

# HONG KONG TAX ALERT

ISSUE 2 | January 2013

## Aviation Fuel Supply Company Limited v CIR – nature of compensation payment – capital or revenue

In a further win for taxpayers, the Court of Appeal upheld the decision of the Court of First instance that a payment was not earned from the carrying on of business and was not taxable. The Court of Appeal handed down its judgement in *Aviation Fuel Supply Company v CIR* on 4 December 2012, finding in favour of the taxpayer. The case concerned whether a lump sum received by AFSC when its franchise agreement with the Airport Authority was terminated was subject to Hong Kong profits tax.

### Background

Aviation Fuel Supply Company (AFSC) entered into a Franchise Agreement with the Airport Authority (AA) to finance, design, construct and commission a fuel service facility (the Facility) at the Hong Kong Airport. As part of the Franchise Agreement, AFSC also entered into a lease with the AA to occupy the site as a tenant for a period of 20 years. The minimum rental under the lease was set at HKD 100.

An associated company of the taxpayer (the Operator), entered into an Operating Agreement with the AA, whereby the Operator earned fees from users of the Facility.

Under the Franchise Agreement, AFSC recovered the costs of constructing the Facility by means of monthly payments (Facility Payments) from the Operator. The recovery of the costs included a margin for a reasonable rate of return of not more than 15 percent.

The AA had the right to accelerate the repayment of the Facility Payments to AFSC. The AA duly notified AFSC of its election under the Franchise Agreement to 'accelerate AFSC's recovery of the Facility costs' and terminated the Lease Agreement. Further, the Operator was subsequently required to make the Facility Payments to the AA.

AFSC received an amount of USD 456,929,590 from the AA. The Inland Revenue Department argued that this amount was chargeable under section 14 of the Inland Revenue Ordinance (IRO), or alternatively, as deemed income under section 15A of the IRO. On the other hand, AFSC argued that the amount was of a capital nature and non-taxable under section 14 of the IRO.

## The decision

The decision of the Court of Appeal was in favour of the taxpayer that the receipt was not chargeable to tax under section 14.

The Court considered that AFSC was not selling building services to the AA; it was buying an interest in the Facility and its operating results. AFSC's obligation to build the Facility was the consideration it gave to acquire its rights, not a service it sold to the AA. The Facility Payments were the share of the operating results which AFSC had purchased, not the consideration received by it.

On this basis, it was held that the amount received did not represent the discounted present value of the Facility Payments, nor was it a receipt derived from AFSC's business. It was not earned *from* the carrying on of business, but arose outside the course of the business activity. It was a payment made by the AA at its election to acquire that business and was not something AFSC could choose to receive or not receive. For this reason, it was not chargeable to tax under section 14.

### *Capital vs. Revenue*

The Court considered the question of whether the amount was income or capital was irrelevant as they had already come to the view that the amount was not a receipt from the business of AFSC. However, the Court dealt with this issue as follows. Assuming that the Sum was from the business of AFSC, it should be brought into account for the purpose of profits tax only if it had the character of income, but not if it had the character of capital. The distinction was made between payments to compensate for loss of profits (which would have the character of income and are taxable) and payments made on the destruction of a business (which are inherently capital in character and not taxable).

### *Deemed trading receipts*

On the question of whether the amount was chargeable to profits tax by virtue of sections 15(1)(m) and 15A, three questions arose: (1) did AFSC have a right to receive income from the property; (2) if the answer to (1) is yes, was such a right transferred to the AA; if the answer to (3) is yes, can AFSC rely on the exception under section 15A(3).

The Court agreed that the judge of the Court of First Instance was correct to hold that from a business and practical view point, AFSC did have a right to receive income and it was a right derived from property, being its interests in the Facility or the business of exploiting the Facility. The Court also agreed with the judge that question (2) should be answered in favour of AFSC. No matter how widely the word 'transfer' is construed, the right of the AA to receive Facility Payments after payment of the Accelerated Facility Cost Payment was an original right already in the hands of the AA, not by virtue of something done by AFSC and did not move from the AFSC. Question (3) did not arise.

### *Depreciation allowance to the AA*

Finally, the Court held that there was a succession to the business of AFSC by the AA and that the assets for which depreciation allowances were claimed had passed by way of succession so that a balancing charge would not be made by virtue of sections 39B(7) and 39D(3). As the successor to the business, the AA would be entitled to claim depreciation allowances on the reducing value of the capital assets as at the time of succession.





# CONTACTS



**Khoon Ming Ho**  
Partner in Charge, Tax  
China and Hong Kong SAR

Tel: +86 10 8508 7082  
khoonming.ho@kpmg.com



**Ayesha M. Lau**  
Partner in Charge, Tax  
Hong Kong SAR

Tel: +852 2826 7165  
ayesha.lau@kpmg.com



**Chris Abbiss**  
Partner

Tel: +852 2826 7226  
chris.abbiss@kpmg.com



**Darren Bowdern**  
Partner

Tel: +852 2826 7166  
darren.bowdern@kpmg.com



**Barbara Forrest**  
Principal

Tel: +852 2978 8941  
barbara.forrest@kpmg.com



**Daniel Hui**  
Principal

Tel: +852 2685 7815  
daniel.hui@kpmg.com



**Charles Kinsley**  
Principal

Tel: +852 2826 8070  
charles.kinsley@kpmg.com



**John Kondos**  
Partner

Tel: +852 2685 7457  
john.kondos@kpmg.com



**Alice Leung**  
Principal

Tel: +852 2143 8711  
alice.leung@kpmg.com



**Curtis Ng**  
Partner

Tel: +852 2143 8709  
curtis.ng@kpmg.com



**Kari Pahlman**  
Principal

Tel: +852 2143 8777  
kari.pahlman@kpmg.com



**John Timpany**  
Partner

Tel: +852 2143 8790  
john.timpany@kpmg.com



**Wade Wagatsuma**  
Partner

Tel: +852 2685 7806  
wade.wagatsuma@kpmg.com



**Jennifer Wong**  
Partner

Tel: +852 2978 8288  
jennifer.wong@kpmg.com



**Chris Xing**  
Partner

Tel: +852 2978 8965  
christopher.xing@kpmg.com



**Karmen Yeung**  
Partner

Tel: +852 2143 8753  
karmen.yeung@kpmg.com



**Kate Lai**  
Director

Tel: +852 2978 8942  
kate.lai@kpmg.com



**Alex Lau**  
Director

Tel: +852 2143 8597  
alex.lau@kpmg.com



**Benjamin Pong**  
Director

Tel: +852 2143 8525  
benjamin.pong@kpmg.com



**Garry Laird**  
Senior Tax Advisor

Tel: +852 2143 8795  
garry.laird@kpmg.com

## [kpmg.com/cn](http://kpmg.com/cn)

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2013 KPMG, a Hong Kong partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. © 2013 KPMG Advisory (China) Limited, a wholly foreign owned enterprise in China and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International.