Hong Kong Tax Alert

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Non-deductible nature of upfront lump-sum payments for assignment of 2G and 4G radio spectrum for 12-year and 15-year periods upheld by Court

Whether a payment or expenditure is capital or revenue in nature is a matter of law. A recent court case[1] however reaffirms that the final outcome of any analysis may not depend on a strict legal classification of the item involved. A practical business and common-sense approach to applying the underlying case-law principles to the factual situation of a case is also required.

The application of the capital-versus-revenue indicia as established by the case-law authorities will depend on the factual context of a particular scenario and can in many instances be very complicated. Where necessary, clients should seek professional tax advice.

Background facts and issue in dispute

In the 1990s, the Appellant was initially only a second generation (2G) personal communications license holder, operating a certain bandwidth of radio frequency band for the provision of services to its customers.

Subsequently, in 2009, the Appellant successfully bid to pay an upfront lump-sum spectrum utilization fee (SUF) of HK$494,700,000 and HK$15,120,000 in a 4G and 2G auction respectively. As a result, certain new 4G and additional 2G radio frequency bands were assigned to the Appellant for a 15 year and 12 year period respectively together with the related licenses.

In its tax returns for the years 2009, 2010 and 2011, the Appellant claimed tax deductions for the straight-line amortization of the upfront lump-sum SUFs over the term of the relevant license.

The Commissioner of Inland Revenue (CIR) denied the Appellant's claims, determining that the amortization was a withdrawal of capital and therefore disallowable under section 17(1)(c) of the Inland Revenue Ordinance (IRO).

On the appeal of the Appellant, the tax tribunal of the Board of Review (BOR) upheld the CIR's determination. The Appellant then further appealed to the Court of First Instance (CFI).

The main arguments mounted by the Appellant in the CFI are discussed below.

1. China Mobile Hong Kong Company Limited v Commissioner of Inland Revenue HCIA 2/2017

Decision of the Court of First Instance

Whether the upfront SUFs were paid for the "right to use" or "actual use" of the radio spectrum?

Counsel for the Appellant contended that the upfront SUFs were a "prepayment" for the actual use of, as opposed to the right to use, the radio spectrum.

Counsel argued that it was only if the upfront SUFs were paid for the acquisition of an intangible asset in the form of a right to use the radio spectrum would the payments be capital in nature and hence disallowable. If the SUFs were a "prepayment" for the actual use of the spectrum, the payments were revenue in nature and therefore deductible under section 16(1) of the IRO.

In support of his contention that the SUFs were paid for the actual use of the spectrum, Counsel referred to certain provisions of the Telecommunication Ordinance (TO). One of those provisions specified that the Telecommunication Authority (TA) "may by order designate the frequency bands in which **the use** of spectrum is subject to the payment of spectrum utilization fee by the **users** of the spectrum".

As such, Counsel also argued that the payment of the SUFs was only a **condition precedent** (i.e., as a prepayment for the actual use of the radio spectrum) rather than a **consideration** for the assignment of the radio spectrum.

Rejecting the niceties of the legal language and argument employed by Counsel, the judge noted that there was no basis to argue that it was a purpose of the TO to (i) give out the right to use radio spectrum free of charge, or (ii) only charge on the actual use of radio spectrum.

The judge added that the wording of the legislative provisions relied upon by Counsel as noted above, namely "the use of spectrum is subject to the payment of spectrum utilization fee", is consistent with the notion that a spectrum utilization fee is required to be paid for either "the right to use" spectrum or that a spectrum utilization fee is required to be paid for the actual "use" of the spectrum.

Upon a consideration of the whole legislative scheme of the TO and looking at the matter from a practical business and common sense point of view, the judge held that the upfront SUFs were the consideration, or price, which the Appellant had to pay for the right to use the designated radio spectrum free from any interference (i.e., an exclusive right to use).

In support of his adopting a practical and business common-sense approach to applying the law to the facts, the judge cited various case-law authorities including the statement below made by Lord Pearce in *BP Australia Ltd v COT [1966] AC 224*:

> *"That answer depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process."*

The judge further noted that the upfront SUFs were payable regardless of whether the Appellant actually used, or made use of, the radio spectrum, and regardless of the extent of its use of the same.

