Chapter 1: Capital vs. Revenue: A Review of Precedent Cases and latest legislative development

Topic List

1. Distinction between capital and revenue receipts
2. Provisions in the IRO that deem capital receipts to be taxable
3. Distinction between capital and revenue expenditures
4. Reliefs for capital expenditures provided in the IRO
5. Contentious tax deductions: provisions for defined benefits retirement scheme and share-based employee benefits

Learning Focus

The chapter discusses the common law principles related to the nature of a receipt and expenditure and reviews the related tax provisions in the IRO.

Learning Outcomes

This chapter covers the following learning outcomes: an understanding of

1. The principles established in the case law in determining the nature of a receipt
2. The application of the Sharkey v Wernher principle in Hong Kong and the enactment of Section 15BA
3. The relevant provisions that deem certain receipts to be taxable
4. The principles established in the case law distinguishing between capital and revenue expenditure
5. Possible statutory reliefs for certain capital expenditure
6. Tax treatments of provisions for defined benefits retirement scheme and share-based employee benefits

Abbreviations

BoR	Board of Review
CFA	Court of Final Appeal
CFI	Court of First Instance
CIR	Commissioner of Inland Revenue
COA	Court of Appeal
DIPN	Departmental Interpretation and Practice Note
EPI	Environmental protection installation
EPM	Environmental protection machinery
FAQs	Frequently asked questions
HKFRS	Hong Kong Financial Reporting Standards
HKICPA	Hong Kong Institute of Certified Public Accountants
IP	Intellectual property
IRD	Inland Revenue Department
IRO	Inland Revenue Ordinance
R&D	Research and development

Table of Contents

1. OVERVIEW

In determining the assessable profits of an entity, (i) capital receipts are excluded under section 14 while (ii) capital expenditures are not deductible under section 17 except in the situations where there are specific provisions in the IRO governing the deductibility of specific capital expenditures. Hence it is important for tax advisors to understand how to distinguish capital receipt (as opposed to trading receipt) as well as capital expenditure (as opposed to revenue expenditure).

Distinction between what is capital and what is not has been argued and debated in numerous court cases. Conclusion in a particular case is usually based on a balanced judgment of the facts of that case. The arguments and conclusions presented in these cases provide some generic guiding principles in making a distinction, yet no single simple test can be used in all circumstances. It is also important to understand that when a sum was determined as capital payment in the hands of the payer, it is not necessary for the sum to be considered as capital receipt in the hands of the recipient, e.g. selling of a residential property by a property developer as a trading stock to an individual holding the property as a long term investment. The business model of the payer, hence the facts leading to the conclusion, may not be the same as that of the recipient.

Although capital receipts are specifically excluded under section 14, some capital receipts are deemed as taxable under the deeming provisions of section 15 or other provisions. On the other hand, there are provisions in the IRO providing tax reliefs for certain capital expenditures.

The tax treatments of provisions for approved defined benefits retirement schemes and share-based payments are quite different from their accounting treatments. These differences have caused concerns for tax practitioners. In the past few years, the IRD has clarified their positions. The last part of this Chapter is devoted to the discussion of these two contentious issues.

2. CAPITAL VS REVENUE RECEIPTS

2.1. Receipts upon disposal of an asset

Receipts upon disposal of an asset can be a trading receipt if the asset is purchased by a business with the intention to resell. On the other hand if the intention of the business is to purchase the asset for its own operations or as investment, receipts from any subsequent disposal would be considered as capital receipts.

The judge in *Marson v Morton (1986)*, an English case, concluded that whether there has been an adventure in the nature of trade is a question of fact that depends on all the facts and circumstances of each particular case. The judge expanded upon the badges of trade, specifying nine factors to be considered in determining the existence of a trade.

(i) "The transaction in question was a one-off transaction. Although a one-off transaction is in law capable of being an adventure in the nature of trade, obviously the lack of repetition is a pointer which indicates there might not here be trade but something else.

(ii) *Is the transaction in question in some way related to the trade which the taxpayer otherwise carries on? For example, a one-off purchase of silver cutlery by a general dealer is much more likely to be a trade transaction than such a purchase by a retired colonel.*

(iii) *The nature of the subject matter may be a valuable pointer. Was the transaction in a commodity of a kind which is normally the subject matter of trade and which can only be turned to advantage by realisation, such as referred to in the passage that the chairman of the commissioners quoted from Inland Revenue Commissioners v. Reinhold, 1953 S.C. 49. For example, a large bulk of whisky or toilet paper is essentially a subject matter of trade, not of enjoyment.*

(iv) *In some cases attention has been paid to the way in which the transaction was carried through: was it carried through in a way typical of the trade in a commodity of that nature?*

(v) *What was the source of finance of the transaction? If the money was borrowed that is some pointer towards an intention to buy the item with a view to its resale in the short term; a fair pointer towards trade.*

(vi) *Was the item which was purchased resold as it stood or was work done on it or relating to it for the purposes of resale? For example, the purchase of second-hand machinery which was repaired or improved before resale. If there was such work done, that is again a pointer towards the transaction being in the nature of trade.*

(vii) *Was the item purchased resold in one lot as it was bought, or was it broken down into saleable lots? If it was broken down it is again some indication that it was a trading transaction, the purchase being with a view to resale at profit by doing something in relation to the object bought.*

(viii) *What were the purchasers' intentions as to resale at the time of purchase? If there was an intention to hold the object indefinitely, albeit with an intention to make a capital profit at the end of the day, that is a pointer towards a pure investment as opposed to a trading deal. On the other hand, if before the contract of purchase is made a contract for resale is already in place, that is a very strong pointer towards a trading deal rather than an investment. Similarly, an intention to resell in the short term rather than the long term is some indication against concluding that the transaction was by way of investment rather than by way of a deal. However, as far as I can see, this is in no sense decisive by itself.*

(ix) *Did the item purchased either provide enjoyment for the purchaser, for example a picture, or pride of possession or produce income pending resale? If it did, then that may indicate an intention to buy either for personal satisfaction or to invest for income yield, rather than do a deal purely for the purpose of making a profit on the turn. I will consider in a moment the question whether, if there is no income produced or pride of purchase pending resale, that is a strong pointer in favour of it being a trade rather than an investment.'*

The leading Hong Kong tax case on this issue is ***All Best Wishes Ltd v CIR (1992)***. The judge in this case reaffirmed that whether there is a trade is an objective decision of fact. There is no single and decisive factor to determine whether a transaction is revenue or capital in nature and "*the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of the evidence*".

In another Hong Kong tax case, ***Lee Yee Shing and Yeung Yuk Ching v CIR (2008)***, the judge reiterated the objective indicators of an intention to trade are *"whether the taxpayer:*

1. *has frequently engaged in similar transactions?*
2. *has held the asset or commodity for a lengthy period?*
3. *has acquired an asset or commodity that is normally the subject of trading rather than investment?*
4. *has bought large quantities or numbers of the commodity or asset?*
5. *has sold the commodity or asset for reasons that would not exist if the taxpayer had an intention to resell at the time of acquisition?*
6. *has sought to add re-sale value to the asset by additions or repair?*
7. *has expended time, money or effort in selling the asset or commodity that goes beyond what might be expected of a non-trader seeking to sell an asset of that class?*
8. *has conceded an actual intention to resell at a profit when the asset or commodity was acquired?*
9. *has purchased the asset or commodity for personal use or pleasure or for income?"*

The conclusion of whether the relevant profit is a trading profit is based on totality of facts. All the facts should be considered together and no one single fact overrides the others. When considering all the facts, one fact may be considered as important in one case while the same fact may not be considered as so important in another.

The earliest Hong Kong tax case related to whether a trade existed was ***CIR v Dr. Chang Liang Jen (1977)***. In this case, the taxpayer had a doctoral degree in economics and had numerous transactions in shares. The gains he made from these transactions were held by the BoR as non-trading profits. In the appeal by the Commissioner, the court held that to determine whether an activity is an adventure of trade was a matter of facts and was conclusive in the decision of the Board and hence there was no point of law for the court to consider.

On the other hand, the insurance company in the case ***CIR v Sincere Insurance & Investment Co Limited (1973)*** was held to be engaged in trading when it sold part of its property. The court held that realization of property was one of the normal steps in the operations of insurance business. Similarly, in the case *Central Enterprise Limited v CIR (1986)*, having no evidence to show there was an intention to hold the property for long-term investment, the company was held by the court to have derived trading profit from the disposal of those properties.

The Hong Kong tax cases on the same subject include: ***Beautiland Co Ltd v CIR (1991), CIR v Waylee Investment Limited (1990)***, ***Brand Dragon Limited and Harvest Island International Limited v CIR (2002)***, ***Stanwell Investments Limited v CIR (2004)***, ***China Map Limited & Others v CIR (2005), Church Body of the Hong Kong Sheng Kung Hui &***

Hong Kong Sheng Kung Hui Foundation v CIR (2014) and Aviation Fuel Supply Co v CIR (2015).

2.2. Change of intention

2.2.1. The Sharkey v Wernher Principle

A company acquires an asset with the original intention to hold for long-term may decide later to hold the asset as trading stock and vice versa. When there is a change of intention on the use of the asset, there would be potential consequences on the tax treatments of the asset.

When the intention has been changed from trading (or short-term) to capital (or long-term), at the date of change of intention, the asset is no longer a trading stock. It becomes the capital asset of the company. According to the English case of ***Sharkey v Wernher (1956)***, the excess of the market value over its historical cost should be treated as taxable on the date of change of intention, as if the company had sold the trading asset on the date.

On the other hand, the intention of holding an asset may be changed from capital asset to trading stock. The taxable profit of the disposal of the asset subsequent to the change of intention is the excess of the sales proceed of the asset over the market value on the date of change of intention.

2.2.2. Application of the Sharkey v Wernher Principle in Hong Kong

In the Hong Kong case, ***CIR v Quitsubdue (1999)***, although the taxpayer was found to have changed its intention of holding its property from trading stock to capital stock upon the change of shareholding in the company, the Board refused to accept that the principle in *Sharkey v Wernher* applied in Hong Kong. The Commissioner appealed to the CFI. The CFI upheld the Board decision but on a different reason. The judge concluded that there is no change of intention in the first place. The intention had been for long-term from the very beginning and hence the gain so derived was capital in nature.

In her judgment, the judge, however, did comment that the principle of *Sharkey v Wernher* should not be applicable in Hong Kong on the ground that a person could not make a profit trading with oneself. Instead of taxing the notional profits, the proper tax treatment should be withdrawn all expenses related to the asset previously allowed. Although this is an *obiter dictum*, it casted doubts on the application of the *Sharkey v Wernher* principle in Hong Kong before the enactment of the Inland Revenue (Amendment) (No. 6) Ordinance 2018 (see 2.2.4 below).

There are two cases which illustrate the issue of capital vs trading and the issue of change of intention. The ***Church Body of the Hong Kong Sheng Kung Hui & Hong Kong Sheng Kung Hui Foundation v CIR (2014)*** and ***CIR v Perfekta Enterprises (2018)***. The issue in the latter case is whether an "initial payment" received by the taxpayer pursuant to a redevelopment agreement entered into with a land developer to co-redevelop a piece of land previously held by the taxpayer as a capital asset is capital or revenue nature. The CFA handed down its judgment in the latter case in July 2019. The CFA overturned the lower courts' judgments and held that there was <u>no change of intention</u> of the taxpayer from holding the land as capital asset to trading stock and therefore the initial payment received by the taxpayer is capital in nature and not subject to profits tax.

