such protection.

On the basis that an assessment of the balancing charge, if allowed, would require the taxpayer to revisit matters after the limitation period for a fresh assessment had expired, the CFA held that it would not be fair to require the taxpayer to do so, and dismissed the appeal. The CFA further took the view that the CA should not have entertained the application.

The CFA was of the view that the Sum was paid by the Authority in consideration for the taxpayer’s disposal of the buildings, plant, machinery etc in question, and the taxpayer’s 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. An apportionment of the Sum to the various assets that had attracted allowances would accordingly be necessary in order to assess the balancing charge for which the taxpayer should be liable.

However, as it was conceded by the Commissioner, the CFA observed that no material had been submitted to the CA to enable it to make such apportionment. Whilst the CFA agreed that the Commissioner had the power to allocate a purchase price to each individual asset pursuant to section 38A of the IRO, it would not be fair to require the taxpayer to revisit these matters after the limitation period for a fresh assessment had expired. The CFA further pointed out that the Commissioner could have made alternative assessments: one treating the whole Sum as income and the other claiming a balancing charge, but it was too late to invoke section 67(7)(b) of the IRO to achieve the same result.

Should a balancing charge be made even if the Commissioner was allowed to make an assessment on the new basis?

On the merits, the CFA found that the CA was incorrect to hold that no balancing charge should be made because the Authority had succeeded to the taxpayer's business. The CFA was of the view that, in deciding whether a balancing charge should be made by virtue of section 39B(7) and section 39D(3) of the IRO, the CA should have considered whether the Authority succeeded to the business of the taxpayer without the plant and machinery being sold to the Authority. If it was a succession of the business without a sale of plant and machinery, then no balancing charge would be made.

The CFA considered that in this case, there was clearly a sale of plant and machinery alongside the succession to the taxpayer’s business by the Authority, and the Commissioner would have been entitled to make an assessment on that basis if he had not been barred from making such assessment. The CFA did not accept the taxpayer’s submission that some or all of the plant and machinery were fixtures owned by the Authority and hence, could not be sold to Authority. The CFA also disagreed with the taxpayer's alternative contention that the plant and machinery were transferred to the Authority by operation of law upon the termination of the Lease.

Conclusion

The CFA has dismissed the Commissioner's appeal against the CA's decision on the balancing charge but on a basis different from that of the CA.. Although the CA concluded that it could deal with the Commissioner's new basis of assessment without the need for further evidence, the CFA disagreed.

The CFA has recognised that the expiry of the limitation period for making an additional assessment is not an absolute bar to the Commissioner making an assessment on an entirely new basis so long as the taxpayer will not be required to revisit and address transactions that occurred before the expiry of the limitation period. As in this case, the CFA has held that it would be unfair to the taxpayer if the Commissioner is allowed to vary his assessment to take into account the balancing charge as this will involve the taxpayer revisiting matters beyond the limitation period for raising a new assessment.

The CFA's judgment has important implications on the tax liability of a taxpayer who objects to/appeals against an assessment, as the taxpayer's profits tax exposure will not be restricted to the original assessment forming the subject matter of the appeal. So long as the Commissioner is able to demonstrate that it would not be unfair to the taxpayer (e.g. no further or additional investigation), the Commissioner could raise assessments on new grounds even after the expiry of the relevant limitation period.

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