Did the circumstances that led to the SUFs being charged as upfront payments rather than annual fees impact on the nature of the payments?

The requirement to pay SUFs for the assignment of radio spectrum was first imposed by the TA in 2001 when 3G licenses for mobile networks were granted in Hong Kong by means of an auction.

In that 3G licensing exercise, the licensees were only required to make payment of SUFs on an annual, or royalty basis, based on a percentage of the turnover subject to a minimum. At that time, adopting the royalty basis approach was viewed as a means by which to reduce the financial burden of the successful 3G licensees, thereby also benefiting their customers. It was feared that the licensees might otherwise have entered bids that were irrational if the assignment of the 3G radio spectrum were determined based on who made the highest upfront lump-sum SUFs.

After 2001 when the TA started to charge annual SUFs for the assignment of the 3G radio spectrum, the Appellant was later also required to pay annual SUFs from 2006, when it renewed its initial 2G license for the continued use of the original radio spectrum. The Inland Revenue Department (IRD) had allowed the Appellant's claims for tax deduction of the annual SUFs in its tax returns for all the relevant years.

In 2007, given that the 3G telecommunication services market had become more mature, the possibility that bidders would bid irrationally for the assignment of radio spectrum was no longer an overriding concern of the TA. As such, from 2007 onwards all new or additional 2G, 3G or 4G radio spectrum has been assigned to the bidders who offer to pay the highest upfront lump-sum SUFs.

The TA considered that changing the basis of assigning radio spectrum from an annual payment to a single upfront lump-sum was quick and easy to administer, and the amount of SUFs so determined would equally reflect the market value of the radio spectrum.

Against this background, Counsel for the Appellant argued that the drivers for the change in the charging basis for the assignment of radio spectrum were clearly limited to economic and business considerations and administrative convenience. As such, the change in the charging basis should not change the nature of such payments from revenue to capital. Counsel therefore contended that the upfront SUFs paid by the Appellant for the radio spectrum were revenue in nature, as being a "prepayment" for the actual use of the radio spectrum.

While accepting the submission of the Counsel regarding the circumstances and reasons for the change in the charging basis, the judge considered that it did not mean that the nature of SUFs paid under the two bases must, as a matter of law, both be regarded as either capital or revenue in nature (i.e., that the nature of the payments before and after the change must be the same).

The judge noted that the motive or purpose of the recipient (i.e., the TA in this case) in fixing the method of payment is not a relevant consideration in deciding whether the payment is capital or revenue in nature as far as the profits tax position of the payer is concerned. The correct question is what the payment (or expenditure) is calculated to effect from the payer's (not the recipient's) practical and business point of view.

From the Appellant's perspective, the judge considered that the payments were made to:

I. acquire an intangible asset in the form of the right to use the new or additional radio spectrum assigned. The new 4G radio spectrum enabled the Appellant to venture into a new line of business, and the additional 2G radio spectrum expanded and strengthened its existing line of 2G business, thereby enlarging the profit-earning structure of the Appellant;

II. the new or additional 4G and 2G radio spectrum would bring enduring benefits to the business of the Appellant for the next 15 years and 12 years under the term of the relevant license;

III. the upfront SUFs were lump-sum payments incurred once and for all, instead of periodic payments to meet an ongoing demand for expenditure.

On the above basis, the judge also rejected Counsel's argument on the point.

Relevance of the circulating capital test in determining the nature of the upfront SUFs

Counsel's circulating capital argument was heavily based on the *BP Australia* case heard by the Privy Council in the UK in 1965. In that case, it was held that lump-sum payments made by a petrol company to its network of petrol stations for the latter each agreeing to exclusively sell petrol supplied by the company for an average period of approximately 5 years, were deductible revenue expenses. In his judgment, Lord Pearce considered that the lump-sums paid were prima facie circulating capital of the petrol company, which had to come back penny by penny with every order placed with the company by a petrol station during the period of exclusivity concerned.

When the case was heard at the tax tribunal, whilst doubting the correctness or relevance of the circulating capital test as applied to this case, the BOR also added that there "is simply no evidence showing that the upfront SUFs have come back "penny by penny" with the customers' subscriptions to the particular 4G and 2G mobile services operated by the Taxpayer".

