

HCIA 6/2007

**IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION**

COURT OF FIRST INSTANCE
INLAND REVENUE APPEAL NO. 6 OF 2007

BETWEEN

CANTON INDUSTRIES LIMITED

Appellant

and

COMMISSIONER OF INLAND REVENUE

Respondent

Before: Hon Reyes J in Court
Date of Hearing: 7 March 2008
Date of Judgment: 7 March 2008

J U D G M E N T

I. INTRODUCTION

1. This appeal raises a short question of profits tax. That is whether expenditure for the acquisition of permanent quota is an expense in the nature of revenue and so deductible from assessable profits.

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2. Inland Revenue Ordinance (Cap.112) (IRO) s.16(1) permits the deduction of expenses of a revenue nature incurred by a business in the production of assessable profits. But IRO s.17(1)(c) disallows the deduction of expenditure of a capital nature from assessable profits.

3. The Board of Review held that expenditure on permanent quota was of a capital nature and consequently not deductible. In this appeal Canton submits that the Board was wrong in its Decision.

4. The Board stated a single question for my determination:-

“On the facts found by the Board, did the Board err in law in failing to conclude that the expenditure concerned was revenue in nature?”

II. BACKGROUND

5. The facts before the Board were largely agreed.

6. Canton is in the textile business. It appeals against profits tax assessments in the financial years 2000/01 to 2004/05. In such assessments, the Revenue disallowed Canton's claims to deductions in respect of the utilisation of permanent quota.

7. During the financial years assessed, it was not possible to export textiles to Europe or the United States without quota. At the time there were 2 types of transfers of textile quota in Hong Kong.

8. One type concerned the transfer of permanent quota. Here a transferee (such as Canton) obtained the right to use a quota allocation year after year for the life of the quota, provided only that one used a certain percentage of the allocation in any previous year.

9. The other type concerned the transfer of temporary quota. Here a transferee obtained the right to use transferred quota for a relevant year. The transferee's use of the transferred quota would be attributed to the transferor and no further quota would be allocated to a transferee in a succeeding year.

10. Canton acquired both permanent and temporary quota as part of its business.

11. Its accounting policy was to write off permanent quota as being utilised on a straight-line basis over the useful economic lives of the same. The permanent quotas were classified in Canton's balance sheet as non-current assets at their written-down values (that is, net of annual utilisation).

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12. In contrast, Canton charged the cost of temporary quota against its profits and loss account as part of the cost of textile sales.

13. In consequence of the Mainland's membership in the World Trade Organisation, it was anticipated that the quota system would come to an end on 31 December 2004. The permanent quota acquired by Canton over the relevant years therefore had a short life span.

14. The question before the Board was whether (as Canton claimed) the utilisation of permanent quota could be deducted from assessable profits or whether (as the Board held) the utilisation cost was an expense of a capital nature.

15. Both Canton and the Revenue agreed that the income earned and expenses incurred from dealings in temporary quota were revenue in nature and so deductible.

III. DISCUSSION

A. Tests for revenue or capital

16. It is not always easy to decide whether an expense is of a capital or revenue nature. One first considers the salient features of an expense. Then, applying commonsense, one assesses whether the sum total of features tip the balance towards one or other nature. See *BP Australia Ltd. v. Commissioner of Taxation* [1966] AC 224 (PC), at 264E-265B. There can be grey areas where the correct characterisation will have to depend on "degree and comparison".

17. A number of tests are often resorted to as general guides.

18. One test is the "enduring benefit" test. This considers whether an expenditure has been incurred to bring into existence an asset for the enduring benefit of a trade. An expenditure falling within such category is likely to be of a capital nature. See, for example, *British Insulated and Helsby Cables Ltd. v. Atherton* [1926] AC 205 (HL), at 213-4 (Viscount Cave LC).

19. A similar test is the "once and for all expenditure" test. This posits that a capital expenditure is typically something spent once and for all, while a revenue expenditure is typically something that recurs annually. See, for example, *Vallambrosa Rubber Company Limited v. Farmer* (1910) 5 TC 529 (Court of Session), at 536 (Lord Cullen).

20. Another test is the "fixed or circulating capital" test. This examines whether an expense is incurred in connection with fixed or circulating capital. Fixed capital consists of assets which, having been acquired, generate income for a business without further action. In contrast, circulating capital relates to things sold, traded or otherwise circulated over and over again during the conduct of a business so as to generate profit for a person. Expenses relating to fixed capital are usually treated as capital in nature. Expenses relating to circulating capital are usually treated as

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revenue in nature. See, for example, *Ammonia Soda Company v. Chamberlain* [1918] 1 Ch D 286 (cited by the Board at Decision §15).

