Case No. D34/16

Profits tax – additional assessment – whether expenses are revenue or capital in nature – whether the deductions are prohibited from deduction – sections 16(1) & 17(1)(c) of the Inland Revenue Ordinance ('the Ordinance')

Panel: Liu Man Kin (chairman), Stephen Suen Man Tak and Claire Wilson.

Dates of hearing: 11 to 13 and 18 April 2016.
Date of decision: 17 January 2017.

The Taxpayer was a provider of mobile telecommunication and related services in Hong Kong. It was the successful bidder for a licence to provide second generation ('2G') personal communications services, and for a licence to provide broadband wireless access ('4G') service. The Taxpayer paid a one-off lump sum upfront as spectrum utilisation fee ('Upfront SUF') for each of the 2G licence and the 4G licence to the Telecommunications Authority ('TA') as regulated by the Telecommunications Ordinance ('TO'). It was granted the 4G licence in March 2009 for a period of 15 years, and the 2G licence in June 2009 for a period of 12 years. These licences enabled the Taxpayer to develop a new business in the provision of 4G mobile services, and increased its capacity to enhance its 2G services. For the 2009/10, 2010/11, and 2011/12 years of assessment, the Taxpayer claimed deductions for the Upfront SUF, amortised over the length of the licences. The Assessor raised profits tax assessments for those years of assessment as per the returns filed by the Taxpayer. Subsequently, the Assessor opined that the Upfront SUFs were capital expenditure, and raised additional assessments by disallowing the deduction of the amortised Upfront SUFs. The Deputy Commissioner confirmed the additional assessments. The Taxpayer then appealed against the additional assessments.

Held:

1. Under section 16(1) of the Ordinance, whether expenditure was capital in nature was a question of law (Shui On Credit Co Ltd v CIR (2009) 12 HKCFAR 392 followed). It had to be approached by applying common sense rather than strict application of any single legal principle (Regent Oil Co Ltd v Strick [1966] AC 295; BP Australia Ltd v COT [1966] AC 224 considered).

2. The useful indicia which would give guidance on the nature of the expenditure were: (i) whether the expenditure was incurred once and for all, or was made to meet for an ongoing demand (Vallambrosa Rubber Co Ltd v Farmer (1910) 5 TC 529 considered); (ii) whether the expenditure was paid in return for an asset or an advantage for enduring benefit

(British Insulated and Helsby Cables Ltd v Atherton [1926] AC 205; Henriksen v Grafton Hotel Ltd [1942] 2 KB 184; BP Australia Ltd v COT [1966] AC 224 considered); (iii) whether the expenditure was on the profit-yielding subject or on its operations (Wharf Properties Ltd v CIR [1997] AC 505; Robert Addie & Sons' Collieries Ltd v CIR (1924) 8 TC 671; RTZ Oil and Gas Ltd v Elliss [1987] 1 WLR 1442; Ausnet Transmission Group Pty Ltd v CoT (2015) 322 ALR 385 considered). It was also useful to look at the character of the advantage sought, the manner in which it was to be used, relied upon, or enjoyed, and the means adopted to obtain the advantage (Sun Newspaper Ltd v FCT (1938) 61 CLR 337 considered).

3. The TO authorised the TA to make the Upfront SUFs as a condition for the assignment of the relevant radio spectrum required for the 2G and 4G services. By paying the Upfront SUFs, the Taxpayer acquired the exclusive right to use the assigned spectrum without the interference of other mobile telecommunications operators in the market. It could not have been the purpose of the TO to give out the right to use radio spectrum free of charge, and to only impose charges on the actual use of the spectrum. The Board rejected the Taxpayer's interpretation of the TO.

4. The indicia pointed to the capital nature of the Upfront SUFs. The Upfront SUFs were incurred once and for the right to use the specified frequency bands during the periods respectively covered by the 2G and the 4G licences. They were the final provision to secure the assignment of the licences. They were paid with a view to bringing into existence an advantage for the enduring benefit of the Taxpayer's mobile telecommunications business in Hong Kong. They were the cost of enlarging, enhancing and strengthening the permanent profit-producing business structure of the Taxpayer and its income-generating capacity.

5. The view that the Upfront SUFs were capital in nature was also supported by authorities in overseas jurisdictions (BFH v Comptroller of Income Tax [2013] 4 SLR 568; ITC 1726 (2000) 64 SATC 236; ITC 1772 (2003) 66 SATC 211 considered).

