

Tax

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Hong Kong Tax Analysis

Court of Appeal upheld upfront lump sum spectrum utilisation fees as non-deductible

Hong Kong's Court of Appeal (CA) released its decision on *China Mobile Hong Kong Company Limited v. Commissioner of Inland Revenue [2022 HKCA 1637]* on 3 November 2022 and upheld the Court of First Instance's (CFI) judgement that upfront lump sum spectrum utilisation fees (SUFs) paid by the taxpayer to the Telecommunications Authority were capital in nature and hence not deductible for profits tax purpose.

In this article, we summarize the facts of the case and highlight the key messages of the CA's judgment. For a detailed discussion of the facts of the case and the CFI's judgment, please refer to our previous *Hong Kong Tax Analysis Issue H98/2020* published in September 2020.

Background

The taxpayer was engaged in the provision of mobile telecommunication and related services in Hong Kong.

In 2009, the taxpayer successfully bid a 4G spectrum for 15 years and two additional 2G spectrums for 12 years. According to the contracts, it paid upfront lump sum SUFs (Upfront SUFs) and annual licence fees to the Telecommunications Authority for the exclusive right to use the spectrums.

In the audited financial statements, the Upfront SUFs were classified as non-current intangible assets and amortised on a straight-line basis over the relevant licence periods.

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History of the dispute

The taxpayer claimed deduction on the amortisation of Upfront SUFs on the ground that the Upfront SUFs were revenue in nature.

The Inland Revenue Department (IRD) disagreed and disallowed the deduction claim on the ground that the Upfront SUFs were capital in nature.

The taxpayer lodged appeals to Board of Review (BoR), CFI and CA. All of them held that the Upfront SUFs were capital in nature and non-deductible.

Decision of the CA

The taxpayer relied on the same grounds of appeal as in CFI and lodged a new argument in the appeal to CA. CA upheld CFI's judgment with the following major comments:

- **Nature of Upfront SUFs** – CA confirmed that the Upfront SUFs brought into existence fixed assets of an enduring nature which were held and used by the taxpayer in its business of providing mobile telecommunications services to its customers. The spectrums were not consumed or used up but retained as assets for producing income. As such, they were in the nature of fixed capital, as opposed to circulating capital.
- **Enlarged profit-earning structure** – By paying the SUFs, the taxpayer's profit-yielding infrastructure was enlarged and strengthened. These findings were based on the press release issued by the taxpayer.
- **Accounting treatment** – CA considered that the accounting treatment cannot be determinative of the issue as a matter of principle. The expenditure cannot be concluded as revenue nature merely because the taxpayer amortized the payment over the cost of producing income.
- **Relevance of annual SUFs** – CA reaffirmed that there were significant differences between the Upfront SUFs and the annual SUFs, e.g. in terms of payment method, covered period, and calculation basis. Therefore, they did not fulfil exactly the same business and economic function. As such, the annual SUFs was not relevant in considering the deductibility of Upfront SUFs.

On top of the original grounds of appeal, the taxpayer tried to present a new argument, stating that the nature of its business was obtaining the spectrum from the government for reselling to its customers for their own use. The annual SUFs and Upfront SUFs paid for the use of spectrum should be a direct cost, and therefore revenue in nature.

In response, CA found that such contention was raised for the first time only in the appeal. In addition, the relevant evidence was not adduced to BoR for finding of facts from which inference may be drawn. CA reiterated that it could only rule on a question of law and draw inference of fact, but not receive any further evidence, or reverse or vary any conclusion made by BoR on questions of fact, unless it found that the conclusion was erroneous in point of law. As such, the CA rejected to accept the taxpayer to run this argument in the appeal.

In short, the CA rejected all the grounds of appeal raised by the taxpayer.

Our observation

The decisions all through BoR, CFI and CA are consistently not in favour of the taxpayer. There is no doubt that the judgment will have a negative impact on the telecommunication sector. In particular, the Upfront SUFs are regulatory payments that are required to be made for entering into the telecommunication business but they were considered as capital in nature and non-deductible.

On one hand, the Telecommunications Authority set an upfront lump sum payment as a bidding criteria for the spectrum. On the other hand, the IRD disallowed the upfront lump sum payment on the basis that it was capital in nature. This reduces the attractiveness of setting up telecommunication businesses in Hong Kong because the significant cost of business cannot be deductible for tax purpose. In order to improve Hong Kong's competitiveness in the telecommunication sector, the government should coordinate the different departments involved to come up with a solution.

Another point that is worth noting from this case is the CA's refusal to accept a new argument in the appeal. This reminds the taxpayer of the importance of bringing all the arguments and relevant facts to BoR as far as possible. Otherwise, additional information would not be entertained by the higher courts.

As of the date of this publication, it is yet known if the taxpayer will appeal to the Court of Final Appeal. Telecommunication companies should assess the impact of this case on their operations and seek professional advice accordingly.

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