Deloitte. 德勤

Tax
Issue H98/2020 – 23 September 2020

Hong Kong Tax Analysis

Court of First Instance ruled upfront lump sum spectrum utilisation fees non-deductible

Hong Kong's Court of First Instance (the CFI) ruled on 28 July 2020 in the case, *China Mobile Hong Kong Company Limited v. Commissioner of Inland Revenue [2020 HKCFI 1649]*, that upfront lump sum spectrum utilization fees paid by the taxpayer to the Telecommunication Authority were capital in nature and hence not deductible for profits tax purpose. The CFI made the decision based on the grounds that the subject payments, which were incurred once and for all, expanded the taxpayer's income-generating capacity and brought about enduring benefits.

In this Tax Analysis, we will summarise the facts of this case and highlight the key principles discussed.

Background

The taxpayer was incorporated in Hong Kong in 1994 and was engaged in the provision of mobile telecommunication and related services in Hong Kong. It paid the following spectrum utilization fees (SUFs) to the Telecommunications Authority (TA) for the use of assigned spectrum in order to provide communication services:

2G SUFs – Since 1996, the taxpayer had paid annual SUFs to TA for the use of radio spectrum for its second generation (2G) operations. The SUFs were set out on a cost-recovery basis, i.e., to cover the operating cost of TA in administering the licences. The Inland Revenue Department (IRD) accepted the annual SUFs as revenue nature and deductible.

4G SUFs – On 22 January 2009, the taxpayer successfully bid a 4G spectrum and paid an upfront lump sum SUF of HK$494.7 million to TA on 10 March 2009 for the exclusive right to use the assigned 4G spectrum for a period of 15 years.

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Additional 2G SUFs – On 10 June 2009, the taxpayer successfully bid two additional 2G frequency bands to enlarge its 2G spectrum capacity. The SUFs for the exclusive right to use the two additional 2G frequency bands for about 12 years consisted of two components: (a) annual variable sums calculated based on rate per kHz assigned and by reference to turnover, which were on the same basis as the existing 2G frequency bands assigned; and (b) a one-off lump sum (HK$15.12 million).

The upfront lump sum SUFs for 4G and the additional 2G spectrums were classified as non-current intangible assets and amortised on a straight-line basis over the relevant license period in the audited financial statements.

The dispute

The taxpayer claimed the amortisation of the upfront lump sum SUFs as deductible in the profits tax returns for the years of assessment 2009/10 to 2011/12.

However, the IRD considered that the upfront lump sum SUFs were capital expenditure and raised additional profits tax assessments for the years of assessment 2009/10 to 2011/12 to disallow the deduction of amortisation charge on the upfront lump sum SUFs.

The taxpayer appealed to the Board of Review (BoR) which also held that the upfront lump sum SUFs were capital in nature and non-deductible.

The case was then further appealed to the CFI.

Court decision

The CFI upheld the BoR's decision and ruled that the upfront lump sum SUFs were capital in nature and non-deductible based on the following grounds:

(1) Income-generating capacity – The upfront lump sum SUFs were paid for the acquisition of the right to use certain frequency bands in the 4G and 2G spectrums which were part of the necessary and permanent profit-earning structures required by the taxpayer to venture into a new line of business (i.e. the provision of 4G services), or expand and strengthen its existing line of business (i.e. the provision of 2G services), thereby boosting the income-generating capacity.

(2) Enduring benefits – The frequency bands in the 4G/2G spectrums brought about enduring benefits to the business of the taxpayer, in that it could provide 4G/additional or enhanced 2G services to its customers for the next 15/12 years.

(3) Once and for all – The upfront SUFs were lump sum payments incurred once and for all, instead of periodic payments to meet an ongoing demand for expenditure.

Major principles discussed

Capital vs. revenue expenditure

The CFI reiterated the well-established principles in determining whether an expenditure is capital or revenue in nature. Whether an expenditure is capital or revenue in nature is a question of law. There is no decisive test. The issue has to be approached by applying common sense from a practical and business point of view having regard to all relevant features of the case.

The CFI set out some useful *indicia* which can assist in determining the nature of an expenditure:

- once and for all *versus* recur every year;
- whether with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade;
- cost of creating, acquiring or enlarging the permanent structure of which the income is to be produced *versus* cost of earning that income itself or performing the income-earning operations.

Not necessary to sought distinction between a payment for the "right to use" and "use" of spectrum

The taxpayer put forth the argument that payment to acquire an asset or a right forming part of the profit-earning structure of a business was capital nature while payment relating to the operation of the regular income-producing process of the business was revenue in nature. The taxpayer contended that the upfront SUFs were paid for the "use" of the radio spectrum, not for the "right to use", and therefore were revenue in nature.

The CFI considered that it was wrong in principle to treat the distinction between payment for (i) the right to use, and (ii) the use of spectrum as being decisive of whether the payment was capital or revenue. Even so, the CFI was of the view that the upfront SUFs were paid for the right to use the designated spectrum, regardless of whether it actually used the spectrum.

Motive of the recipient in deciding the payment method is irrelevant in determining the nature of payment

TA started to require upfront payment of SUFs in lump sum for licensing of spectrum since 2007. The change of payment method was driven by TA due to economic, business and administrative considerations. The taxpayer argued that such considerations should not change the nature of the payment which should be remained as revenue in nature.

The CFI pointed out that the motive or purpose of the recipient in the method of payment should not be a relevant consideration in deciding whether the payment is capital or revenue in nature. The correct question is how the payment is calculated from the payer's (not the recipient's) practical and business point of view. In the present case, the upfront SUFs which were lump sum payments incurred once and for all by the taxpayer supported the view that they were capital in nature.

It does not follow that nature of expenditure under two payment basis must be consistent

The taxpayer argued that the IRD had previously accepted the annual SUFs as revenue in nature and deductible. As the change in payment method did not change the nature thereof from revenue to capital, the upfront lump sum SUFs should remain as revenue in nature and deductible.

The CFI did not consider that the SUFs paid under the two bases (i.e. annual and upfront lump sum) must consistently be regarded as either capital or revenue in nature. In particular, there were significant differences between the annual SUFs and upfront lump sum SUFs. The former payments were (i) made annually, and (ii) calculated by reference to the network turnover of the taxpayer while the latter upfront SUFs were lump sum payments incurred once and for all. As such, the nature of the annual SUFs and upfront lump sum SUFs should be considered separately.

Our observation

The tax treatment of lump sum upfront SUFs has long been a controversial issue faced by many telecommunication businesses in Hong Kong. It is yet to know whether the taxpayer will appeal to a higher level of court or not. The judgment of this case, if becomes final and conclusive, will definitely have a negative impact on the deductibility of similar expenditure incurred by other taxpayers in the same industry.

In the CFI decision, many of the long established principles of "capital versus revenue" were reiterated and discussed. However, having considered the evolving business environment and market practices, some of these principles may not be applicable or need to be re-interpreted. In this connection, we would suggest the Government consider introducing a legislative change or issuing departmental interpretation and practice notes to clarify the tax deductibility of this kind of "black-hole" expenditures related to intangible assets (i.e., expenditure being considered as capital in nature but not qualified for any deduction or capital allowances under the existing tax legislation). This can provide more guidance and certainty to taxpayers and help improving Hong Kong's competitiveness by providing a level playing field not only for the telecommunication sector, but as an international intellectual property hub.

On the other hand, telecommunication companies should assess the impact of this case on their operations and seek professional advice accordingly.

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