Hong Kong Tax Alert

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Court of Appeal upholds that upfront lump-sum payments for assignment of 2G and 4G radio spectrum for 12-year and 15-year periods were non-deductible capital expenditure

In our previous Hong Kong Tax alert, we reported that the Court of First Instance (CFI) ruled that upfront lump-sum spectrum utilization fees (SUFs) paid by the Appellant to the government for the assignment of 2G and 4G radio spectrum for 12-year and 15-year periods were capital in nature and non-deductible[1].

The Appellant lodged an appeal against the CFI decision. Recently, the Court of Appeal (CA) handed down its decision on the case upholding the lower court's decision and dismissing the taxpayer's appeal[2].

Before the CA hearing, Counsel for the Appellant advanced a new primary argument that the CFI judge misunderstood the Appellant's manner of earning its profits and misapplied the relevant tests in determining the nature of the upfront SUFs.

This new primary argument was however premised on the "agreed facts" that the upfront SUFs were incurred by the Appellant to use specific bands of the radio spectrum and sold the same to its customers. The upfront SUFs were therefore in the nature of circulating assets that came back "penny by penny" with the customers' subscriptions to the mobile telecommunication services operated by the Appellant. As such, the upfront SUFs should be regarded as ordinary revenue operating costs of the Appellant's business and tax deductible.

However, this new contention was only raised for the first time before the CA. No evidence was adduced before the tax tribunal of the Board of Review (BoR) for the BoR to make findings of facts as regards these "agreed facts". The CA therefore held that the new primary argument must be rejected as the Courts in Hong Kong must only base their decisions upon the facts found by the BoR.

In addition to the new primary argument, Counsel also pursued in the CA all the same grounds of appeal which he relied on in the CFI. The CA also rejected all these grounds of appeal essentially on the same reasons as those given by the CFI judge.

This alert discusses the CA decision.

1. Please refer to Hong Kong Tax alert – 17 August 2020 (2020 Issue No. 9) for details of the CFI decision.
2. China Mobile Hong Kong Company Limited v Commissioner of Inland Revenue (CACV 500/2020)

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 made a successful bid to pay an upfront lump-sum 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.

On the appeal of the Appellant, the BoR upheld the CIR's determination. The BoR's decision was upheld by the CFI. The Appellant then further appealed to the CA.

Decision of the CA

The new primary argument of the Appellant

In his new primary argument before the CA, Counsel contended that the CFI judge misunderstood the Appellant's manner of earning its profits and misapplied the underlying case-law principles in determining the nature of the upfront SUFs.

While the above contention was raised for the first time before the CA, Counsel submitted that the following "accepted facts" could support his new contention:

(i) a description of the Appellant's business as providing mobile telecommunication services in Hong Kong extracted from the CIR's determination;

(ii) an analysis of the Appellant's turnover for the years ended 31 December 2009 to 2011 as comprising substantial "airtime and service charges" included in the Statement of Agreed Facts placed before the BoR; and

(iii) the witness statement of the Appellant's Chief Executive Officer placed before the BoR stating his evidence that the SUFs were incurred in the process of carrying on the day-to-day income producing operations of the Appellant in its provision of a mobile telephone network service to its customers.

Counsel then argued that based on the "agreed facts", the true and only reasonable view was that as a mobile network operator, the Appellant earned its profits by paying the upfront SUFs to the government for the use of the designated radio spectrum and sold the same to its customers.

As such, Counsel contended that this was plainly a situation to which the "circulating capital" test as espoused by the Privy Council decision in *BP Australia Ltd v COT* [1966] was apt in describing, i.e., the SUFs were being turned over in the course of the Appellant's business of selling airtime and came back "penny by penny" with the customers' subscriptions to the 4G and 2G mobile services operated by the Appellant.

On the above bases, Counsel submitted that the upfront SUFs were incurred by the Appellant to use specific bands of the radio spectrum as part, and in the course of, its income operating process, to meet the cost of satisfying the continuous and constant demand of its customers themselves to use the same specific bands of the spectrum by transmitting the signals and was recovered by the Appellant charging its customers by reference to airtime for their use of the spectrum. Thus, the upfront SUFs were revenue in nature because they were the direct cost for a mobile network operator of providing airtime services to its customers.

The new primary argument was rejected

Under the existing tax appeal mechanism, it is for the BoR to make findings of facts including inference drawn from the primary facts and then based on the facts so found to answer the relevant questions of law.

On hearing an appeal against a decision of the BoR, while the Courts may draw any inference of fact, they must not receive any further evidence, or reverse or vary any conclusion made by the BoR on questions of fact unless the Courts find that the conclusion is erroneous in point of law.