6. The Board concluded that the Assessor was correct to disallow the deduction as per section 17(1)(c) of the Ordinance.

Appeal dismissed.

Cases referred to:

Shui On Credit Co Ltd v Commissioner of Inland Revenue (2009) 12 HKCFAR 392

Regent Oil Co Ltd v Strick [1966] AC 295

BP Australia Ltd v COT [1966] AC 224
Vallambrosa Rubber Co Ltd v Farmer (1910) 5 TC 529
British Insulated and Helsby Cables Ltd v Atherton [1926] AC 205
Henriksen v Grafton Hotel Ltd [1942] 2 KB 184
Wharf Properties Ltd v Commissioner of Inland Revenue [1997] AC 505
Robert Addie & Sons' Collieries Ltd v Commissioner of Inland Revenue (1924) 8 TC 671
RTZ Oil and Gas Ltd v Elliss [1987] 1 WLR 1442
AusNet Transmission Group Pty Ltd v CoT (2015) 322 ALR 385
Sun Newspapers Ltd v FCT (1938) 61 CLR 337
HKSAR v Wong Yuk Man et al (2012) 15 HKCFAR 712
ABD Pte Ltd v Comptroller of Income Tax [2010] 3 SLR 609
BFH v Comptroller of Income Tax [2013] 4 SLR 568
ITC 1726 (2000) 64 SATC 236
ITC 1772 (2003) 66 SATC 211

Stewart K M Wong and Bonnie Y K Cheng, instructed by Squire Patton Boggs, for the Appellant.
Eugene Fung, Senior Counsel and Zabrina Lau, Counsel, instructed by the Department of Justice, for the Commissioner of Inland Revenue.

Decision:

The issue

1. This is the appeal by Company A ('the Taxpayer') against the Additional Profits Tax Assessments ('the Assessments') for the years of assessment 2009/10, 2010/11 and 2011/12 raised on it by the Commissioner of Inland Revenue ('the CIR').

2. The issue in this appeal is the true nature of the amortisation of certain upfront lump sum payments of spectrum utilisation fee ('Upfront SUFs') made by the Taxpayer to the Telecommunications Authority ('TA'). i.e. whether those Upfront SUFs are revenue in nature and hence is allowed for deduction under section 16(1) of the Inland Revenue Ordinance (Chapter 112) ('IRO'), or are capital in nature and are therefore prohibited from deduction under section 17(1)(c) of the IRO.

The facts

The facts as found by this Board

3. The facts set out below are based upon the Agreed Facts signed by the parties, the documents before this Board, and the background concerning the Upfront SUFs contained in the Appellant's witness' evidence.

4. (a) The Taxpayer was incorporated in Hong Kong in 1994. It closed accounts annually on 31 December.

(b) At all material times, the principal activity of the Taxpayer was the provision of mobile telecommunication and related services in Hong Kong.

5. (a) In September 1996, the Taxpayer was awarded a licence for a term of 10 years for the provision of second generation ('2G') personal communications services in Hong Kong ('the PCS Licence'). In January 1997, the Taxpayer launched the 2G mobile services under a brand name and operated with 2 x 11.6 MHz bandwidth in the 1800 MHz radio frequency band.

(b) Upon the expiry of the PCS Licence, the Taxpayer was granted a mobile carrier licence with a term of 15 years (i.e. up to and including 29 September 2021) to continue its 2G operations in Hong Kong.

(c) In September 2008, a unified carrier licence ('UCL') (Licence No.XXX) was issued to the Taxpayer to replace the mobile carrier licence.

6. (a) The Taxpayer as a holder of mobile carrier licence was required to pay annual licence fees. The licence fees were set out on a cost-recovery basis to cover the operating costs of the Office of the TA (or its successor, the Office of the Communications Authority) in administering the licences.

(b) The annual spectrum utilisation fee ('SUF') payable by the Taxpayer for the use of radio spectrum for its 2G operations was stipulated in the Telecommunications (Level of Spectrum Utilization Fees) (Second Generations Mobile Services) Regulation (Chapter 106AA).