The *Church* ***Body of the Hong Kong Sheng Kung Hui & Hong Kong Sheng Kung Hui Foundation v CIR (2014)*** which illustrates the issue of change of intention was summarised as follows:-

2.2.3. Church Body of the Hong Kong Sheng Kung Hui & Hong Kong Sheng Kung Hui Foundation v CIR (2014)

There are three issues in this case: (1) whether the profits derived from the disposal of properties were trading profits, (2) if the profits were not trading profits from the beginning, were there any change of intention before the disposal, and (3) could the taxpayer, as a charity, be entitled to have the profits exempted under section 88 of the IRO.

In this case, two charitable bodies of Hong Kong Sheng Kung Hui (i.e. the taxpayers) owned land in Tai Po together since the 1930s with part of the land occupied by an orphanage. In September 1989, the taxpayers were seriously considering relocating the orphanage and redeveloping the land. Thereafter, a series of actions were taken by the taxpayers between 1990 and 1998 which eventually led to the sales of certain residential units and car parking spaces on the redeveloped land with substantial profits.

The following table summarises the various actions taken by the taxpayers in redeveloping the land and disposing the redeveloped properties together with the timeline of those actions.

September 1989	The re-provisioning of the orphanage was treated as a separate project and the taxpayers applied for planning permissions to redevelop the land into a residential area.
Early 1990s	Architects commissioned by the taxpayers submitted various plans to the HKSAR Government for the purposes of obtaining planning permission for a substantial residential development on the land.
December 1990	Architects appointed by the taxpayers applied for a land exchange to permit the building of the residential development as approved.
May 1993	A land premium of HK$704 million was agreed between the taxpayers and the HKSAR Government.
July 1993	The taxpayers invited various developers to submit tender offers either to purchase the land outright from the taxpayers or to enter into a joint venture with the taxpayers for the redevelopment of the land.
August 1993	The taxpayers accepted the tender from one of the developers for forming a joint venture for the redevelopment.
November 1993	The taxpayers surrendered the land to the HKSAR Government in exchange for a new grant of the land.
December 1993	The taxpayers entered into a joint venture agreement with the selected developer for the redevelopment of the land as a private residential area.
March 1998	Certain number of residential units and car parking spaces on the redeveloped land were allocated to the taxpayers.

August 1998	An occupation permit for the development was issued by the HKSAR Government.
1998 to 2006	The taxpayers sold the residential units and car parking spaces and derived a profit of around HK$1.1 billion.

Profits tax assessments were issued to the taxpayers in respect of the profits made from sales of the redeveloped properties. The taxpayers appealed against the assessments to the Board based on the following grounds:

- There was no change of intention in respect of the purpose of holding the land. The land had always been held for investment purpose and not for trade.
- As an alternative, any change of intention only occurred (1) in August 1993 when the taxpayers accepted the tender from a property developer for forming a joint venture for redeveloping the land into a private residential area or (2) in December 1993 when the taxpayers entered into a joint venture agreement with that property developer for the redevelopment.
- Section 88 of the IRO, which exempts approved charitable institutions from tax, should be applicable as the conditions specified in that section were satisfied.

The Board affirmed the assessments and held that although the taxpayers initially acquired the land as a capital asset, there was a change of intention from capital holding to trading by September 1989 (when the re-provisioning of the orphanage had been treated as a separate project and the taxpayers applied for planning permission for the residential development) or December 1990 (when the taxpayers applied for a land exchange to permit the building of the residential development as approved) at the latest.

Matters that the Board had taken into account in its conclusion include: (1) change in the nature of the use of the land; (2) the taxpayers approached the redevelopment on commercial principles; (3) appointment of professional advisers including architects and lawyers to work on the redevelopment; (4) applying for planning permissions to redevelop the land; (5) applying for land exchange and the granting of the exchange; and (6) active marketing of the disposal of the land by the taxpayers by approaching developers in Hong Kong for offers and tenders.

The Board also held that section 88 of the IRO was not applicable since the taxpayers failed to discharge their burden of proof in providing sufficient evidence to demonstrate that the three conditions specified in the section were satisfied, namely (1) the profits are applied solely for charitable purposes; (2) the profits are not expended substantially outside Hong Kong; and (3) the trade or business carried on by the charitable institution from which the profits are derived is exercised in the course of the actual carrying out of the expressed objects of such institution.

On appeal by the taxpayers, the CFI upheld the Board’s decision as it found that the Board's conclusion was not perverse or unreasonable based on the evidence adduced. The taxpayers then further appealed to the COA. The two issues put forward for the COA to consider in the appeal are:

- Whether there was any change of intention from capital holding to trading/business, whether by September 1989 or December 1990 or at all.

- Whether section 88 of the IRO should apply if there was a change of intention.

The COA overturned the CFI's judgment and held that there was no change of intention from capital holding to trading by September 1989 or December 1990 on the following grounds:

- The purpose of acquiring the land was not for trading purpose. Realisation of the land would not turn it into trading even with the work done on the land for the purpose of maximising the profit in the disposal.
- Land owners can, to a certain extent, enhance the value of their land for realisation purposes. In this case, the various enhancement activities (e.g. engaging professionals to work on the development, seeking planning permissions and applying for land exchange) taken by the taxpayers in the period up to December 1990 were merely part of the process of realising the land to achieve the best return. These enhancement activities would not cause the realisation of asset to become a business and do not mean the taxpayers were then engaged in trading. This argument is referred to as the 'Enhancement for realisation principle' in the case.
- The taxpayers only accepted the HKSAR Government's terms of the land exchange, invited submission of tender offers and entered into a joint venture agreement with the selected property developer in 1993, which was nearly three years after the date of change of intention was found by the Board.

As for the issue of whether the change of intention occurred on some other subsequent dates, the COA held that due to the lack of analysis by the Board on this issue, the issue could only be decided by the Board when the matter is remitted to it for consideration. The COA therefore remitted the case to the Board for it to consider whether the change of intention occurred in August 1993 or December 1993 or alternatively some other date or dates (other than September 1989 or December 1990).

Given the COA found that there was no change of intention in September 1989 or December 1990, it is not necessary for it to rule on whether section 88 of the IRO applied to the taxpayers. However, in its *obiter dictum*, the COA made some important observations regarding the application of section 88 as well as the general rules of the tax appeal procedures.

The Commissioner then appealed against the COA's judgment to the CFA. The main issues raised by the CIR in its appeal to the CFA are:

- Whether there is any 'enhancement for realisation' principle established by case law as cited by the COA in its judgment; and
- Whether the Board erred in law in not applying the 'enhancement for realisation' principle and determined that the taxpayer had changed their intention to trading based solely on the enhancement activities carried out by the taxpayers.

The CFA handed down its judgment on 4 February 2016. It dismissed the CIR's appeal and upheld the COA's decision that there was no change of intention by the taxpayers by September 1989 or December 1990 on the following grounds:

- There is no ‘enhancement for realisation’ principle laid down by case law. Such principle is contrary to the holistic approach of taking into accounted all the facts and circumstances of a particular case in deciding whether the taxpayer is engaged in a trade.
- Whether the taxpayer’s activities to enhance the value of the asset disposed amount to a trade or business is a question of fact and degree and has to be answered by considering all the facts and circumstances of each particular case as well as the interaction between the various factors present in the case.
- Although the badges of trade provide some guidance on determining whether there was trading or intention to trade, no list of relevant factors can be exhaustive and no single factor can be decisive. The badges of trade should not be applied mechanically but with a holistic approach.
- In this case, the Board failed to consider a critical badge of trade in its decision, namely “whether the taxpayer has expended time, money or effort in selling the asset or commodity that goes beyond what might be expected of a non-trader seeking to sell an asset of that class?”
- The CFA held that the taxpayers’ enhancement work in 1989 or 1990 was necessary for finding out the potential of the land and ascertaining its maximum value. None of those enhancement activities had gone beyond what might be expected of a non-trader owner in similar circumstances. This is particular true as the land concerned was an agricultural and restricted building land which would not yield a very attractive price if it were to be sold as such.
- To infer there is a change of intention to trade, precision in the fact finding process is required. The inference must be grounded on clear findings of primary facts and the inference must be a logical consequence of those facts. The Board’s finding that the taxpayers had formed the intention to trade by September 1989 or December 1990 was not formulated with particular precision. Although the Board had considered the various badges of trade based on the facts of the case, it failed to evaluate/ elaborate on how its fact findings on the various badges of trade support its conclusion that there was a change of intention.
- The taxpayers had two options in 1993, that is, either to (1) accept the developer’s offer to purchase the land outright or (2) enter into a joint venture with the developer for the redevelopment of the land. If the taxpayers accepted to sell the land outright, it would be difficult to see that they would be trading in the land. This shows that the taxpayers did not have a firm intention to commit to one method or another before they had determined to take the second option in August 1993.

Based on the above, the CFA held that although the COA erred in applying the so-called ‘enhancement for realisation’ principle, it was correct to conclude that there was no change of intention of the taxpayers from capital holding to trading/ business by September 1989 or December 1990. Accordingly, the CFA dismissed the CIR's appeal and the case will be remitted back to the Board for it to ascertain whether a change of intention occurred on a later date as previously ordered by the COA.

While the ultimate finding is very often a matter of degree and fact-specific, one key message for taxpayers from the CFA's judgment in this case is that certain enhancement activities performed by a taxpayer to enhance the value of its capital asset before disposal would not render the transaction an adventure in the nature of trade, provided that such activities do not go beyond the 'safety zone' (i.e. activities that may be expected of a non-trader owner to maximise the value of the asset before disposal). However, there is no universal rule on what may be expected of a non-trader owner as that also varies depending on the particular fact patterns of each case.

2.2.4. Codification of the Sharkey v Wernher Principle: Section 15BA

The Inland Revenue (Amendment) (No. 6) Ordinance 2018 introduced a specific provision – section 15BA, which formally codifies the Sharkey v Wernher principle in Hong Kong. Pursuant to the provision, taxpayers are required to have tax adjustments to bring into account the market value of an asset as deemed taxable trading receipt, or vice versa cost to the taxpayer, when a change of intention has occurred in respect of the asset, that is from trading stock to for non-trading purposes or inversely from non-trading purposes to trading stock, effective from year of assessment 2018/19.

2.3. Other receipts

As discussed above, if an asset is purchased with the intention for one's own operations, the receipts upon disposal of that asset should be considered as capital in nature. There are situations where sums are received without disposal of an asset. For example, compensation received for the interruption of business operations or financial subsidies. In determining whether such sum is capital in nature or otherwise, particular facts of the case are important. The following principles have been established from tax cases.

2.3.1. Compensation for the loss of an asset

Receipt derived from permanent loss of a fixed asset is capital receipt. In the case of ***Glenboig Union Fireclay Co Ltd v CIR (1922)***, the taxpayer operated as a business of extracting fireclay from beds underlying the railway tracks of a railway company. The latter took legal action to prevent the taxpayer to continue to extract fireclay but failed. Then the railway company paid the taxpayer a sum of money in return for stopping work on the fireclay bed. The sum was determined as a capital receipt and not taxable. In the court, Lord Wrenbury explained:

> *"Was that compensation profit? The answer may be supplied, I think, by the answer to the following question: Is a sum profit which is paid to an owner of property on the terms that he shall not use his property so as to make a profit? The answer must be in the negative. The whole point is that he is not to make a profit and is paid for abstaining from seeking to make a profit…It was the price paid for sterilising the asset from which otherwise profit might have been obtained".*

2.3.2. Compensation for the suspension of the use of an asset

Contrasting the case of *The* ***Glenboig Union Fireclay Co Ltd v CIR (1922)***, the sum received by the taxpayer in the case of ***Burmah Steam Ship Co Ltd v CIR (1930)*** was held to be a trading receipt. The taxpayer in this case received compensation from a ship repairer for delay in completion of repairs. The payment was to cover the consequential loss of expected profits had the vessel been available for business operations on time. The compensation has the same nature of trading profits lost during the repairs.

