Case No. D21/06

Profits tax – franchise fee – whether capital or revenue – whether expenditure on the purchase of rights to trade mark – Inland Revenue Ordinance ('IRO') section 16E

Panel: Kenneth Kwok Hing Wai SC (chairman), Erik Shum and Alan Wong Chiu Ming.

Date of hearing: 25 March 2006.
Date of decision: 11 May 2006.

The appellant paid a franchise fee under a Store Franchise Agreement to purchase the rights to operate a store for seven years.

The main issue is whether the franchise fee was of a capital nature.

Held:

1. The Board found that the franchise fee was of a capital nature as it was the cost of acquiring the permanent structure of which the income was to be the produce or fruit. (Wharf Properties Ltd v CIR applied)

2. The Board also found that the franchise fee was paid to obtain the grant of a non-exclusive licence to sue the store, the trademarks, etc. Section 16E of the IRO was amended in 1982. The original provision which allowed deduction of capital expenditure incurred on the purchase of 'rights to trade mark or design' was repealed. Capital expenditure on the purchase of rights to trade mark ceased to be deductible. Thus, the franchise fee was not deductible.

Appeal dismissed.

Cases referred to:

Wharf Properties Limited v Commissioner of Inland Revenue [1997]AC 505
Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd [1964] AC 948
Henriksen v Grafton Hotel Ltd [1942] 2 KB 184

Taxpayer in person.
Tang Hing Kwan and Wong Siu Suk Han for the Commissioner of Inland Revenue

Decision:

1. This is an appeal against the Determination of the Deputy Commissioner of Inland Revenue dated 1 December 2005 whereby:

(a) Profits Tax Assessment for the year of assessment 2003/04, dated 10 November 2004, showing assessable profits of $256,933 was confirmed; and

(b) Personal Assessment for the year of assessment 2003/04 under Charge Number 6-1533047-04-8, dated 10 November 2004, showing net chargeable income of $164,740 with tax payable thereon of $19,751 was confirmed.

2. The appellant paid a franchise fee under a Store Franchise Agreement dated 31 October 2002 and contended that such fee, amortised over a seven year period, should be deductible in ascertaining the assessable profits.

3. Ms TANG Hing-kwan:

(a) conceded that it was a deductible expense under section 16(1) of the Inland Revenue Ordinance, Chapter 112, but

(b) contended that it was an 'expenditure of a capital nature' excluded by reason of section 17(1)(c).

4. Wharf Properties Limited v Commissioner of Inland Revenue [1997] AC 505 was an appeal to the Privy Council from Hong Kong. This judgment is binding on the Board of Review. The Privy Council held at page 510 that:

(a) in the absence of express contrary language, expenditure which comes within section 16 will not be deductible if it falls within one of the prohibited categories in section 17;

(b) for section 17(1)(c), the relevant head of prohibition is 'any expenditure of a capital nature';

(c) in thus adopting a criterion of deductibility which refers to the 'nature' of the payment – either capital or revenue – the statute is adopting an accounting concept as a rule of law;

(d) expenditure is either of a capital nature or it is not, and whether it is one or the other is a question of law; and

(e) the cost of 'creating, acquiring or enlarging the permanent . . . structure of which the income is to be the produce or fruit' is of a capital nature, while 'the cost of earning that income itself or performing the income-earning operations' is a revenue expense, citing Viscount Radcliffe in Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd [1964] AC 948.

5. In Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd, Viscount Radcliffe said at page 960 that 'permanent' did not mean 'perpetual'

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6. In Henriksen v Grafton Hotel Ltd [1942] 2 KB 184 (also reported in 24 TC 453), the English Court of Appeal held that a right for three years had enough durability to justify being treated as a capital asset.

7. By letter dated 18 November 2004, the appellant stated that he had paid the franchise fee to obtain the right to operate the store for seven years and contended that it was 'a necessary outgoings expense to purchase the rights to operate the store and production of assessable profits for 7 years'.

8. We agree with the appellant's contention that the franchise fee was an expense to purchase the rights to operate the store. Under the Store Franchise Agreement, the franchise fee was paid prior to signing of the Store Franchise Agreement (see Article 2) and the appellant was granted a non-exclusive licence to use the store, the trademarks etc. (see Article 3).