7. On 3 December 2007, the TA, by the document 'Providing Radio Spectrum for Broadband Wireless Access Services: Statement of the Telecommunications Authority', proposed to allocate some frequency bands for the provision of broadband wireless access services. An auction ('the 4G Auction') would be conducted to determine the SUF (with a minimum set by the Secretary for Commerce and Economic Development), which would be in the form of an upfront lump sum. The conclusion reached by the Authority (stated at paragraph 67 of the said document) was that it would:

> 'recommend the SCED to make a regulation under section 32I(2) of the TO specifying that the SUF for the BWA spectrum will be determined by auction. The bidder who offers the highest bid will be the successful bidder. The SUF will be in the form of an upfront lump sum payment'.

8. Before the 4G Auction, the Taxpayer was only operating 2G mobile services in Hong Kong and it was not a 3G operator at the time. In order to maintain its market position, the Taxpayer was eager to succeed in the 4G Auction because there was a concern that other mobile network operators would outbid the Taxpayer with a view to eliminating it from the market.

9. The 4G Auction was completed on 22 January 2009. The Taxpayer was the successful bidder of one of the frequency bands. The SUF payable for the use of the bands was in the lump sum of HK$494,700,000.

10. As a result of assignment of the 4G spectrum, the Taxpayer has enlarged its profit-earning structure and capacity by venturing into a new field of business and strengthening its market competitiveness.

11. Separately, in 2008, the TA proposed to make available certain frequency bands to incumbent 2G licensees (of which the Taxpayer was one). At the time, the 2G licensees had been assigned frequency bands for use in their 2G mobile network services, and the SUFs they were paying for the use of the bands were annual sums, with the first five years being at a rate per kHz assigned, and subsequent years at the higher of the per kHz rate or a sum calculated by reference to turnover. It was proposed that the annual SUFs for the use of the frequency bands to be assigned would be charged on the same basis because the frequency bands to be assigned would be incorporated into the existing 2G licences. However, it was proposed in the paper 'Assignment of the Available Radio Spectrum in the 900 MHz and 1800 MHz Bands: Consultation Paper' (18 January 2008) that an additional, one-off lump sum component of the SUF be charged as well, for the following reason:

> '23. As mentioned in paragraph 17, the TA proposes to assign the frequencies by auction. For the purpose of the auction, the TA proposes to assign the frequencies to the successful bidder(s) who has/have offered the highest additional one-off lump sum SUF on top of the annual variable SUF described in paragraph 20 above. Such additional component of SUF will also be used to determine the respective priority rights of the successful bidders in choosing preferred set(s) of frequency bands. The bid will have to be equal to or greater than the reserve price set by the Secretary for Commerce and Economic Development ("SCED") for each frequency block. The reserve prices for all frequency blocks will be set at the same amount and it will be determined and announced nearer to the time of auction.
>
> 24. Following the approaches outlined above, the TA proposes that a two-tier SUF payment arrangement be adopted. The SUF will consist of two components: (a) an annual variable component based on the SUF calculation formula for the 2G spectrum under the existing 2G licences as described in paragraph 21 above and (b) a

> one-off lump sum component based on a sum committed by the successful bidder(s) in the forthcoming auction as described in paragraph 23.'

12. In the relevant brief to the Legislative Council Panel on Information Technology and Broadcasting – 'Legislative Council Panel on Information Technology and Broadcasting: Assignment of the Available Radio Spectrum in the 1800 MHz Band' (1 December 2008), it was said that the lump sum component would

> 'serve to determine the successful bidder(s) and the respective priority rights of the successful bidder(s) to choose the preferred set(s) of frequency bands.'

13. Accordingly, the auction ('the 2G Auction') to be held was to determine the lump sum component of the SUF to be paid for the use of the bands, and which bidder would be assigned which frequency bands. The annual component of the SUF would be the same as that applicable to the then already assigned frequency bands to 2G licensees.

14. The Taxpayer was the successful bidder of two of the frequency bands at the 2G Auction, which was completed on 10 June 2009. The total lump sum SUF payments were HK$15,120,000.

15. On 10 March 2009, the Taxpayer paid the TA the upfront SUF committed in the 4G Auction in the sum of HK$494.7 million.

16. On 31 March 2009, a UCL (Licence No.XXX) was issued to the Taxpayer.

17. On 1 June 2009, a UCL (Licence No.XXX) was issued to the Taxpayer to replace the UCL (Licence No.XXX) issued on 30 September 2008 and the UCL (Licence No.XXX) issued on 31 March 2009.