In distinguishing this case from the case of ***Glenboig Union Fireclay Co Ltd v CIR (1922)***, Lord Clyde drew the following distinction between filling a hole in the trader's profits and filling a hole in the trader's assets:

> *"Suppose some one who chartered one of the appellant's vessels breached the charter and exposed himself to a claim of damages at the appellant's instance, there could, I imagine, be no doubt that the damages recovered would properly enter the appellant's profit and loss account for the year. The reason would be that breach of the charter was an injury inflicted on the appellant's trading, making (so to speak) a hole in the appellant's profits, and the damages recovered could not therefore be reasonably or appropriately put by the appellant - in accordance with the principles of sound commercial accounting - to any other purpose than to fill that hole. Suppose, on the other hand, that one of the appellant's vessels was negligently run down and sunk by a vessel belonging to some other ship owner, and the appellant recovered as damages the value of the sunken vessel, I imagine that there could be no doubt that the damages so recovered could not enter the appellant's profit and loss account because the destruction of the vessel would be an injury inflicted, not on the appellant's trading, but on the capital assets of the appellant's trade, making (so to speak) a hole in them, and the damages could therefore - on the same principles as before - only be used to fill that hole."*

Similarly in the case of ***London & Thames Haven Oil Wharves Ltd v Attwooll (1966)***, the taxpayer received a compensation for damage to one of its jetties rendering it unusable for a year. The compensation for the loss of use of the jetty was to make up a hole in the profits and was taxable.

2.3.3. Compensation for the loss of profits

Applying the principle in the case of ***London & Thames Haven Oil Wharves Ltd v Attwooll (1966)***, the court in the cases, ***White v G & M Davies (1979)*** **and** ***CIR v W Andrew Biggar (1982)***, held that the ***<u>compensation to the farmers to make a notional loss of income during the period when the farmers had undertaken to convert from dairy activities into meat production were taxable as trading income</u>***.

Browne-Wilkinson J, in the case of ***White v G & M Davis (1979)***, had the following reasoning for his application of the principle in ***London & Thames Haven Oil Wharves Ltd v Attwooll (1966)***:

> *"……It seems to me that the principle as stated applies to all cases where somebody, whether under ordinary contract, or under a contract of insurance, or by way of damages,*

receives a sum of money intended to make good, or to help in making good, a deficiency of some sort in receipts he would otherwise have had. Therefore, the question to be answered is this: Is the premium received under the EEC scheme to be treated as a premium paid to make good income losses which would otherwise have been suffered by the taxpayers, or is it to make good, or to help to make good, a capital loss?"

2.3.4. Compensation for the cancellation of contracts

In general, a compensation arising from ***a trading contract, either sales or purchases contract, is revenue in nature***.

Compensation for cancellation of long-term business contracts fundamental to the existence of the business may be regarded as capital receipts. In the case of *Van Den Berghs Limited v Clark (1935)*, the taxpayer had an agreement with a foreign company over the production of margarine. When the agreement was terminated, the foreign company paid a sum to the taxpayer in consideration of its release from the agreement. The court held that the sum received was capital in nature as the agreement was related to the whole business structure of the taxpayer. Similarly in the case of ***Barr, Crombie & Co Ltd v CIR (1945)***, the taxpayer received a sum as a result of the cancellation of a ship management agreement. The entire business of the taxpayer relied on this agreement. The sum was held to be capital in nature. The same argument was applied by the Hong Kong BoR in its decision *D64/98*, in which the compensation for early termination of distribution agreement was held to be for the loss of the taxpayer's capital asset and a destruction of its profit-making structure.

By contrast, the compensation received by the taxpayer in the case of ***Short Brothers Ltd v CIR (1927)*** for the cancellation of contracts for the construction of two ships was held to be a trading receipt. Similarly in the case of ***Kelsall Parsons & Co Ltd v CIR (1938)***, the compensation received by the taxpayer for the cancellation of one of the many agency contracts it had was found to be a trading receipt. In this case, Lord Normand, drew the following important distinction between the contracts in the *Kelsall Parsons* case and the agreements in the *Van Den Berghs* case:

> *"…..That was a contract incidental to the normal course of the Appellant's business. Their business, indeed, was to obtain as many contracts of this kind as they could, and their profits were gained by rendering services in fulfilment of such contracts.*

2.3.5. Compensation for the loss of right

If the ***compensation received by a business is for the loss of right, no matter that right is recorded in the financial statements of the business or not, the sum received is likely to be considered as capital in nature***. In the case of *Higgs v Olivier (1952)*, an actor Sir Laurence Olivier received a sum in return for agreeing not to take part in any films for a period following the release of the film in which he was the leading actor. Olivier's income was subject to tax as professional income. The sum was held to be capital in nature, Singleton L J felt that the sum "*was a payment for abstaining from following his vocation*."

2.3.6. Financial subsidies or assistance

It is possible to apply common law principles established in tax cases to tax financial subsidies which are revenue in nature. In the case of ***Smart v Lincolnshire Sugar Co Ltd (1937)***, the taxpayer received a weekly subsidy under the statute from the government when the price of sugar fell. There would be repayment when the price of imported sugar rose above certain levels. The court held that the weekly subsidies were revenue receipts.

In a later case of the ***British Commonwealth International Newsfilm Agency Ltd v Mahany (1962)***, a payment made by the holding company of the taxpayer to the taxpayer expressly to compensate its trading losses, to supplement its trading revenue, to contribute towards its ongoing trading expenses, or to preserve and maintain trading stability and solvency was held to be revenue in nature.

Reference should be made to Section 15(1)(c) (See 2.4.1 below) of the IRO which deems certain subsidies or grants as taxable.

2.3.7. Compensation for the loss of trading stock

Compensation for the loss of trading stock can be viewed as proceeds from the sales of the stock. In ***J Gliksten & Son Ltd v Green (1929)***, the company received an insurance recovery for the timber that was destroyed by fire, as the timber is part of the trading stock of the taxpayer, the receipt was held to be a trading receipt. In his judgment, Lord Buckmaster made the following comments:

> *"What has happened has been this, that the timber which the appellants held has been converted into cash. It is quite true it has been converted into cash through the operation of the fire, which is no part of their trade, but loss due to it is protected through the usual trade insurances, and the timber has thus been realised. It is now represented by money, whereas formerly it was represented by wood. If this results in a gain, as it has done, it appears to me to be an ordinary gain – a gain which has taken place in the course of their trade ……"*

2.4. Deeming provisions in the IRO

2.4.1. Section 15(1)(c)

Section 15(1)(c) deems "*<u>sums received by or accrued to a person by way of grant, subsidy or similar financial assistance in connection with the carrying on of a trade, profession or business in Hong Kong, other than sums in connection with capital expenditure made or to be made by the person</u>*" as taxable. Not all financial subsidies are taxable. Only those receipts which are not connected with capital expenditure will be taxable. Strictly speaking, subsidies that are connected with capital expenditure are precluded from this section. Receipts that are capital in nature but not connected to capital expenditure, for example donated capital by a holding company to its subsidiary, technically are not precluded from this deeming provision.

2.4.2. Sections 15(1)(m) and 15A

Section 15(1)(m) deems "*sums received or receivable by a person as consideration in respect of the transfer of a right to receive income, as provided for in section 15A*" as taxable. Under section 15A, a payment for the transfer of a right to receive income from property is taxable unless the transfer of a right to receive income from property is made together with the transfer of the legal or equitable ownership of the property.

The application of section 15(1)(m) was recently argued in the Hong Kong case, ***Aviation Fuel Supply Company v CIR (2015)***, which is discussed further below.

2.4.3. Other provisions

There are some other special provisions which provide tax deduction for certain capital expenditure. These special provisions are discussed later in this Chapter. Usually the same provisions will deem the recovery of the following capital expenditures which were previously allowed as deduction as taxable receipts:

(a) lump sum contribution to approved retirement scheme deducted under **section 16A**
(b) research and development expenditure deducted under **section 16B**
(c) purchase cost of patent rights deducted under **section 16E**
(d) purchase cost of specified intellectual property rights deducted under **section 16EA**
(e) capital expenditure of prescribed fixed assets deducted under **section 16G**
(f) capital expenditure of environmental protection facilities, including environment-friendly vehicles deducted under **section 16I**
(g) cost of spectrum utilization fees specifically for mobile network operators (section 16N)
(h) capital expenditure of building and structure of which depreciation allowances have been allowed under **part VI**

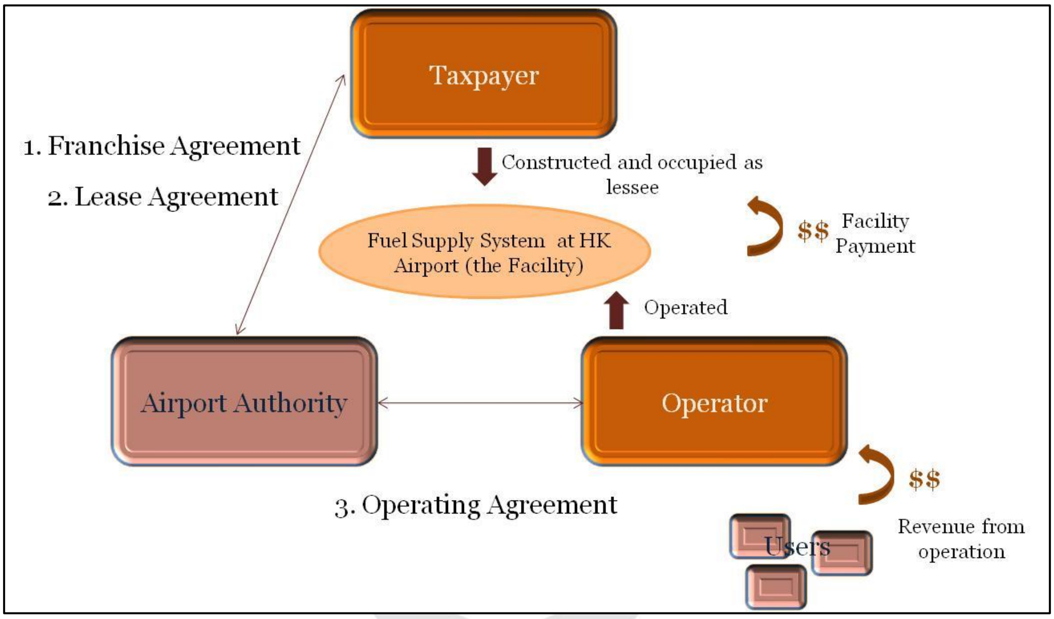
2.5. Aviation Fuel Supply Co v CIR (2015)

The case involves a sophisticated commercial arrangement whereby the taxpayer's group entered into various agreements with the Airport Authority (the Authority) to develop and operate the aviation fuel supply system at the Hong Kong airport (the Facility) on a "Build-Operate-Transfer" model.

Under the franchise agreement, the taxpayer expected to recover the cost of constructing the Facility (Facility Cost) with a reasonable rate of return. This was achieved by means of a monthly payment (Facility Payments) to the taxpayer for a period of 20 years funded by the revenue derived by the taxpayer's related company (the Operator) from operating the Facility under the operating agreement entered into between the Operator and the Authority.

