KPMG

Hong Kong (SAR) Tax Alert

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The Court upheld upfront lump-sum spectrum licence fees as capital in nature and non-deductible

Summary

The Court of Appeal (COA) recently dismissed the taxpayer's appeal against the lower court's judgment in the *China Mobile* case. The COA upheld that the upfront lump-sum spectrum licence fees paid by the telecommunication service provider in the case are capital in nature and not deductible.

In this news alert, we summarise the COA's analysis and discuss our observations from the case.

Background

The COA handed down its judgment in *China Mobile Hong Kong Company Limited v Commissioner of Inland Revenue*[1] on 3 November 2022. The case concerned whether the upfront lump-sum spectrum utilisation fees paid by the taxpayer (Upfront SUFs) are capital or revenue in nature. The COA dismissed the taxpayer's appeal and upheld the Court of First Instance (CFI)'s judgment[2] that the upfront SUFs are capital in nature and not deductible. Please refer to the diagram below for the key facts of the case.

1. Upfront lump-sum payments for spectrum utilisation

- The taxpayer is a mobile telecommunication service provider in Hong Kong
- It had been paying annual licence fees (annual SUFs) for use of 2G spectrum to the Telecommunications Authority (TA) before the auctions mentioned below
- It acquired 4G and 2G licences from the TA through auctions and made upfront SUFs (HK$494.7M for the 4G spectrum and HK$15.12M for the 2G spectrum) to the TA in 2009

2. The taxpayer's positions

- In its audited accounts, the taxpayer classified the upfront SUFs as **non-current intangible assets** and amortised them on a straight-line basis over the licence periods.
- The taxpayer treated the amortisation expenses as deductible in its profits tax computations for years of assessment (YOAs) 2009/10 to 2011/12

3. The IRD's position

- The IRD raised additional assessments to disallow the amortisation expenses on the basis that the upfront SUFs are capital in nature

4. Objection and appeal

- The taxpayer lodged objection and appeal against the additional assessments
- Both the Board of Review and the CFI regarded the upfront SUFs as capital in nature and the amortisation expenses as non-deductible.
- The taxpayer then lodged a further appeal to the COA

1 The COA judgment can be accessed via this link to the Judiciary website.
2 The CFI judgment can be accessed via this link to the Judiciary website.

The issues in dispute

To decide on whether the upfront SUFs are capital or revenue in nature, the key issue in dispute is whether there should be a distinction between a payment for "right to use" and a payment "for use" of the spectra, and whether such distinction is decisive in determining the nature of the upfront SUFs.

In the appeal before the COA, the taxpayer put forward a new argument that was not raised before as its primary argument. The taxpayer argued that it paid the annual and upfront SUFs to the TA for the use of spectra and then re-sold exactly the same thing to its customers for their use of the spectra. The upfront SUFs therefore represented the direct costs for providing the telecommunication services to the customers and earning the taxpayer's income (i.e. being circulating capital) and were revenue in nature.

The COA's judgment and analysis

Below is a summary of the COA's analysis and comments:

The COA rejected the new argument put forward by the taxpayer on the bases that:

- the new contention was not argued before the Board of Review and no evidence was adduced before the Board for it to make a finding of facts about it; and
- an appeal against a Board's decision to a court should be on a ground involving only a question of law and the court must not receive any further evidence on questions of fact on hearing of an appeal.

On the distinction between payments for "right to use" and "for use" of the spectra, the COA held that:

- There is no error in the CFI judge's approach for not recognising the distinction between payments made for "right to use" and "for use" of the spectra as decisive since there is no single decisive test to determine whether a payment is capital or revenue in nature.
- The proper construction of the Telecommunications Ordinance (TO) and the subsidiary legislation suggests that the legislature does not intend to make such a distinction and there is nothing in the TO suggesting that the obligation to pay the upfront SUFs only arises upon actual use of the spectra either by the taxpayer or its customers.
- The upfront SUFs were paid for the valuable exclusive right granted to the taxpayer to use the designated spectra assigned to it for 12-15 years. They were costs for acquiring or enlarging the profit-earning structure of the taxpayer's business. The payments brought into existence fixed assets of an enduring nature which are held and used by the taxpayer in its business.
- The distinction between payment as a condition for the assignment of the designated spectra and payment as consideration for the assignment is of little relevance. Such distinction is a too narrow focus for answering the question of what the upfront SUFs were really paid for.
- The upfront SUFs did not fulfil exactly the same business and economic function as annual SUFs (which were periodic payments for the use of or the right to use spectrum for a short period only) and cannot be regarded as compounded annual payments.

Accordingly, the COA dismissed the taxpayer's appeal and held that the upfront SUFs are capital in nature and not deductible.

KPMG observations

We set out our observations from the case as follows:

- The judgment in this case has reiterated the key principles for determining whether an expenditure is capital or revenue in nature, namely whether the expenditure is incurred: (1) once and for all; (2) to bring into existence an asset with enduring benefit and (3) to create, acquire or enlarge the permanent income-producing structure of the taxpayer. These principles have been well established by case law and are not in dispute but their application to a particular set of facts is often contentious.

- As pointed out by the judges in this case, arguments and supporting evidence that are not raised before the Board cannot be put forth to the courts for determination subsequently. Taxpayers should therefore exercise caution and have a thorough consideration when formulating the grounds of appeal for Board hearing.
- As a separate matter, this case highlights a broader tax policy issue that has been raised with the HKSAR Government by the telecommunication industry and the tax profession, namely the non-deductibility of the so-called “blackhole expenditure” under the Hong Kong tax system.

  This refers to the non-deductibility of capital expenditure incurred by taxpayers to acquire certain intangible assets (e.g. payments for acquiring a licence or an indefeasible right of use (IRU) of data transmission capacity) even though the sums are necessarily incurred by the taxpayers to produce their assessable profits.

  Consistent with the practice in other comparable jurisdictions, to foster further development of the innovation and technology sector and the telecommunication industry, we urge the government to consider amending the Hong Kong tax law and expanding the current scope of tax deduction for purchase costs of intangible assets to cover the above blackhole expenditure. We also urge the government to relax the existing restrictions on tax deduction of capital expenditure incurred on purchase of specified intellectual properties (IPs). For example, tax deduction of costs of acquiring a specified IP in the following circumstances should not be denied: (1) purchase of the IP from a related party if the purchase price is at arm’s length and (2) the IP purchased is used by someone other than the taxpayer outside Hong Kong under a licensing arrangement but the royalty income derived from the IP is subject to profits tax in Hong Kong.

  The above is particularly relevant in light of the introduction of the foreign-sourced income exemption (FSIE) regime in Hong Kong from 1 January 2023. Under the FSIE regime, offshore royalty income from use of non-patent related IPs will be taxable in Hong Kong and offshore royalty income from use of patent or similar IPs will only be tax exempt if qualifying expenditure on R&D activities related to the IPs is incurred by taxpayers.

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