18. In June 2009, the Taxpayer paid the TA the upfront SUF committed in the 2G Auction in the sum of HK$15.12 million. The Taxpayer paid the said SUF by setting-off the cash deposit of HK$48 million made to the TA on its submission of application for participating in an auction in May 2009.

19. On 26 June 2009, the UCL (Licence No.XXX) issued to the Taxpayer on 1 June 2009 was amended.

20. The Taxpayer's success in the 2G Auction enlarged and strengthened its profit-yielding infrastructure by increasing its 2G spectrum capacity and improving the service quality of its 2G mobile services.

21. The Taxpayer furnished Profits Tax Returns for the years of assessment 2009/10 to 2011/12 together with its audited financial statements and tax computations for the respective years ended 31 December 2009 to 2011. In the returns, the Taxpayer

declared the following Assessable Profits after deducting, among other things, amortisation of the Upfront SUFs mentioned in paragraphs 9 and 14 above as follows:

	2009/10	2010/11	2011/12
	$	$	$
Assessable Profits	598,757,316	806,070,243	772,560,530
After deducting:			
Amortisation of the Upfront SUFs	25,368,699	34,212,877	34,212,877

22. (a) The Taxpayer analysed its turnover for the years ended 31 December 2009 to 2011 as follows:

Year ended 31 December	2009	2010	2011
	$	$	$
Airtime and service charges	2,315,578,225	2,495,286,850	2,664,853,144
Sales of handsets and accessories	239,831,454	268,389,088	440,127,935
	2,555,409,679	2,763,675,938	3,104,981,079

(b) The Taxpayer recognised telecommunications service revenue when the service was rendered to customers on the basis of the usage of its digital mobile radio telephone network and facilities.

(c) In its audited financial statements for the years ended 31 December 2009 to 2011, the Taxpayer classified the Upfront SUFs as Non-Current Intangible Assets and amortised them on a straight-line basis over the relevant licence periods.

(d) The amortisation of the Upfront SUFs for the years ended 31 December 2009 to 2011 was analysed as follows:

		Amortisation		
Licence Period	SUF $	2009 $	2010 $	2011 $
4G 31/3/2009-30/3/2014	494,700,000	24,735,000	32,980,000	32,980,000
2G 26/6/2009-29/9/2021	15,120,000	633,699	1,232,877	1,232,877
	509,820,000	25,368,699	34,212,877	34,212,877

23. The Assessor raised on the Taxpayer Profits Tax Assessment for the years of assessment 2009/10 to 2011/12 in accordance with its returns. The Taxpayer did not object to the assessments.

24. The Assessor opined that the Upfront SUFs were capital expenditure. Accordingly, he raised on the Taxpayer the following Assessments for the years of

assessment 2009/10 to 2011/12 to disallow the deduction of amortisation charge on the Upfront SUFs:

	2009/10 $	2010/11 $	2011/12 $
Additional Assessable Profits	25,368,699	34,212,877	34,212,877
Additional Tax Payable thereon	4,185,835	5,645,124	5,645,125

25. The Taxpayer through its tax representatives objected to the Assessments.

26. By a Determination dated 30 December 2014, the Deputy Commissioner of Inland Revenue confirmed the Assessments.

27. By a Notice of Appeal dated 29 January 2015, the Taxpayer appealed to this Board against the Assessments.

The Taxpayer's witness

28. The Taxpayer called one factual witness, who was one of its directors and its Chief Executive Officer.

29. Apart from outlining his personal background, the witness' evidence was divided into 2 parts – (a) the background concerning the upfront SUFs, and (b) the nature of the Upfront SUFs.

30. As to (a), the CIR has no dispute on this. Accordingly, we accept this part of the witness' evidence.

31. As to (b), we refuse to accept the witness' evidence on this issue.

32. The role of a factual witness is to give evidence on factual issues, which are within his personal knowledge, or are reasonably believed by him to be true. Opinion evidence given by a factual witness is inadmissible or has minimal weight. As to the nature of the Upfront SUFs, the witness' evidence on this point is his personal opinion. We are unable to accept this evidence.

33. Further, on contested issues between the parties, we do not regard the witness as a reliable witness. The witness was clearly not forthcoming when giving evidence.