In October 2002, as allowed under the franchise agreement, the Authority made an election to accelerate the taxpayer's recovery of the Facility Cost by making an Accelerated Facility Cost Payment of around US$449 million (the Sum) to the taxpayer. Upon payment of the Sum, the Facility vested in the Authority and the lease agreement between the taxpayer and the Authority was terminated. Facility Payments were since then payable to the Authority (instead of the taxpayer) by the Operator.

The diagram below shows the relationships of the parties involved in the arrangement.



The Sum was not offered for profits tax assessment by the taxpayer in year of assessment 2003/04 on the basis that it should be regarded as a compensation for the surrender of its business and a payment made by the Authority to acquire its business. As such, the amount should be capital in nature and not taxable under section 14 of the IRO.

The issues in dispute are whether the Sum is taxable under section 14 of the IRO and if not, whether it would be deemed as a taxable trading receipt by virtue of sections 15(1)(m) and 15A as consideration for the transfer of a right to receive income from property.

The CFI held in favour of the taxpayer on both the section 14 and sections 15(1)(m)/15A issues.

In a nutshell, the CFI held that the taxpayer was carrying on a business of developing the Facility for its own benefit and exploiting or operating the Facility with a view to profit instead of providing the services of building the Facility to the Authority. It followed that the Sum was not a receipt derived from the taxpayer's business. In addition, the Sum was a payment made to acquire the taxpayer's business and resulted in a change of ownership of the Facility so it should be regarded as capital in nature. The Sum was therefore not taxable under section 14. On the sections 15(1)(m)/15A issue, the CFI agreed with the taxpayer that there was no transfer of right to receive income from property from the taxpayer to the Authority and even if there was a transfer of such right, the exception in section 15A(3) would apply as the ownership of the Facility was transferred along with the right to receive income from the Facility.

The Commissioner then lodged an appeal to the COA against the CFI's decision. The COA handed down its judgment in the case on 4 December 2012, dismissing the Commissioner's appeal.

The COA identified the key question to be considered in the case as "how the business of the taxpayer, the Facility Payments and the Sum should be characterised". The COA largely agreed with the CFI on its analysis of the taxpayer's business and held that the Sum was not taxable under section 14 on the following grounds.

- Even though there were two separate agreements for the services of building and operating the Facility and the two services were performed by different parties, frequent references were made in one agreement to the terms of the other regarding the obligations undertaken and the rights granted in the triangular relationship between the taxpayer, the Authority and the Operator and the taxpayer was entitled to nominate a separate entity related to it to operate the Facility.
- The whole contractual arrangement between the taxpayer, the Authority and the Operator should be considered in a property context and taking into account the commercial reality. Taking this approach, it becomes obvious that in substance, the taxpayer's business was to build and exploit the Facility, earning fees from the operation of the Facility.
- The Facility Payments were the share of the operating results of the Facility that the taxpayer had acquired by undertaking to build the Facility.
- In contrast to the Facility Payments, the Sum was not a receipt derived from the taxpayer'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 Authority at its election to acquire the taxpayer's business and the taxpayer had no control over receiving it or not.
- The Sum was a payment made to acquire the taxpayer's business, and not as a substitute or compensation for the loss of the Facility Payments. The Sum resulted in the transfer of ownership of the Facility (which was treated as a capital asset in the taxpayer's accounts) and termination of the taxpayer's long-term (i.e. 15 years) right under the franchise agreement so it is a capital receipt.

The Sum is also not taxable under sections 15(1)(m) and 15A on the following bases:

- The right of the Authority to receive Facility Payments from the Operator was an original right in the hands of the Authority under the operating agreement. It is different from the taxpayer's right to receive Facility Payments from the Operator. The situation in the present case amounted to extinguishing of one set of right and arising of a new set of right rather than a transfer of the rights in question. As such, there was no transfer of right to receive income from property from the taxpayer to the Authority in any practical or business sense.
- Even if there was a transfer of right to receive income from property, the relevant property from which income was derived must have included the Facility, which was transferred from the taxpayer to the Authority upon payment of the Sum. As such, the exception in section 15A(3) would apply.

The Commissioner also raised the issue of whether balancing charge should be brought into account by the taxpayer in respect of the Facility, on which substantial depreciation allowances had been claimed by the taxpayer in the previous years of assessment. The issue of balancing charge was not raised at the CFI but the COA exercised its discretion to consider the issue despite the procedural objection of the taxpayer on the following bases:

- In seeking to vary the assessment to take into account a balancing charge, the Commissioner was not attempting to make a new assessment on a different or wider basis than the assessment under objection.
- No unfairness in procedure would be suffered by the taxpayer as a result of the exercise of the discretion as the taxpayer can object to any additional assessment made on account of the balancing charge according to the appeal provisions in the IRO.

The COA was of the view that there was a succession to the taxpayer's business by the Authority and that the Facility had passed by way of succession so a balancing charge would not be made by virtue of section 39D(3) of the IRO.

In appealing to the CFA, the CIR no longer sought to argue that the lump sum was trading receipt subject to profits tax but only focused on the COA's judgment in respect of the balancing charge issue.

Although the CIR sought to appeal against the COA's judgment on the merits that the Facility was passed to the Authority by sale rather than by succession, the CFA considered that the chief question was indeed whether the CIR should have been allowed to raise the balancing charge issue at the last minute before the hearing in the COA.

The CFA dismissed the CIR's appeal and held that the COA should not have entertained the CIR's application on the balancing charge issue as doing so is unfair to the taxpayer. Below is the analysis of the CFA on this issue:

- The COA has all the authority to make any assessment that the CIR is empowered under the IRO and hence is allowed to exercise a discretion to increase the original assessment under appeal on a different basis (i.e. by imposing a balancing charge) as that is all part of the original assessment, however, the COA needed to consider whether it would be fair to do so before exercising such discretion.
- By the time the COA was invited to make the assessment (it was 2012), the statutory six-year limitation period for making an additional assessment (the assessment in dispute is for year of assessment 2003/2004) under section 60(1) of the IRO had already expired. Although the COA's assessment is not an additional assessment within the meaning of section 60(1), the effect of making such assessment is to deprive the taxpayer of the protection of the limitation period against what may be in substance an entirely new claim.
- Imposing a correct amount of balancing charge on the taxpayer would require: (1) apportioning part of the lump sum received by the taxpayer as the sale proceeds of the Facility and (2) allocating the sale proceeds to each individual asset concerned. This would require the taxpayer to investigate transactions that took place more than six years ago (e.g. the taxpayer would need to find out the value the assets back in 2003 when the assets were transferred). In the CFA's opinion, it would be unfair to the taxpayer to require it to investigate these matters after the limitation period for a fresh assessment had expired, in particular that the CIR could have originally made an alternative assessment claiming a balancing charge.

3. TAX CERTAINTY ENHANCEMENT SCHEME (THE SCHEME)

In the 2023-24 Budget Speech, the Financial Secretary announced that the HKSAR Government would put forward a scheme to provide greater upfront certainty of non-taxation of onshore disposal gains that are of capital nature. Against this background The Inland Revenue (Amendment) (Disposal Gain by Holder of Qualifying Equity Interests) Ordinance 2023 ("the Amendment Ordinance") was enacted on 15 December 2023 specifically providing a tax certainty enhancement scheme ("the Scheme") for onshore disposal gains. Under the Scheme, any Onshore Disposal Gain derived by an eligible investor entity meeting specified conditions is to be regarded as capital in nature and not chargeable to profits tax, and there is no need to conduct the "badges of trade" analysis.

3.1. Basic Provisions[1]

Pursuant to the amendment ordinance <u>and subject to specific exclusions of the Scheme</u>, any gain or profit ***(disposal gain)***, arising in or derived from Hong Kong, that an entity ***(investor entity)*** derives from a disposal ***(subject disposal)*** of equity interests ***(subject interests)*** in another entity ***(investee entity)*** –

(a) is to be regarded as arising from the sale of capital assets; and
(b) is not chargeable to profits tax under section 14.

Specifically the Scheme:-

- applies strictly to onshore disposal gains
- to any disposal occurs on or after 1 January 2024 and accrues in the basis period for a year of assessment beginning on or after 1 April 2023
- subject to taxpayers' application of the Scheme, as taxpayers can choose whether to apply or not
- In the case where the Scheme does not apply to an Onshore Disposal Gain for the reason that the "badges of trade" analysis would continuously be used if no application for the scheme
- in respect of onshore losses on disposal of equity interests, the Scheme will not affect the existing tax rule under which its nature is determined again based on the "badges of trade" analysis
- foreign-sourced disposal gains derived from the sale of equity interests that are deemed to be sourced from Hong Kong under the Foreign-sourced Income Exemption regime *(to be discussed in the next topic)* are not eligible for the Scheme

3.2. Eligible investor entity

An investor entity must be a legal person (not including a natural person) or an arrangement that prepares separate financial accounts, such as a partnership, a trust and a fund. However, an insurer is specifically excluded to be a eligible investor entity.

[1] Inland Revenue (Amendment) (Disposal Gain by Holder of Qualifying Equity Interests) Ordinance 2023, Section 4, Part 2, section 5(1)

3.3. Eligible investee entity

An investee entity must also be a legal person (not including a natural person) or an arrangement that prepares separate financial accounts, such as a partnership, a trust and a fund, irrespective of whether they are Hong Kong resident or non-Hong Kong resident, whether they are incorporated or established in Hong Kong or outside Hong Kong, or whether they are listed or non-listed entities.

3.4. Eligible equity interest

An equity interest in an investee entity refers to an interest that carries rights to the profits, capital or reserves of the investee entity and is accounted for as equity in the books of the investee entity under general accepted accounting principles. In this regard the equity interest can appear in different structures, including ordinary shares, preference shares and partnership interests, provided that the equity interest carries rights to the profits, capital or reserves of the investee entity and is regarded as equity from the perspective of the investee entity under general accepted accounting principles[2].

3.5. Equity holding conditions

The threshold for (i) the holding period *(with respect to the equity interests in an investee entity)* is 24 months and that (ii) for the holding percentage is at least 15%, i.e.,

- the investor entity has held the subject interests throughout the continuous period of 24 months immediately before the date of disposal of the subject interests *(reference period)* under the subject disposal; and
- the subject interests by themselves, or together with certain other equity interests in the investee entity also having been held by the investor entity throughout the reference period, constitute at least 15% of equity interests *(qualifying interests)* in the investee entity.

The 15% holding threshold could be satisfied on a "group basis". Essentially if the equity interests have been held by the investor entity and its closely related entity/entities throughout the reference period in aggregate, the equity holding conditions can still be met aggregately. Specifically an entity is a closely related entity of another entity if[3]:

- one of them has control over the other; or
- both of them are under the control of the same entity.

An entity (entity A) has control over another entity (entity B) if:

[2] In determining whether a financial instrument should be classified as an equity instrument or a financial liability, Hong Kong Accounting Standard 32 and International Accounting Standard 32 have provided detailed guidance on this aspect. If the investee entity is not required to comply with any specified accounting standard for preparing its financial accounts, the general accepted accounting principles should be the International Financial Reporting Standards

[3] IRD website, Tax information, Individual/Businesses, Onshore Gain on Disposal of Equity Interests – Tax Certainty Enhancement Scheme

- entity A has more than 50% of direct or indirect beneficial interest in, or in relation to, entity B; or
- entity A is directly or indirectly entitled to exercise, or control the exercise of, more than 50% of voting rights in, or in relation to, entity B.