21. Still another test is the “profit-yielding structure” test. That distinguishes between expenditure to set up, replace or enlarge a business structure for the purpose of generating profit and regular outlays to maintain a process which brings in regular returns to an organisation. The former expenditure is likely to be capital in nature, the latter revenue. See, for example, *Sun Newspapers Ltd. and Associated Newspaper Ltd. v. Federal Commissioner of Taxation* (1938) 61 CLR 337 (HCA), at 359 (Dixon J).

22. The tests are not necessarily conclusive.

B. *Canton’s case*

23. Mr. Neil Thomson (appearing for Canton) says that the Board was wrong to decide that the utilisation of permanent quota was capital in nature.

24. Mr. Thomson reasons as follows:-

- (1) The permanent quota acquired by Canton had a limited life. That quota acquired in 2001 had a life of 3 years; that acquired in 2002 had a life of 2 years; and that acquired in 2003 had a life of only 1 year.
- (2) By writing-off the acquisition costs of the permanent quota over the useful life of the same, Canton attributed the expenditure rateably to a given year as part of the cost of sales incurred for that year.
- (3) This was reasonable, since without quota Canton would not have been able to make relevant sales and generate profit. The rateable attribution of quota to given years merely reflected a necessary regular outlay of the process whereby Canton obtained its regular returns.
- (4) The Commissioner accepted that the cost of acquiring temporary quota was a revenue expense. There is no meaningful distinction between such situation and the acquisition of permanent quota. If one is a revenue expense, so must the other be a revenue expense.

25. Mr. Thomson relies in support on an analogy with the situation in *BP Australia*.

26. In that case, BP claimed that its payments of a “development allowance” constituted expenditure of a revenue nature. BP paid out the allowances in consideration of individual service

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stations undertaking to retail only certain brands of petrol for a fixed number of years. Allowances were paid every year to new retailers.

27. The Privy Council (speaking through Lord Pearce) held (at 266) that “the sums in question were sums which had to come back penny by penny with every order during the period in order to reimburse and justify the particular outlay”. Accordingly, the development allowance payments constituted “circulating capital which is turned over and in the process of being turned over yields a profit or loss”.

28. Mr. Thomson suggests that the quota here was used as part of the process of the continuous and recurrent struggle to produce sales of garments in quota countries. The use of permanent quota by Canton was thus analogous to the payment of recurrent fees relating directly to garments exported, rather than to the structure of Canton’s business.

C. Evaluation of Canton’s case

29. Although the quota had a short lifespan, the Board did not believe that was determinative. The Board instead considered that, once acquired, Canton’s permanent quota became part of the profit-yielding structure or fixed capital of Canton’s business.

30. The Board reasoned that the acquisition of permanent quota had resulted in enduring benefits to Canton in the form of “(a) [the] continuous ability to trade with USA and Europe and (b) income derived from the temporary transfer out of the PQ [permanent quota]”.

31. The Board did not find any analogy with the situation in *BP Australia*. It observed that the facts of the latter case were different as they “concerned incentives paid by oil companies to petrol stations to secure their exclusive trade”.

32. In my judgment, the Board came to the right conclusion.

33. With the acquisition of permanent quota, Canton obtained an enduring benefit. That benefit was the ability to conduct business continuously over the duration of the quota. Although the life of the quota may not have been long, I agree with the Board that such shortness cannot be conclusive.

34. In contrast to temporary quota which is purchased from time to time as and when required by a business in a given year, the acquisition of permanent quota is a once and for all expenditure. Having acquired the permanent quota, provided that it maintains exports at a certain level, a permanent-quota holder can exploit the bundle of exclusive rights which comes with the quota to generate profits for its trade over the life of the quota.

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35. Thus, once acquired, the permanent quota became incorporated into Canton's profit-making structure or fixed capital.

36. Expenditure on permanent quota does not have a circulating or recurrent nature. Nor does expenditure on permanent quota have the character of a regular outlay incurred as part of the process of bringing regular returns through the trading of garments. I do not agree with Mr. Thomson that the cost of permanent quota (or a proportion of such cost) was merely a cost directly attributable to Canton's sale of garments in any given year.

37. Like the Board, I do not derive assistance from *BP Australia*.

38. It could be said metaphorically of any expense (whether capital or revenue) that ultimately every penny must be returned to a business in some form or other if the latter is to succeed. The process of obtaining a return in relation to any expense (whether capital or revenue) may accordingly loosely be described as part of the continuous imperative on a business to struggle through times good or bad.

39. Metaphor apart, the actual outcome in *BP Australia* hinged on the case's peculiar facts. I therefore doubt whether any useful analogy can be drawn for the purposes of this appeal.

IV. CONCLUSION

40. I would answer the Board's question in the negative. The Board did not fall into any error of law. Canton's appeal is dismissed.

(A. T. Reyes)
Judge of the Court of First Instance
High Court

Mr Neil Thomson, instructed by Messrs Sam Fu & Co., for the Appellant

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Ms Yvonne Cheng, instructed by the Department of Justice, for the Respondent