(a) Despite having used the term 'profit-earning structure' in his own witness statement, he told the Board that he did not know the definition of the term and avoided the question of whether the Taxpayer's 4G and 2G networks form part of its profit-earning structure.

(b) Despite the fact that he did not look at the Taxpayer's accounts when they were prepared or study them in the course of this appeal, he saw fit to assert in his witness statement that the 'SUF payments were made from the circulating capital of the Appellant'.

(c) Having been shown Clause 2.1 of the UCL which allows the Taxpayer to transfer the UCL upon the TA's consent, the witness still refused to acknowledge that the UCLs were part of his company's profit earning structure despite his own definition that the term refers to 'something that one owns or can pass or transfer to another party'.

The Law

Statutory Provisions

34. Section 16(1) of the IRO provides:

> '*In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period…*'

35. Section 17 of the IRO contains a list of various kinds of expenditure in respect of which '*no deduction shall be allowed*'. The relevant head of prohibition in section 17 in this case is section 17(1)(c), which prohibits deduction in respect of '*any expenditure of a capital nature*'.

The Legal Principles

36. The legal principles are not in dispute.

37. The issue to be determined in this case is a question of law. As said by Lord Walker NPJ in Shui On Credit Co Ltd v CIR (2009) 12 HKCFAR 392 at paragraph 38:

> '*… Whether an expenditure is on capital or income account for tax purpose is a question of law: Beauchamp (Inspector of Taxes) v. FW Woolworth Plc [1990] 1 AC 478, cited by Lord Hoffmann in Wharf Properties Ltd v CIR [1997] AC 505 at p.510.*'

38. The issue has to be approached *by applying common sense*, and there is no one test or principle which is paramount. Lord Reid in Regent Oil Co Ltd v Strick [1966] AC 295 at 313D-G said:

> '*One must, I think, always keep in mind the essential nature of the question. The Income Tax Act requires the balance of profits and gains to be found. So a profit and loss account must be prepared setting on one side income receipts and on the other expenses properly chargeable against them. In so far as the Act prohibits a particular kind of deduction it must receive effect. But beyond that no one has to my knowledge questioned the opinion of Lord President Clyde in Whimster & Co. v. Inland Revenue Commissioners, where, after stating that profit is the difference between receipts and expenditure, he said:*
>
> > "*the account of profit and loss to be made up for the purpose of* ascertaining that difference *must be framed consistently with the ordinary principles of commercial accounting so far as applicable ...*"
>
> *So it is not surprising that no one test or principle or rule of thumb is paramount. The question is ultimately a question of law for the court, but it is a question which must be answered in light of all the circumstances which it is reasonable to take into account, and the weight which must be given to a particular circumstance in a particular case must depend rather on common sense than on strict application of any single legal principle.*' (underline supplied)

39. Further, in BP Australia Ltd v COT [1966] AC 224 at 264E-F, Lord Pearce said:

> '*The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a commonsense appreciation of all the guiding features which must provide the ultimate answer.*' (underline supplied)

40. While there may not be a single decisive test for the issue, there are however some useful indicia which would give us guidance on the question. The indicia are as follows:

(1) Whether the expenditure was incurred once and for all, or was made to meet for an ongoing demand - see Vallambrosa Rubber Co Ltd v Farmer (1910) 5 TC 529 at 536, per Lord Dunedin.

(2) Whether the expenditure is paid in return for an asset or an advantage for enduring benefit.

(a) In British Insulated and Helsby Cables Ltd v Atherton [1926] AC 205 at 213-214, Viscount Cave LC said:

'*But 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. For this view there is already considerable authority.*'

(b) 'Enduring' does not mean 'permanent' but means 'sufficient durability'. This point was made in Henriksen v Grafton Hotel Ltd [1942] 2 KB 184 at 192 by Lord Greene MR):

'*The thing that is paid for is of a permanent quality although its permanence, being conditioned by the length of the term, is short-lived.*'

And at 195-196 (du Parcq LJ):

'*It is true that the period for which the right was acquired in this case was three years and no more, and a doubt may be raised whether such a right is of "enduring benefit" or "of a permanent character". These phrases, in my opinion, were introduced only for the purpose of making it clear that the "asset" or "right" acquired must have enough durability to justify its being treated as a capital asset ... "Permanent" is indeed a relative term, and is not synonymous with "everlasting." In my opinion the right to trade for three years as a licensed victualler must be regarded as attaining to the dignity of a capital asset, whereas the payment made for an excise licence is no doubt properly regarded as part of the working expenses for the year.*'