Direct beneficial interest

The extent of direct beneficial interest of entity A in entity B is determined as follows:

- If entity B is a corporation that is not a trustee of a trust estate – the percentage of the issued share capital (however described) of the corporation held by entity A;
- If entity B is a partnership that is not a trustee of a trust estate – the percentage of the income of the partnership to which entity A is entitled;
- If entity B is a trustee of a trust estate – the percentage in value of the trust estate in which entity A is interested; or
- If entity B is an entity that is not a corporation - a partnership or a trustee of a trust estate, the percentage of entity A's ownership interest in the entity.

Indirect beneficial interest

If entity A has an indirect beneficial interest in, or is indirectly entitled to exercise or control the exercise of voting rights in, entity B through another entity (interposed entity), the extent of the indirect beneficial interest or voting rights of entity A in entity B is determined as follows:

- If there is one interposed entity – the percentage arrived at by multiplying the percentage of the beneficial interest or voting rights of entity A in the interposed entity by the percentage of the beneficial interest or voting rights of the interposed entity in entity B; or
- If there is a series of two or more interposed entities – the percentage arrived at by multiplying the percentage of the beneficial interest or voting rights of entity A in the first interposed entity in the series by the percentage of the beneficial interest of each interposed entity (other than the last interposed entity) in the series in the next interposed entity in the series and the percentage of the beneficial interest of the last interposed entity in the series in entity B.

3.6. Disposals on a first-in-first-out basis

If an investor entity or a closely related entity of an investor entity has acquired equity interests in the same investee entity longitudinally, the equity interests are taken to be disposed of in the order in which they are acquired (that is, on a first-in first-out basis) when determining whether the equity holding conditions are met for a specified disposal.

3.7. Exception to equity holding conditions: long-held left-overs (Disposal of equity interests in tranches)

In order to address the issue of long-held left-overs (disposal of equity interest in tranches, and the 15% threshold cannot be met subsequent to specific tranche(s) disposal), the Scheme provides for an exception to the equity holding conditions under which Onshore Disposal Gains arising from such long-held left-overs are regarded as capital in nature and not chargeable to profits tax if:

- before disposal of the subject interests (i.e. long-held left-overs) in an investee entity, the investor entity has certain equity interests in the investee entity of which, partly were disposed of by the investor entity ("**earlier disposal**");
- the Scheme applies to the Onshore Disposal Gains derived from the earlier disposal on the basis that the equity holding conditions are met for the earlier disposal and that the subject interests constituted a part of the qualifying interests (in other words, if the subject interests had been disposed of altogether in the earlier disposal, the subject interests would have been qualified for the Scheme on the basis that the equity holding conditions had been met);
- the disposal of the subject interests occurs within **24 months after the earlier disposal (24-month time limit)**, and
- if more than one earlier disposal in tranches, the ***latest*** earlier disposal would be counted for the purpose of considering the 24-month time limit.

Accordingly, Onshore Disposal Gains arising from a disposal of left-over interests are eligible for the Scheme if the disposal is made within 24 months from the latest earlier disposal for which the investor entity has last met the equity holding conditions.

3.8. Exclusions

3.8.1. Excluded investor entity

The Scheme specifically excludes insurers as the investor entity on the basis that making investments for returns is normally considered as revenue in nature for insurers' business[4].

3.8.2. Excluded equity interests – trading stock

Equity interests held as trading stocks are not capital assets and therefore would not be applicable to the Scheme. Essentially equity interest that has been brought into account to compute the taxpayers' assessable profits in an assessment (or in the computation of tax loss where applicable) which has become final and conclusive would be regarded as trading stocks. If there is a change of intention in holding the equity interest from trading stock to capital assets, the respective equity interests would be regarded as capital assets if the deemed gain up the to date of change of intention has been chargeable to profits tax accordingly, and specifically the 24 months holding period threshold would be stipulated from the date of such change of intention.

3.8.3. Excluded equity interests – non-listed equity interests in property-related entities

In order to avoid potential abuses on the Scheme by businesses holding immovable properties as trading stock and to claim the subsequent disposal gain as non-taxable, the Scheme is

[4] An entity is regarded as insurer if its assessable profits is ascertained pursuant to Subdivision 1 of Division 11 of Part 4 of the IRO

specifically not applicable to non-listed equity interests in an investees engaging in (i) property trading, (ii) property development, or (iii) property holding in line with the following details:

3.8.3.1. Property trading

An investee entity is regarded as an excluded entity and is not applicable to the Scheme if it carries on a business of property trading (i.e. the business of acquisition and sale of immovable properties in or outside Hong Kong) in the relevant basis period in which the disposal occurs, unless the acquisition and sale of immovable properties are incidental to the undertaking of any property development by the entity.

3.8.3.2. Property development

An investee entity is regarded as an excluded entity and is not applicable to the Scheme if it undertakes or has undertaken property development (i.e. construction or causing the construction of any building or part of a building, and includes acquisition of any land or building or part of a building for such construction of any land or building or a part of a building for such construction and sale of any building or part of a building after such construction, in Hong Kong or elsewhere), in or before the relevant basis period.

3.8.3.3. Property holding

An investee entity is regarded as an excluded entity and is not applicable to the Scheme if it holds any immovable properties in Hong Kong or elsewhere, directly or indirectly, in the relevant basis period (in which the disposal occurs) and the percentage of vale of such immovable properties out of the entity's total assets in that basis period exceeds 50%. Specifically for those immovable properties which are utilized by the entity for carrying on its own trade or business (including it business of letting immovable properties) but are not for sale, the value of such immovable properties is to be excluded from the numerator in determining the relevant percentage.

4. CAPITAL VS REVENUE EXPENDITURES

Section 17(1)(c) of the IRO specifically prohibits the deduction of capital expenditures including capital losses and section 17(1)(d) prohibits the deduction of costs of improvements that are of capital nature.

Whether any expenditure is capital or otherwise depends on the facts of a particular case. Although case law may shed light on the relevant factors for consideration, they only provide guidance on the approach of addressing the issue. This is a question of law to be determined in the light of the facts of an individual case. In *Heather v P E Consulting Group Ltd (1972)*, Lord Denning made the following influential observations:

> *"The question - revenue expenditure or capital expenditure - is a question which is being repeatedly asked by men of business, by accountants and by lawyers. In many cases the answer is easy: but in others it is difficult. The difficulty arises because of the nature of the question. It assumes that all expenditure can be put correctly into one category or the other: but this is simply not possible. Some cases lie on the border between the two: and this border is not a line clearly marked out; it is a blurred and undefined area in which anyone can get lost. Different minds may come to different conclusions with equal*

propriety. It is like the border between day and night, or between red and orange. Everyone can tell the difference except in marginal cases; and then everyone is in doubt. Each can come down either way. When these marginal cases arise, then the practitioners - be they accountants or lawyers - must of necessity put them in one category or another. And then, by custom or by law, by practice or by precept, the border is staked out with more certainty. In this area at least, where no decision can be said to be right or wrong, the only safe rule is to go by precedent. So the thing to do is to search through the cases and see whether the instant problem has come up before. If so, go by it. If not, go by the nearest you can find."

Because what is considered as capital and what is not is facts-driven, it is not easy to have a clear demarcation between the two. It is also not possible to have exhaustive lists of items of capital expenditure and revenue expenditure. There are, however, guiding principles which can be drawn from precedent cases. These include:

- Expenditure in the acquisition, disposal or modification of an identifiable capital asset, tangible or intangible is usually capital in nature
- Expenditure which produces an enduring result is usually capital in nature
- One-off expenditure can be indicative, but not conclusive, that the expenditure is capital in nature

4.1. Expenditure in the acquisition, disposal or modification of an identifiable asset

In the case of *Rolfe v Wimpey Waste Management Ltd (1989)*, the expenditures incurred by the taxpayer on works related to the landfill sites for dumping waste, including the costs of restoration of the sites when ceased dumping were held to be capital in nature even though the average life of the sites from acquisition to final restoration was about seven years.

In the case of *Mallett v The Staveley Coal and Iron Company Ltd (1928)*, the taxpayer made two payments to be released from the remaining term of two mining leases which were found to be uneconomic to continue mining. The payments were held to be capital on the following grounds:

- the company's business was not and did not include dealing in mining leases;
- the leases were fixed capital assets of the company's business; and
- the expense of acquiring or disposing of a capital asset was itself capital.

Rowlatt J in this case explained why these payments were capital in nature:

"…….The company does not make these payments to get rid of any annual charge against revenue in the future. They make these payments to get rid of the loss in the business or apprehended loss in the business…They are paying this money in other words in order pro tanto to go out of business. They are not meeting in advance an annual demand in the business."

Similarly, in the case of *Cowcher v Richard Mills and Company Ltd (1927)*, the lump sum paid by the taxpayer to the landlord to give up the lease on the premises of an unprofitable branch was held to be capital. The lease was considered as asset of the taxpayer and the sum was the cost of getting rid of the onerous asset. Rowlatt J in this case commented:

> *"……….. What has a payment in respect of these premises got to do with a business of the character they carry on? It has to do with it as a matter of history. They used to carry on the business at these premises too, but these premises were abandoned and went out of the business. It ceased to be a part of the business ... It is not an expense in earning money in the business that is carried on. Neither the instalment, nor the commutation of the instalment was."*

These cases supported the standpoint of the IRD in its FAQs on the tax treatments for reinstatement cost. The IRD makes it clear that "*the actual amount of reinstatement cost is not deductible under section 16 of IRO. Where the lease is a capital asset, the reinstatement cost when incurred is regarded as part of the capital cost of acquiring the lease. The expenditure is therefore capital instead of revenue in nature. Thus, it is precluded from deduction under section 17(1)(c) of the IRO*."

Improvement expenditure is considered as capital in nature. Improvement means adding something new to the asset while repairs refer to the restoration of the asset to its original state. Hence, expenditure to enhance the quality or productivity of an asset should be regarded as improvement and disallowed. In the case of *Tucker v Granada Motorway Services Ltd (1979)*, a sum paid by the taxpayer to the landlord to change the basis for the computation of the periodic lease payments was held to be capital in nature. Under the revised basis, the periodic lease payments would be reduced and the court held that the sum made the lease, an identifiable capital asset, more advantageous.

Sometimes instead of repairing the asset, enlargement or improvement to it has been made. In such case, the whole amount is capital expenditure and no allowance is due for the hypothetical repairs which might have been carried out.

In *William P Lawrie v CIR (1952)*, the taxpayer's business was carried on in a wooden building with an asbestos, corrugated iron and glass roof supported by brick piers. The roof leaked and the pillars were shaky. Instead of repairing the roof, the taxpayer spent money enlarging the building by one fifth. The taxpayer claimed a part of the expenditure as repair expenditure. The court held the whole expenditure was inseparable and was capital in nature. The whole amount was not allowed, nor an estimated cost of notional repairs.

What is an identifiable asset could be an issue. Sometimes it is not clear whether the expenditure to replace a part of an asset could be considered as repair of the asset or replacement of the entire asset. The latter should be considered as capital in nature. The two classic cases on this issue are *Bullcroft Main Collieries Ltd v O'Grady (1932)* and *Samuel Jones & Co (Devonvale) Ltd v CIR (1951)*.