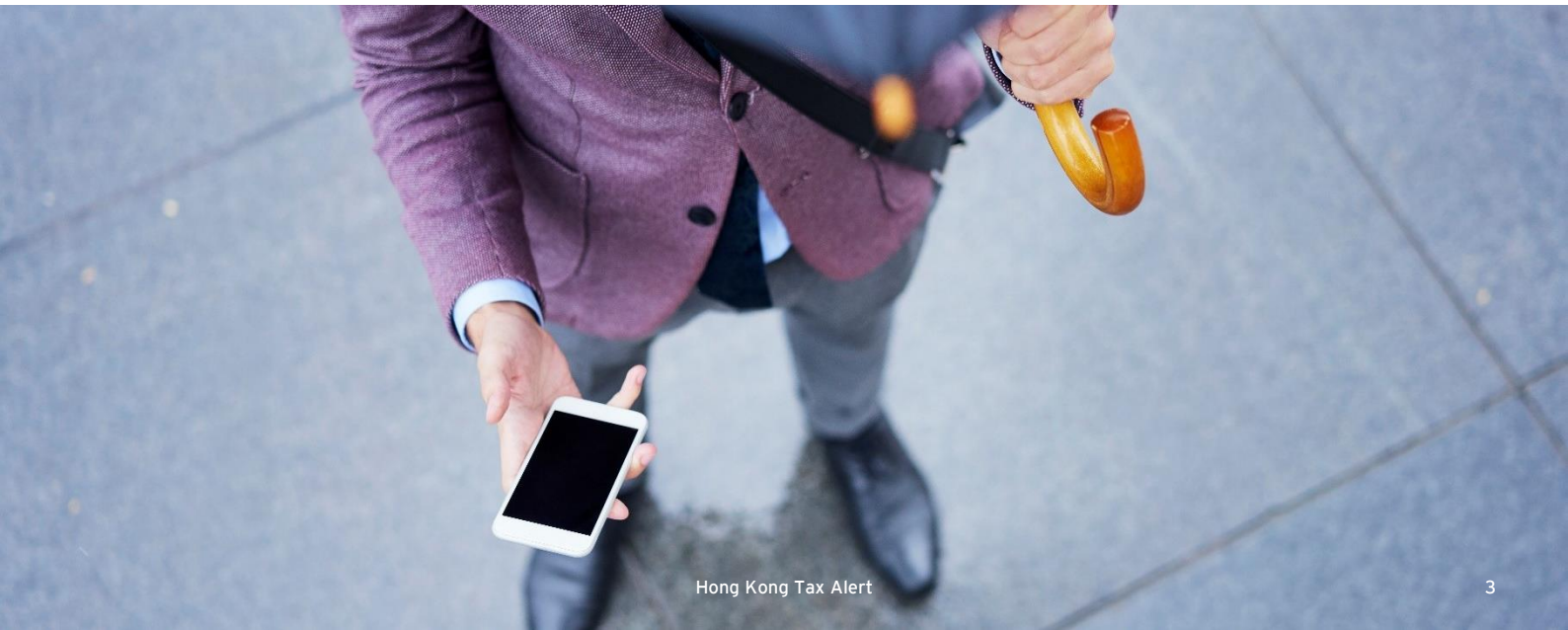
At the CFI, because there is no single decisive test to distinguish a revenue payment from one that is capital in nature, and given the presence of the capital indicia of the upfront SUFs as noted above, the judge also rejected the argument of the Counsel on the point as simply not assisting to advance the Appellant's case.

The judge added that that the circulating capital test may be more useful when one is concerned with the profits of a trading company which buys or sells goods and makes a difference between the purchase and sale price. It is, however, less useful when one is concerned with a service company which employs its capital in building an infrastructure to provide services to its customers in return for fees or charges.

Conclusion

Whether a payment or expenditure is capital or revenue in nature is a matter of law. This case however reaffirms that the final outcome of any analysis may not depend on a strict legal classification of the item involved. It is also necessary to adopt a practical business and common-sense approach when applying the underlying case-law principles to the facts and circumstances of a particular case.

In many scenarios however, how the capital-versus-revenue indicia of an item are to be applied to the facts of a particular case can be very complicated. Where necessary, clients should seek professional tax advice.



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