(c) On the question of whether the benefit obtained by paying the expenditure is an "enduring" benefit, the length of time, though not a decisive factor, is a relevant factor. In BP Australia Ltd v COT [1966] AC 224 at 267E-F, Lord Pearce said:

'*What additional indication is given by the actual length of the agreements? That must be a question of degree. Had the agreements been only for two or three year periods that fact would have pointed to recurrent revenue expenditure. Had they been for 20 years, that fact would have pointed to a non-*

recurring payment of a capital nature. Length of time, though theoretically not a deciding factor, does in practice shed a light on the nature of the advantage sought. The longer the duration of the agreements, the greater the indication that a structural solution was being sought.'

(3) Whether the expenditure is on the profit-yielding subject or on its operations.

(a) In Wharf Properties Ltd v CIR [1997] AC 505 at 510G-H, Lord Hoffmann said:

'*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*'.

(b) *Expenditure* paid for the purpose of fulfilling an obligation which is a condition of acquiring a profit-yielding structure would be capital in nature, as it is the price for acquiring the profit-yielding structure. See Robert Addie & Sons' Collieries Ltd v CIR (1924) 8 TC 671; RTZ Oil and Gas Ltd v Elliss [1987] 1 WLR 1442; and AusNet Transmission Group Pty Ltd v CoT (2015) 322 ALR 385.

41. Lastly, we would also like to mention the Sun Newspapers' 3 criteria. In Sun Newspapers Ltd v FCT (1938) 61 CLR 337, Dixon J at 363 suggested 3 criteria to be considered for the purpose of determining whether an expenditure is capital or revenue in nature. The 3 criteria are as follows:

(a) the character of the advantage sought, and in this its lasting qualities may play a part;

(b) the manner in which it is to be used, relied upon or enjoyed and in this and under the former head recurrence may play its part; and

(c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment.

Analysis

Regulatory regime of radio spectrum in Hong Kong

42. As defined in section 2 of the TO, 'radio spectrum' means 'the range of frequencies within which radiocommunications are capable of being carried out'. In other words, radio spectrum is not a tangible thing, but is the range of frequencies for electromagnetic radiation.

43. In Hong Kong, the use of radio spectrum is principally regulated by the regulatory regime under the TO. See HKSAR v Wong Yuk Man et al (2012) 15 HKCFAR 712 at paragraphs 11-14 per Ma CJ. Under that regulatory regime, the TA would

(a) allocate particular frequencies within the radio spectrum to various radiocommunications services (sections 32G(1) and 32H(1));

(b) assign certain frequencies to individual users (sections 32H(2)(c) and 32H(5)); and

(c) prescribe the terms and conditions for the use of spectrum, including the payment of SUF (sections 32H(6) and 32I(1)).

Any 'short answer' to the issue?

44. Mr Steward Wong SC (leading Ms Bonnie Cheng) on behalf of the Taxpayer submits that there is a short answer to the issue in this appeal – that short answer lies in section 32I(1) of the TO.

45. Section 32I(1) of the TO provides:

> '*Subject to the consultation requirement under section 32G(2), the Authority may by order designate the frequency bands in which the use of spectrum is subject to the payment spectrum utilization fee by users of the spectrum.*' (underline supplied)
>
> '*在符合第32G(2)條的諮詢規定下，管理局可藉命令指定任何頻帶，而使用該頻帶內的頻譜的使用者須繳付頻譜使用費。*' (underline supplied)

46. Mr Wong SC submits that the wording of the section is clear – the Upfront SUFs is paid *for the use* of the radio spectrum, *not for the right to use* the radio spectrum. Accordingly, the Upfront SUFs are expenditure which is revenue and not capital in nature.

47. Mr Eugene Fung SC (leading Ms Zabrina Lau) on behalf of CIR submits that the point made by Mr Wong cannot be a short answer to the issue in this appeal. Mr Fung SC submits:

(a) The section does not say that the Upfront SUF is paid for the actual use of the spectrum. The phrase 'the use of spectrum is subject to the payment of spectrum utilization fee' simply means that a user is required to pay SUF before it can legitimately use the designated frequency assigned to it. The word 'use' is used in the general sense (as in 'make use of', 'deploy' or 'utilise') without any special meaning in it.