In the case of *Bullcroft Main Collieries Ltd v O'Grady (1932)*, the cost of replacement of a chimney that was separated from the factory was disallowed as the court regarded the chimney as an entirety. By contrast, the court in the case of *Samuel Jones & Co (Devonvale) Ltd v CIR (1951)* allowed the expenditure related to the replacement of a factory chimney which was an integral part of the factory. In this case, the factory together with the chimney was regarded as an entirety. Rowlatt J in the latter case explained:

> *"Of course, every repair is a replacement. You repair a roof by putting on new slates instead of the old ones, which you throw away. There is no doubt about that. But the critical matter is…what is the entirety? The slate is not the entirety of the roof. You are repairing the roof by putting in new slates. What is the entirety? If you replace in entirety, it is having a new one and it is not repairing an old one. I think that it is very largely a question of degree, but it seems to me the Commissioners have taken the only possible view here."*

Another important area in whether expenditure incurred relates to an identifiable asset is the cost incurred on secondhand assets. The repairs to a secondhand asset may either be revenue or capital in nature. The distinction depends on the state of the asset being acquired and the purchase price. Expenditure to repair a secondhand asset was disallowed in the case of *Law Shipping Co. Ltd v CIR (1923)* as the ship in this case could not be used at the time of purchase and substantial repair was required before the ship could be seaworthy. By contrast, in the case of *Odeon Associated Theatres Ltd v Jones (1971)*, the repair to a secondhand theatre was allowed as revenue expenditure. In the latter case, the court distinguished this case from the case of *Law Shipping Co Ltd v CIR (1923)* on the following grounds:

- The purchase price of the ship was substantially less than if it had been in a fit state of repair while the purchase price of the cinemas was not affected by their condition.
- The ship could not continue as a profit-earning asset without being repaired shortly after acquisition while the cinemas could and were used in the 'as acquired' condition.
- No evidence in the *Law Shipping* case that on sound commercial accountancy principles the deferred repairs could be charged as revenue expenditure whereas there was accountancy evidence in the *Odeon*.

This principle is also applicable where there is deferred repair in leased assets. In the case of *Jackson v Laskers Home Furnishers Ltd (1956)*, the taxpayer leased a property for 14 years and the property was in a bad state of repair. Rent was charged at below market rate for the first year. The company spent money repairing the property and the expenditure was held to be capital in nature.

4.2. Expenditure creating enduring benefit

Expenditures for the acquisition or disposal of identifiable assets are capital in nature. Similarly, expenditures which provide a long-term benefit can be viewed as expenditure creating intangible assets or rights and could be considered as capital in nature.

The key is not whether the expenditure will bring in benefit to the taxpayer. It is almost certain all expenditures, capital or otherwise, will bring in benefit to a business. The important point is the nature and duration of the benefit that the expenditure brought in.

In the case of *MacTaggart v B & E Strump (1925)*, the initial premium paid in a lease is considered as creating the right of the taxpayer to occupy a property and was held to be capital.

In a later case, *Strick v Regent Oil Co Ltd (1965)*, the taxpayer paid a lump sum upfront for a 20-year lease of petrol filling stations with a nominal annual rent and then subleased the stations to operators for the same period less three days at a nominal annual rent. The courts held that the lump sum payment was premium for leases and was capital in nature. Lord Pearce commented in this case:

"The acquisition of such an interest in land points strongly to a capital expenditure and, on the facts of these cases, dominates other indications. This indication of a capital expenditure is not diminished by the argument that the wholesalers might have obtained the substance of what they wanted by a revenue payment and without purchasing an interest in the land. They did not do so. Instead they chose to enter into these particular arrangements, which were not shams but genuine commercial transactions. They entered into them in order to satisfy insistent customers who were anxious to produce genuine transactions which would render the sums paid to them capital receipts in their hands. There seems no justification for regarding these transactions as other than in fact they were, or for treating them as anything but acquisitions of leases for premiums with the object of obtaining trade ties. The fact that they were acquisitions of leases tilts the balance in favour of regarding the premiums as capital payments."

Payments to retiring directors for agreeing not to compete with the company were considered as enhancing the taxpayer's goodwill by buying off potential competitors and were considered as capital expenditure in the case of *Associated Portland Cement Manufacturers Ltd. v Kerr (1945)*. In his judgment, Lord Greene explained:

"What is the true nature of the asset which the company has acquired? It has acquired two choices in action, the benefit of two restrictive covenants against competition…for which it has paid a total sum of £30,000. The danger against which these covenants protected the company was serious and imminent. It would be quite wrong to allow oneself to think for a moment that the company was not getting its money's worth. When these gentlemen left the board they were free to compete, not merely in Great Britain, but in Mexico, and indeed in the South Sea Islands. Against that danger the company has protected itself. What is the true business result of all that? When these gentlemen left the company the goodwill of the company would immediately have become extremely vulnerable. When the company had the monopoly of their services it was in a very advantageous position. As soon as they became potential competitors there was ground for thinking that the goodwill of the company would receive a serious shock. The risk of competition and damaging competition was great. The company succeeded in protecting itself against that risk. In effect the company was buying off two potential competitors. It seems to me that the effect of buying off potential competitors must of its very nature affect the value of the company's goodwill...
As I have said, these benefits acquired by the company were solid; they were permanent; and they were world-wide. They protected the company against certain risks, and the value to be set on that protection was shown by the company itself in deciding to pay these amounts…..."

By contrast, a payment to get rid of an unsatisfactory employee was held to be a normal revenue expense in the case of *Mitchell v BW Noble Ltd. (1927)*.

A lump sum payment to set up a retirement fund for staff was viewed as bringing into existence an advantage for the enduring benefit of the trade and was a capital expenditure as held in the case of *Atherton v British Insulated & Helsby Cables Ltd. (1925)*. Viscount Cave gave the following famous remarks on the distinction between capital and revenue:

> *"…when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital."*

On the other hand, a lump sum payment to replace a continuing revenue expense was held to be revenue expenditure in the case of *Hancock v General Reversionary & Investment Co. Limited (1919)*. The taxpayer in this case paid a lump sum to a retired employee in commutation of the pension payable. The lump sum was held to have the identical character as the pension that it replaced. Similarly, in the case of *Smith v. Incorporated Council of Law Reporting for England and Wales (1914)*, a lump sum paid to an employee on his retirement was held to be revenue in nature.

4.3. One-off expenditure can be indicative, but not conclusive, that the expenditure is capital in nature

Lump sum payment was involved in both the case of *British Insulated and Helsby Cables Ltd v Atherton (1926)* and the case of *Hancock v General Reversionary & Investment Co. Ltd (1919)*. However, in one case the lump sum was held to be capital and in the other case it was held to be revenue in nature. This indicates that being an one-off payment is not a conclusive factor in determining whether a payment is capital or revenue in nature. The key is whether any asset or any enduring benefit has been created by the expenditure.

In the case of *CIR v Carron Co (1968)*, the taxpayer was a company incorporated by royal charter and applied supplement charter to change its constitution suitable to modern business conditions. A shareholder took proceedings against the procedure adopted by the taxpayer and the taxpayer settled the action by buying out the shares of the aggrieved shareholder. The payments were held to be revenue in nature. In making his judgment in this case, Lord Clyde made the following remarks:

> *"…it appears to me that what was achieved by these payments was the removal of disabilities to the company's trading operations which prejudiced its operations in its competition with its rivals. This was achieved without the acquisition of any tangible or intangible new asset and without the creation of a new branch of its existing trading activities. From a commercial and business point of view nothing in the nature of additional fixed capital was thereby obtained. The benefit was essentially of a revenue character because the company became able more easily to finance its day-to-day transactions, and more efficiently to carry on its day-to-day manufacture."*

On the other hand, there are cases where recurrent payments could be considered as capital in nature. In the case of *CIR v Land Securities Investment Trust Ltd. (1969)*, the taxpayer acquired the interest in properties with rent charges totaling 96,000 pounds per annum for ten years. The annual rent charges were held to be capital in nature.

In a Hong Kong case, *Wharf Properties Ltd v CIR (1997)*, the interest paid on a loan to finance its development project before the completion of the project were held to be incurred for the provision of the properties under the project and was capital in nature. Similarly, in the BoR decision *89/96*, the Board held that the recurring payment made by the taxpayer to another company which agreed to transfer to the taxpayer "all documents on possible places to buy and information concerning suppliers and purchase conditions" and to support the taxpayer in transferring the existing business relationships was capital in nature. The Board held that the principal purpose of the payments was for 'transfer of information' and gaining access to connections with suppliers cultivated by the other company and was capital in nature. Spreading payment of the price did not detract the purpose of such payment.

4.4. China Mobile Hong Kong Company Limited v CIR [2022 HKCA 1637] and subsequent IRO amendment

In this case, the key issue is whether the upfront lump sum spectrum utilisation fees (Upfront SUFs) paid by the taxpayer to the Telecommunications Authority (TA) were capital in nature and not deductible.

Key facts of the case are summarised as follows:

- Since 1996, the taxpayer has paid annual spectrum utilisation fees (Annual SUFs) to the HKSAR Government for the use of 2nd Generation (2G) frequency bands assigned to it for its operations.
- In 2007, the TA recommended to the HKSAR Government that the future 4th Generation (4G) spectra would be allocated by auction and the SUF would be in the form of an upfront lump sum payment. The auction of 4G spectra was completed early 2009 and the taxpayer was the successful bidder of one of the frequency bands. The taxpayer paid a one-off lump sum SUF in the amount of HK$494,700,000 in March 2009.
- In 2008, the TA proposed to the HKSAR Government to make certain unallocated 2G frequency bands available to the existing 2G licensees by auction. In addition to the Annual SUFs, a successful bidder was required to pay a one-off lump sum SUF. The taxpayer was the successful bidder of two frequency bands in the auction held in June 2009 and made total lump sum payments of HK$15,120,000.
- In its audited financial statements, the taxpayer classified the Upfront SUFs as non-current intangible assets and amortised them on a straight-line basis over the relevant licence periods.
- The taxpayer sought to deduct the Annual SUFs and amortisation of the Upfront SUFs in its profits tax computations for years of assessment 2009/10 to 2011/12. The assessor raised assessments for these years of assessment in accordance with the returns.
- Subsequently, the assessor raised additional assessments disallowing the deduction of the amortisation of the Upfront SUFs on the basis that such fees were capital in nature. These assessments were confirmed by the determination of the Deputy CIR.

- The taxpayer appealed against the assessments to the Board, which dismissed the taxpayer's appeal and held that the Upfront SUFs were capital in nature and not deductible.
- The taxpayer then lodged an appeal against the Board's decision to the CFI.

In the appeal before the CFI, the taxpayer sought to draw a distinction between (1) a payment for the "**right to use**" radio spectrum (which is capital in nature) and (2) a payment for the "**use of**" such spectrum (which is revenue in nature). The taxpayer's key argument, based on the various provisions of the Telecommunications Ordinance (TO), was that the Upfront SUFs were paid for the use of, as opposed to the right to use, the 2G and 4G frequency bands and therefore were revenue in nature and deductible.

The CFI dismissed the taxpayer's appeal and upheld the Board's decision that the Upfront SUFs were capital in nature and non-deductible.

In short, the CFI considered that it is not necessary in every case to draw a distinction between a payment for the "right to use" and a payment for the "use of" an asset for the purpose of determining whether the payment is capital or revenue. It is, in the judge's view, wrong in principle to treat such distinction as being decisive of determining the nature of a payment. The Upfront SUFs would bring about enduring benefits to the taxpayer's business as the taxpayer could provide 4G and additional/enhanced 2G services to its customers for the next 15 years / 12 years. Also, the Upfront SUFs were lump sum payments incurred once and for all, instead of periodic payments to meet an ongoing demand for expenditure.

The taxpayer appealed the case to the COA, and also tried to present a new argument that the nature of its business was essentially required to obtain the said specific spectrum from the government and then for onward resale to its ultimate customers. In this regard both the Annual SUFs and Upfront SUFs should be revenue in nature and should be deductible.

COA released its decision on 3 November 2022 and upheld CFI's judgment with the following comments:

- CFI is correct that it is not necessary in every case to draw a distinction between a payment for the "right to use" and a payment for the "use of" an asset for the purpose of determining whether the payment is capital or revenue.