The CA however considered that, on the bases below, the "accepted facts" relied on by Counsel did not provide evidential support for the new inference sought to be drawn:

(i) The first piece of "agreed fact", namely the description of the Appellant's business as providing mobile telecommunications services in Hong Kong extracted from the CIR's determination was only an earlier determination of the Deputy Commissioner and was not in fact in evidence before the BoR. It was not included in the subsequent Statement of Agreed Facts placed before the BoR.

(ii) The analysis of the Appellant's turnover for the years 2009 – 2011 as comprising substantial "airtime and service charges" provided no support for the inference that the Appellant had charged its customers' use of spectrum. This was because the analysis was silent on whose use of the spectrum for which the customers were charged, i.e., it could be that the customers were charged for the Appellant's own use of the spectrum rather than the customers' use of the spectrum.

(iii) The BoR only accepted the evidence of the Appellant's Chief Executive Officer in respect of the background concerning the upfront SUFs and refused to accept his evidence regarding the nature of the upfront SUFs. The BoR only noted that his evidence on the latter was just his personal opinion. Furthermore, the witness statement only mentioned that the use of the spectrum was by the mobile network operator and not by the customers.

In addition, the CA also noted that new contention was not argued before the BoR and the lower court and relevant evidence, such as the Appellant's contract with its customers on provision of telecommunication services, was not adduced for the BoR to make findings of fact from which appropriate inference may be drawn. Nor was there evidence showing that the upfront SUFs had come back "penny by penny" (applying the "circulating capital" test in *BP Australia*) with customers' subscription to the 4G and 2G mobile services operated by the Appellant. It would therefore be unfair to the CIR to allow the Appellant to run this new primary argument on appeal as the CIR had been deprived of the opportunity to adduce and make submissions on findings and inference that should be made.

For the above reasons, the CA rejected the new primary argument of the Appellant.

Other grounds of appeal by the Appellant in the CFI were also pursued in the CA but were all rejected

In addition to the new primary argument discussed above, Counsel also pursued in the CA all the grounds of appeal relied on by him in the CFI. The CA however rejected all these grounds of appeal essentially on the same reasons as those given by the CFI judge. Our previous tax alert analyzing the decision of the CFI can be accessed from this link.

In essence, the CA upheld the conclusion of the CFI that the upfront SUFs were non-deductible capital expenditures on the following grounds:

- The upfront SUFs were incurred to obtain a valuable right to use the designated spectrum exclusively for 12 or 15 years. 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. The upfront SUFs were therefore the cost of acquiring and enlarging the profit-earning structure of the Appellant.
- The upfront SUFs were not akin to the cost of buying trading stock in one go and securing a supply extending over several years but were once-and-for-all capital payments and did not form a regular part of expenditure in the Appellant's business.
- The upfront SUFs brought into existence fixed assets that brought enduring benefits to the Appellant for the next 12 years or 15 years under the term of the relevant license. The spectrum itself was not consumed or used up (although the period for which the right to use the spectrum exclusively would diminish with time) but was retained in the shape of assets and being used to produce income by providing services to the customers. They were in the nature of fixed capital, as opposed to circulating capital.
- The accounting treatment of amortizing the upfront SUFs by the Appellant as an expense could not be determinative of the issue.

Commenting on the "circulating capital" test in *BP Australia*, the CA also considered that the sum paid had to come back "penny by penny" with every order during the period in order to reimburse and justify the particular outlay should not be understood as asserting that the amounts paid by the taxpayer in that case were on revenue account merely because the taxpayer could, did or even had to amortize them over the cost of producing income. The CA was of the view that a taxpayer's capital outlay that can be expressed in terms of an economically equivalent projected stream of income payments does not convert the capital outlay into a revenue outgoing.

For the above reasons, the CA upheld the CFI decision and dismissed the Appellant's appeal.

Conclusion

Given the CA's comments on *BP Australia* noted above and that the upfront SUFs can hardly be said to be trading stock of the Appellant, one may wonder whether the CA's rejection of Counsel's new primary argument on the grounds that the "agreed facts" relied on were not found by the BoR was no more than a convenient way of dismissing the appeal.

In any case, the CA decision provides a reminder that in a tax appeal, the Courts of Hong Kong would only answer questions of law based upon the facts and evidence found by the BoR. At the outset of an appeal, litigants should be clear what facts are agreed and what not. If facts are not agreed, evidence should be introduced to establish the facts and the BoR be asked to draw inference based on the facts established. For example, in this case, whether the business of the Appellant was to resell the use of airtime it acquired from the government and whether its customers were charged for their use of the airtime should be established at the BoR.

Tax litigations and the procedures involved are by nature complicated. Where necessary, clients should seek professional tax advice at the earliest stage possible.

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