(b) Further, to say that a payment is for the use of X does not tell you whether the payment is capital or revenue in nature. This can be illustrated by this simple example. A payment is described to be for the use of land. However, such a payment can be a premium paid for a lease (which produces an asset for future use and is a capital payment) and rent under a lease (which is for current use and is a revenue payment).

48. We agree with Mr Fung SC.

49. In ascertaining the true meaning of a statutory provision, apart from the wording of the statute, the purpose of the statute must also be borne in mind. Mr Wong SC's submissions, if correct, would mean that a purpose of the TO is to give out *the right to use* radio spectrum free of charge and would only impose charges on the *actual use* of radio spectrum. In our view, this is not a purpose of the TO.

50. Our view is supported by section 32H(6) of the TO, which provides:

'Where an assignment which may be made under subsection (1) relates to the use of spectrum which under section 32I is subject to the payment of spectrum utilization fee-

(a) by the user of the spectrum; and

(b) the method for determining which is prescribed under section 32I(2)(b)[1],

then the Authority may, in determining applications for the assignment, regard the fees, if any, arising or resulting from that method as a determining factor in relation to those applications.'

[1] which can be auction or tender or a combination of auction and tender, or any other method as the Secretary for Commerce and Economic Development thinks fit

51. Pursuant to section 32H(6) of the TO, in determining the applications for assignment of radio spectrum, the TA may regard the SUF proposed by each applicant as a determining factor. Clearly, SUF may well be relevant to the assignment of radio spectrum.

52. We do not think that the TO has a purpose of giving out *the right to use* radio spectrum free of charge and would only charge on the *actual use* of radio spectrum. On the contrary, we take the view that the TO authorizes the TA to make the Upfront SUFs (which is the fees arising or resulting from the method prescribed by the Secretary for Commerce and Economic Development, i.e. the 4G Auction and the 2G Auction) as a condition for the assignment of the relevant radio spectrum.

True Nature of the Upfront SUF

53. The Upfront SUFs are the fees arising or resulting from the 4G Auction and the 2G Auction.

54. The Notice of Terms and Conditions of the Auction (Including the Form of the Licence) for the 4G auction ('4G Notice') states:

> 'By this Notice, the Telecommunications Authority, in exercise of the powers conferred by section 32I of the Telecommunications Ordinance, the Telecommunications (Determining Spectrum Utilization Fees by Auction) Regulation and all other powers enabling him for this purpose, specifies the terms and conditions of the auction of the right to use the frequency bands specified in this Notice and the payment of the spectrum utilization fees. This Notice shall, where appropriate, also constitute guidelines issued under section 6D of the Telecommunications Ordinance indicating the manner in which the Telecommunications Authority proposes to perform his function in determining applications for licences which may be issued by him pursuant to section 7 of the Telecommunications Ordinance including licensing criteria and other relevant matters he proposes to consider.' (underline supplied)

There are similar contents in the Notice of Terms and Conditions of the Auction (Including the Conditions to be added to the Licence) for the 2G auction ('2G Notice').

55. The assignment of the right to use the specified frequency bands and the granting of a UCL was *conditional upon* the payment of the Upfront SUF. Paragraphs 5.2 and 5.4 of the 4G Notice provide:

> '5.2 Duties of Provisional Successful Bidder
>
> 5.2.1 Within thirty Business Days after publication of the Provisional Successful Bidder Notice, each Provisional Successful Bidder shall:

(a) pay to the Authority in cash the Spectrum Utilization Fee payable by it; and …

…

5.2.3 Where a Provisional Successful Bidder fails to comply with the requirements specified in paragraph 5.2.1, the Authority shall not grant a Licence to that Provisional Successful Bidder and shall disqualify that Bidder from the Auction…

…

5.4 Successful Bidder Notice and grant of Licence

5.4.1 After the later of:

(a) the date on which a Provisional Successful Bidder has complied with the requirements specified in paragraph 5.2.1 and

(b) the date on which the Authority receives notification from the Provisional Successful Bidder that it is not subject to an Approval in accordance with paragraph 5.1.1…, the Authority shall, subject to the compliance by the Provisional Successful Bidder of the terms and conditions of this Notice,

(i) …

(ii) grant a Licence to the Successful Bidder under which the Frequency Band or Frequency Bands for which that Bidder is the Successful Bidder shall be assigned.'