- The Upfront SUFs essentially enlarged the taxpayer's profit-earning structure of an enduring nature.

- There is a idiosyncratic nature of Upfront SUFs and should be differentiated from the Annual SUFs in terms of payment approach, covered period and basis of calculation. Deductibility of the Annual SUFs is irrelevant to the Upfront SUFs.

COA also rejected the new argument put forward by the taxpayer, on the basis that an appeal to the court should only be on a ground involving the question of law instead of any further evidence on questions of fact.

The decision revealed the structural loophole on the statutory payment of SUFs. Specifically the payment, as designated by TA is capital in nature and is not deductible whilst the entire business income derived by the telecommunication network operators is taxable. In order to address the asymmetric tax treatment, corresponding IRO amendment[5] was gazette on 19 January 2024 with effect from the same date. Pursuant to the respective IRO provisions[6], tax deduction would be fully allowed for SUFs to the extent that the amounts are incurred in the production of profits for the use of radio spectrum in its business. Specifically SUFs payment by annual instalments would be allowed for deduction in the year when the instalment is payable, whilst the deduction for any lump-sum SUFs payments would be spread over the spectrum assignment terms (generally 15 years).

5. SPECIFIC DEDUCTIONS FOR CAPITAL EXPENDITURES

The following provisions in the IRO provide specific deductions for certain capital expenditures when conditions are met:

(a) Lump sum contribution to approved retirement scheme (section 16A)
(b) Capital expenditure incurred in research and development (section 16B)
(c) Costs of patent rights (section 16E)
(d) Costs of specified intellectual properties rights (section 16EA)
(e) Costs of building refurbishment (section 16F)
(f) Costs of prescribed fixed assets (section 16G)
(g) Specified capital expenditure incurred in relation to environmental protection facilities (section 16I)
(h) Cost of spectrum utilization fees specifically for mobile network operators (section 16N) (see 4.4 above)
(i) Depreciation allowances (Part VI)

5.1. Research and development expenditure

Inland Revenue (Amendment) (No. 7) Ordinance 2018 was enacted on 2 November 2018, introducing a revamped research and development (R&D) tax deduction regime. The new regime takes retrospective effect for expenditure incurred or payment made on or after 1 April 2018.

Under the prevailing regime, there are two types of qualifying R&D expenditure, namely Type A expenditure and Type B expenditure. Subject to fulfillment of certain specified conditions, the tax deductions available for these two types of R&D expenditure are as follows:

- **Type A expenditure** (R&D expenditure other than a Type B expenditure) – a 100% normal deduction; and

[5] Inland Revenue (Amendment) (Tax Deductions for Spectrum Utilization Fees) Ordinance 2024
[6] Sections 16N, 16Q and 16R of the IRO

- **Type B expenditure** (R&D expenditure on qualifying R&D activities or payments to a DLRI which undertakes qualifying R&D activities) - a 300% deduction for the first HK$2 million and a 200% deduction for the remaining amount, without any limit on the amount eligible for the 200% deduction.

In addition, both expenditure incurred for in-house R&D activities conducted by taxpayers themselves and payments made by taxpayers to a university, college or designated local research institution (DLRI) for subcontracted R&D activities may be eligible for normal or enhanced tax deduction if the specified conditions are met. Some of research and development expenditures are likely of capital in nature and not deductible under the general deduction rule.

The following table provides a summary of the new regime of research and development expenditure:

		Normal deduction (Type A Expenditure)	**Enhanced deduction (Type B Expenditure)**
1)	Rates of deduction (Section 13 of Schedule 45)	• 100%	• 300% for the first HK$2 million • 200% for the remainder (no cap on the amount eligible for the 200% deduction)
2)	R&D activities qualifying for the deduction (Sections 2 and 4 of Schedule 45)	An “R&D activity”, which is defined as: a. an activity in the fields of natural or applied science to extend knowledge; b. a systematic, investigative or experimental activity carried on for the purposes of any feasibility study or in relation to any market, business or management research; c. any original and planned investigations undertaken with the prospect of gaining new scientific or technical knowledge and understanding; or d. the application of any research findings or other knowledge to a plan or design for the producing or introducing new or substantially improved materials, devices, products, processes, systems or services before they are commercially produced or used.	A “qualifying R&D activity”, which is defined as an R&D activity that: • falls within (a), (c) or (d); and • is wholly undertaken and carried on in Hong Kong; but • does not include certain activities that are not regarded as involving advancement in science or technology (e.g. efficiency survey, application of publicly available research findings with an anticipated outcome and without any scientific or technological uncertainty).

		Normal deduction (Type A Expenditure)	Enhanced deduction (Type B Expenditure)
3)	Definition of "R&D expenditure" (Section 6 of Schedule 45)	• A payment made to an R&D institution for an R&D activity • Any other expenditure incurred on an R&D activity, including capital expenditure except capital expenditure on land or buildings • But excludes a payment made to an R&D institution or an expenditure incurred for acquiring rights generated from an R&D activity *Notes:* 1. *The R&D expenditure must be for an R&D activity or a qualifying R&D activity related to the claimant's trade, profession or business or that class of trade, profession or business (e.g. an R&D activity that may lead to or facilitate an improvement in the technical efficiency of that trade, profession or business).* 2. *R&D institution means a DLRI or a university or college that is not a designated local research institution.*	

4)	R&D expenditure qualifying for the deduction (Sections 8, 10 and 12 of Schedule 45)	Type A expenditure, which is defined as an R&D expenditure other than a Type B expenditure e.g.
		• payments made to a university or college that is not a designated local research institution for an R&D activity; and
		• capital expenditure on plant and machinery used for an R&D activity.
		
		If a Type A expenditure is incurred for an R&D activity carried on outside Hong Kong in relation to a trade, profession or business that is carried on partly in and partly outside Hong Kong, an apportionment of the expenditure is required for deduction purpose.
			Type B expenditure, which is defined as an R&D expenditure that is:
			• a payment made to a designated local research institution for a qualifying R&D activity; or
			• an expenditure incurred for a qualifying R&D activity which is:
			  ○ in relation to an employee engaged directly and actively in a qualifying R&D activity (remuneration and benefits paid to a director are specifically excluded); or
			  ○ an expenditure on a consumable item that is used directly in a qualifying R&D activity.

5)	Situations where no deduction is allowed (Section 14 of Schedule 45)	No deduction will be allowed for an R&D expenditure incurred by a person if: • any rights generated from the R&D activity are not, or will not be, fully vested in the person; • the R&D activity is undertaken for another person; • the expenditure is or will be met directly or indirectly by a government, a public or local authority or another person; or • the expenditure is incurred under an arrangement of which the main purpose, or one of the main purposes, is to enable the person to obtain a R&D deduction or a greater R&D deduction that the person would not otherwise be entitled to.	

5.2. Costs of specified intellectual property rights

Section 16EA was enacted in 2011 to allow the deduction of capital expenditure incurred by a person on the purchase of a specified IP right, including legal expenses and valuation fees incurred in connection with the purchase. To promote Hong Kong as an IP trading hub in the region, the HKSAR Government extended the scope of tax deduction for capital expenditure incurred on the purchase of IP rights to cover more types of IP rights in 2018, namely protected layout-design (topography) rights in respect of integrated circuits, protected plant variety rights and performer's economic rights.

Deduction under Section 16EA is allowed if all of the following conditions are met:

- The person must have acquired the "proprietary interest" of the specified IP right;
- The specified IP right is purchased for use in the production of that person's profits chargeable to Hong Kong profits tax;
- The subject trademark, design, performer's economic right, layout-design (topography) right or plant variety right must have been registered / mentioned / granted under the relevant law of Hong Kong or any place outside Hong Kong;
- The specified IP right must have been used in the production of that person's chargeable profits during a part or the whole of the basis period for a year of assessment in which a deduction is claimed; and
- The purchaser must hold the specified IP right at the end of the basis period for a year of assessment in which a deduction is claimed.

The purchase cost is to be deducted over five years of assessment on a straight-line basis starting from the year of assessment in which the capital expenditure is incurred. If the specified IP right is a copyright, performer's economic right, protected layout-design (topography) right, protected plant variety right or registered design and the maximum period of protection is due to expire within the five-year deduction period, the purchase cost can be deducted in equal amounts over the number of remaining years of protection. If the specified IP right is used partly in the production of chargeable profits and partly for any other purposes, apportionment of the capital expenditure is required such that deduction is limited to the extent to which the specified IP right is used for the production of chargeable profits.

The Commissioner is empowered to (1) determine the true market value of a specified IP right for tax deduction purpose (if the consideration for the purchase of that specified IP right does not represent the true market value of the right at the time of purchase) and (2) allocate the consideration for an individual specified IP right when such right is purchased together with another specified IP right or with any other assets for one consideration.

Section 16EB provides for a claw-back of the proceeds from sale of any specified IP right in respect of which a tax deduction has been previously allowed. In essence, the proceeds from sale of such specified IP right will be deemed as taxable trading receipts at the time of sale but the taxable amount will be limited to the deduction previously allowed under section 16EA. If the specified IP right is sold within the five-year deduction period such that part of the purchase cost has not been claimed as deduction at the time of sale (i.e. the unallowed amount), any excess of the unallowed amount over the sale proceeds will be allowed as deduction in the year of sale whereas any excess of the sale proceeds over the unallowed amount will be subject to tax in the year of sale. The claw-back provision in section 16EB is similar to that under section 16G(3)(a) of the IRO that deals with prescribed fixed assets.

Section 16EC includes various anti-avoidance provisions that guard against the possible abuse of the tax deductions allowable under section 16EA. Situations in which a deduction will be denied include:

1. Where a specified IP right is purchased wholly or partly from an associate;
2. Under certain avoidance arrangements involving transfer of a specified IP right in circular route for obtaining tax benefit (i.e. the "sale and license back" arrangements);

3. For any specified IP right that is licensed for use wholly or principally outside Hong Kong by a person other than the purchaser; and
4. For any specified IP right of which the whole or a predominant part of the consideration was financed directly or indirectly by a non-recourse debt (i.e. the "leveraged licensing arrangements").

5.3. Specified capital expenditure incurred in relation to environmental protection facilities (section 16H to section 16K)

Section 16H to section 16K were introduced in 2008 to provide accelerated profits tax deduction for capital expenditure on environmental protection facilities. In 2010, the relevant provisions were amended to include environment-friendly vehicles.

a. Tax treatment of Environmental Protection Machinery (EPM)

Under section 16I, specified capital expenditure incurred on EPM can be fully deducted in the year of acquisition. Similar to the tax treatment of prescribed fixed assets under section 16G, machinery or plant held under a lease and capital expenditure incurred under a hire-purchase agreement will not qualify for the deduction.

The treatment of proceeds from sale of EPM is similar to that of PFAs, that is, the sale proceeds, up to the amount of deduction previously allowed under section 16I, will be treated as a taxable trading receipt.