9. On the appellant's own contention, and applying the Privy Council judgment in the Wharf case, the franchise fee:

(a) was the cost of acquiring the permanent structure of which the income was to be the produce or fruit;

(b) was of a capital nature; and

(c) is not deductible by reason of section 17(1)(c); and

the appeal must fail.

10. There are other reasons why the appeal must fail.

11. One arrives at the same conclusion by applying the tests summarised by P Chan J (as he then was) in his judgment in the Wharf case [1995] 1 HKLR 347:

(a) Fixed/circulating capital test

The franchise fee was for the grant of the a non-exclusive licence to use the store, the trademarks etc.

Different sums were payable for the initial inventory and subsequent inventory, see Article 7(A), (C) and (E) of the Store Franchise Agreement.

(b) Once and for all/recurring expenditure test

The franchise fee was a one-off payment. In contrast, inventory and the charges under Article 10 of the Store Franchise Agreement were recurring expenses.

(c) Enduring benefit test

A period of seven years is sufficiently durable.

(d) Profit yielding structure test

See paragraphs 4 – 9 above.

(e) The character of the advantage sought

It was a non-exclusive licence which enabled the appellant to operate the store for seven years in the name of the store.

(f) The manner in which it is to be used, relied upon or enjoyed

It was by operating the store for seven years in the name of the store.

(g) The means adopted to obtain it

The appellant obtained it by paying the franchise fee under the Store Franchise Agreement.

12. Another reason why the appeal must fail is the amendment to section 16E of the Ordinance by the Inland Revenue (Amendment) Ordinance 1992.

13. Section 16E(1) and (6) currently reads as follows:

> '(1) *Notwithstanding anything in section 17, in ascertaining the profits from any trade, profession or business in respect of which a person is chargeable to tax under this Part for any year of assessment there shall, subject to subsections (2) and (6), be deducted any expenditure incurred by such person during the basis period for that year of assessment (other than any amount which is allowable as a deduction apart from this section) on the purchase of patent rights or rights to any know-how, for use in Hong Kong in the trade, profession or business in the production of such profits.' (Amended 7 of 1986 s. 12; 15 of 1992 s. 2)*
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> *'(6) The amendments made to this section by the Inland Revenue (Amendment) Ordinance 1992 (15 of 1992) apply to patent rights or rights to any know-how purchased under contracts entered into on or after 18 April 1991 and the provisions of this section that were in force immediately before the commencement of that Ordinance continue to apply to patent rights or rights to any trade mark or design purchased under contracts entered into before 18 April 1991 and also to proceeds received from the sale of those rights whether before or after 18 April 1991 as if the amendments had not been enacted.' (Added 15 of 1992 s. 2)*

14. The 1992 Amendment Ordinance amended the principal Ordinance in a number of ways. The material one was the repeal of the words 'trade mark or design' and the substitution of the words 'know-how'. Thus the original provision which allowed deduction of an expenditure incurred on the purchase of 'rights to trade mark or design' was repealed. Expenditure on the purchase of rights to trade mark ceased to be deductible. The franchise fee was paid to obtain the grant of a non-exclusive licence to use the store, the trademarks etc.

15. For completeness, we will comment briefly on the appellant's grounds of appeal.

16. The first contention is that the franchise fee was not the appellant's asset. As Ms Tang Hing-kwan pointed out, the franchise fee, amortised for the period, was classified as an intangible asset in the balance sheet of the store as at 31 March 2004 approved by the appellant as its sole proprietor.

17. The second contention is that the franchise fee was or was also for the supply of inventory. For reasons given in paragraph 11(a) above, we reject this contention.

18. The third contention is that the franchise was not transferable. We agree with Ms Tang Hing-kwan's submission that this is irrelevant to the question whether the franchise fee was an expenditure of a capital nature.

19. For the reasons given above, the franchise fee is not deductible by reason of section 17(1)(c). We dismiss the appeal and confirm the assessment appealed against as confirmed by the Deputy Commissioner.

20. We thank Ms Tang Hing-kwan for her assistance.