Interest payable on capital expenditure incurred on EPM is included in section 16(2)(e) and is allowed for deduction for profits tax purpose subject to sections 16(2A) and 16(2B).

b. Tax treatment of Environmental Protection Installation (EPI)

Before the enactment of Inland Revenue (Amendment) (No. 9) Ordinance 2018 (the Ordinance), capital expenditure incurred on the construction of EPI can be deducted over five consecutive years starting from the year of acquisition at a rate of 20% per year under section16I. After the enactment of the Ordinance in 2018, capital expenditure incurred on the construction of EPI in or after year of assessment 2018/19 can be fully deducted. For any part of the capital expenditure on EPI that was incurred before year of assessment 2018/19 and that remains to be deducted in or after year of assessment 2018/19 can be deducted in full in year of assessment 2018/19. Similar to EPM, capital expenditure incurred under a hire-purchase agreement will not qualify for the deduction. Section 16J includes a re-capture provision on subsequent disposal of the EPI when deduction was previously allowed under section 16I. For EPI that is sold, the sale proceeds, up to the amount of deduction previously allowed, will be treated as a taxable trading receipt.

c. Accelerated tax deduction for environment-friendly vehicles

The 100% deduction for capital expenditure on environment-friendly vehicles is allowed in the year of purchase. As such, the treatment for environment-friendly vehicles will be similar to that of EPM. Similarly, vehicles held under a lease and capital expenditure incurred under a hire-purchase agreement will not qualify for the deduction. The claw-back provision on the sale proceeds applies upon sale of the vehicles.

Qualified vehicles are defined in Part 3 of Schedule 17 of the IRO and include vehicles that are exempt from first registration tax.

Interest payable on capital expenditure incurred on environment-friendly vehicles is included in section 16(2)(e) and is allowed for deduction for profits tax purpose subject to sections 16(2A) and 16(2B).

6. CONTENTIOUS DEDUCTIONS

6.1. Provisions for retirement benefits

Expenditures related to retirement scheme which is not approved by the Commissioner are treated according to the general rules. Only expenditures which are revenue in nature and incurred for the purposes of producing chargeable profits are deductible. Provisions are specifically disallowed under section 17(1)(j).

Expenditures related to retirement schemes approved by the Commissioner are governed by sections16A, 17(1)(h) and 17(1)(i). Under section 16A, any annual contribution to an approved retirement scheme is allowable. However, section 17(1)(h) restricts such deduction to 15% of the emoluments of each employee. Where a payment other than an ordinary annual contribution, such as initial contribution or special contribution, is made to such scheme, the whole payment will be deductible in five equal instalments over five years of assessment, beginning with the basis period in which the payment is actually made under section 16A.

For defined contribution scheme, the obligations of the employer are fixed and defined, the amount charged to the income statement as expenses should be the same as the amount that is required to be contributed by the employer and hence the same amount should be deductible (as it is uncommon for approved retirement scheme having employers' contribution more than 15% of the emoluments of each employee and hence restriction under section 17(1)(h) or section 17(1)(i) applies).

Issues arise in the case of defined benefit scheme. The accounting treatments of defined benefits scheme are governed by Hong Kong Accounting Standard 19 (HKAS 19) and Hong Kong Accounting Standard 26 (HKAS 26). The amounts recognised as expenses in the financial statements reflect the changes in the fair value of assets in the scheme as well as the changes in the actuarial valuation of the obligations of the employers. The expenses so charged are quite different from the amounts allowed under the IRO. The IRD issued DIPN 23, Recognised Retirement Schemes, to clarify its position on the treatments of the provisions made for approved retirement scheme.

Paragraph 51 of DIPN 23 - Recognised Retirement Schemes provides*: "For a ROR scheme that is a defined benefit scheme, the net total charged as an expense to the employer's profit and loss account is treated, for profits tax purposes, as a provision for payment of contributions to the retirement scheme and allowed for deduction, to the extent that the amount does not exceed 15% of the total emoluments of the employees for the period covered. Where the net total is a credit to the profit and loss account, the amount credited will be included in the employer's assessable profits. The actual contributions paid reduce the accrued defined benefit liability in the balance sheet and are not recognized as expenses in the profit and loss account. As the provision has been allowed, the contributions paid are not allowed for* *deduction again. The Department considers that the treatment stated above is in line with the principle established in the case of Secan Ltd. & Ranon Ltd. v. CIR 5 HKTC 266 that assessable profits and losses must be ascertained in accordance with the ordinary principles of commercial accounting as modified to conform with the IRO in that the amount allowed as an expense is computed in accordance with generally accepted accounting principles currently in force subject to the 15% restriction placed under the IRO."*

In June 2011, the issue was revisited by the IRD at the request of taxpayers. The latest positions as disclosed on the IRD website are as follows:

"The Department issued Departmental Interpretation and Practice Notes No. 23 [DIPN 23] in September 2006. The tax treatment for the components of Net Total recognized in the accounts of an entity participating in a defined benefit retirement scheme as required by Hong Kong Accounting Standard 19 [HKAS 19] and the actual contributions paid to such a scheme was explained in paragraphs 49 to 52 therein. In sum, the Net Total charged as an expense to the accounts would be allowed for deduction subject to a restriction of 15% of the employees' total emolument for the period covered, or would be taken as assessable profits if it was a credit; and the actual contributions paid would not be allowed for deduction.

*Following a recent review on this matter, and with the benefit of a legal opinion, it has been concluded that the Net Total is **not** a provision for payment of contributions to the scheme and is prohibited from deduction under section 17(1)(j) of the Inland Revenue Ordinance. As a result, the Department will adopt the following assessing practice from now on:*

(a) Any component forming part of the Net Total recognized in the profit and loss account or statement of comprehensive income is not deductible or assessable;

(b) the ordinary annual contributions paid are allowable under section 16(1) subject to the 15% limitation prescribed in section 17(1)(h); and

(c) the special contributions paid are deductible in accordance with section 16A at the rate of 20% in each of the years starting from the year of payment.

Notwithstanding this revised assessing practice, all assessments made according to the old practice announced in paragraphs 49 to 52 of DIPN 23 cannot be reopened if they have become final and conclusive. If any entity feels aggrieved by the change of the assessing practice, they can write to the Assessor quoting their file reference and provide a computation to show the overall difference in the amounts of assessable profits computed under the two assessing methods. The Assessor will consider deducting the difference from the assessable profits for 2010/11."

6.2. Share-based employee payments

Over the years, there has been considerable debate about the tax deduction of share-based payments for Hong Kong profits tax purpose since the requirement of accounting standards to report the cost of the share-based payments in the financial statements was introduced. An example of such payments is employee share-based compensation in the form of stock options or share awards. Very often, the employees of a Hong Kong company will receive stock options or share awards granted by another group company either in Hong Kong or overseas (the issuing entity) and the issuing entity will recharge the Hong Kong company for the costs associated with granting of such share-based benefits.

Pursuant to HKFRS 2 "Share-based payment", a Hong Kong company is required to recognise in its profit and loss account an expense in relation to the share-based benefits granted to its employees proportionately over the vesting period of such benefits. The expense is computed based on the fair value of the options/awards at the grant date and the estimated number of options/awards that will eventually vest. When there is a recharge from the issuing entity, the Hong Kong company may recognise, at the time of recharge and subject to HKFRS 2, the amount paid/payable to the issuing entity by debiting the equity reserve account without going through the profit and loss account. In some cases, the amount of recharge paid/payable to the issuing entity may be different from the amount of share-based payment expenses recognised by the Hong Kong company under HKFRS 2. Examples include (1) when the recharge is calculated as the market value of the share concerned at the exercise date less the consideration paid by the employees and/or (2) when the share price has been increased or decreased since the grant date.

The current positions adopted by the IRD on this issue are as follows:

- Recharge in relation to both new issue of shares as well as acquisition of shares from the market by a group entity is now considered as expenses incurred provided certain conditions are met and can be allowable.
- There must be a written recharge agreement in place.
- The timing of deduction is the point of exercise of the stock options or the point of vesting of the share awards.
- The amount of deduction claimed must not be excessive. For example, it should not be more than the open market value of the shares acquired at the date when the options are exercised or the awards are vested less the amount or value of consideration given by the grantee/awardee.
- Where any option shares or award shares are subsequently forfeited or cancelled, any deduction previously allowed should be written back as a trading receipt and offered for assessment.

The IRD also emphasised that, where appropriate, it may apply the anti-avoidance provisions to share-based payment transactions that are entered into for tax avoidance purposes.

In addition, the answer to FAQ No. 9 on deductibility of inter-group recharge[7] posits that a recharge is deductible as long as (1) the conditions, including the "incurred" test, under sections 16 and 17 of the IRO are satisfied, and (2)the entity has become unconditionally liable to pay the recharge. Yet any provision for recharge claimed for deduction in the basis period in which (1) the related stock options have not been exercised or (2) the related share awards have not been vested, will then be disallowed.

The position taken by the IRD in cases without a recharge arrangement has not been changed. For example, share-based payment expenses recognised by a Hong Kong company in its income statement in accordance with HKFRS 2 will continue to be non-deductible in cases where (1) the Hong Kong entity issues its own shares to fulfil the stock options or share awards

[7] IRD webpage > Home > Tax Information > Individuals/Businesses > Tax Rep's Corner > FAQ for Share-based Payment Transactions

obligations or (2) new shares are issued by another group entity without a recharge to the Hong Kong company.

Technically, where the provisions of the recharge agreement require the taxpayer to make the recharge payment regardless of whether the related share options/share awards are exercised/vested, the "incurred" test under section 16(1) should have been satisfied at the point of time when the taxpayer has the legal liability to pay the recharge amount in accordance with the recharge agreement, even though the related stock options/share awards may not have been exercised or vested. Accordingly, the deduction of such recharge should not be denied on the basis that the “incurred” test under section 16 has not been met. However, according to the position taken by the IRD, one of the conditions to be satisfied for claiming a deduction on the recharge under the revised practice is the related stock options must have been exercised or the related share awards must have been vested. The IRD has not elaborated on the legal/technical basis upon which this condition is imposed.

The question of whether the recharge received by the granting company is subject to profits tax arises when the granting company is carrying on a business in Hong Kong. In its 2013 meeting with the HKICPA, the IRD took the view that where the granting company discharged the stock option/share award obligations by issuing new shares, the recharge received will normally be considered as a capital receipt and not taxable.

However, if the granting company discharged the obligations by acquiring shares from the market, the taxability of the recharge will depend on whether the granting company has been engaged in any trading of shares. The IRD will not normally regard the acquisition of shares from market by the granting company in satisfaction of its obligations as trading in shares. However, for a granting company that is itself carrying on a share dealing business, the IRD will look at the purposes for which the shares were acquired (i.e. whether the shares were acquired to form its own trading shares portfolio or solely for discharging its obligations under the stock option/share award scheme).

The IRD also made a note that if a portion of the recharged amount constitutes service fee for intra-group services provided by the granting company, such fee should be chargeable to profits tax (assuming that the services were performed by the granting company in Hong Kong).

References:

1. The website of Hong Kong Inland Revenue Department
2. Inland Revenue Ordinance Cap.112
3. Tax Bulletin No 25: 2014 Minutes of Annual Meeting between the Inland Revenue Department and the Hong Kong Institute of Certified Public Accountants
4. Tax Bulletin No 24: 2013 Minutes of Annual Meeting between the Inland Revenue Department and the Hong Kong Institute of Certified Public Accountants
5. Tax Bulletin No 21: 2011 Minutes of Annual Meeting between the Inland Revenue Department and the Hong Kong Institute of Certified Public Accountants
6. Tax Bulletin No 20: 2010 Minutes of Annual Meeting between the Inland Revenue Department and the Hong Kong Institute of Certified Public Accountants
7. Tax Bulletin No 19: 2009 Minutes of Annual Meeting between the Inland Revenue Department and the Hong Kong Institute of Certified Public Accountants
8. Hong Kong Institute of Certified Public Accountants. Qualification Programme – Module 14: Taxation. Second edition 2023, Learning Pack (Chapter 3)
9. Departmental and Interpretation Practice Note No. 5
10. Departmental and Interpretation Practice Note No. 23
11. Departmental and Interpretation Practice Note No. 49
12. Departmental and Interpretation Practice Note No. 55