There are also similar provisions in paragraphs 5.2 and 5.4 of the 2G Notice.

56. Accordingly, if a successful bidder failed to pay the Upfront SUF, there would be no assignment of the specified frequency band(s) and no UCL would be granted.

57. A further observation is that in General Condition 2.1 of the UCLs, it stipulates that the licence, or the right and benefit under the licence, may be transferred with the prior written consent of the TA. The right or benefit mentioned in this clause can only be referable to the right to use the specified frequency band(s).

58. In our view, it is clear that the subject matter of the 4G Auction and the 2G Auction was the granting of the relevant UCL, together with the right to use the specified frequency bands. By paying the Upfront SUFs, the Taxpayer acquired the exclusive right to use the assigned spectrum for a period of about 12 years under the

amended 2G UCL and 15 years under the 4G UCL without the interference of other mobile telecommunications operators in the market.

Upfront SUFs - capital in nature

59. Mr Wong SC submits that the Upfront SUFs are revenue in nature. He has made 3 main points in support of the Taxpayer's case:

(a) The Upfront SUFs are paid for 'the use' of the radio spectrum, and not for 'the right to use'.

(b) The CIR treats the annual SUFs as revenue. There should be no distinction between the Upfront SUFs and the annual SUFs.

(c) By applying the circulating capital test, as the Taxpayer did not borrow any loans or inject any share capital to pay the Upfront SUFs, the Upfront SUFs should be classified as revenue.

60. We have carefully considered all these arguments. With respect, we are unable to agree with Mr Wong SC.

61. As to the first point, the basis of Mr Wong SC's submissions is section 32I(1) of the TO. We have already held that the wording 'the use of spectrum' in section 32I(1) of the TO is in the general sense and does not bear the technical meaning suggested by Mr Wong SC. We have also held that by paying the Upfront SUFs, the Taxpayer has acquired the relevant UCLs together with the right to use the specified frequency bands.

62. Mr Wong SC further argues that the Upfront SUFs are 'pre-paid lump sum for the use of the frequency bands to be assigned under the UCL' and 'a condition precedent to the grant (or amendment) of the UCL', and not payments for the grant or amendment or assignment. We are unable to agree.

(a) The Taxpayer relies upon the Statement of the Communications Authority and the Secretary for Commerce and Economic Development dated 15 November 2013 on the Arrangements for Frequency Spectrum in the 1.9-2.2 GHz Band upon Expiry of the Existing Frequency Assignments for the Provision of 3G Mobile Services and the Spectrum Utilisation Fee ('2013 3G Statement') in support of the 'pre-payment point'. In paragraph 58 of that statement, the Secretary suggests that the upfront lump sum SUF should arrive at the lower limit for the 15-year period by directly multiplying the 2015/16 royalty payment by 15. In reliance on this document, the Taxpayer suggests that the Upfront SUFs are simply prepayments calculated by reference to the expected royalty and the period of the relevant licence.

(b) The flaw of this submission is that the 2013 3G Statement was issued well after the 4G Auction and 2G Auction in 2009. The 2013 3G Statement therefore is not relevant or does not carry any weight for the purpose of determining the true nature of the Upfront SUFs arising or resulting from the 4G Auction and the 2G Auction held in 2009. As a matter of fact, the Upfront SUFs were determined by the highest valid bid in the respective auctions.

(c) As to whether the Upfront SUFs are merely 'a condition precedent' or part of price for the assignment or the grant/amendment of the UCLs, the answer is 'No'. We have already held that the Upfront SUFs were paid by the Taxpayer for the grant of the relevant UCL, together with the right to use the specified frequency bands.

63. As to the second point, the true nature of the Upfront SUFs is a question of law, to be determined by examining the features of the same in the light of the authorities. The true nature of the Upfront SUFs may or may not be same as that of the annual SUFs. As submitted by Mr Fung SC, there are numerous fundamental differences between the Upfront SUFs and the annual SUFs:

(a) The 4G Upfront SUF enabled the Taxpayer to develop a new business in the provision of 4G mobile services; the 2G Upfront SUF substantially increased the Taxpayer's 2G spectrum capacity which in turn enhanced its service level. In contrast, the annual SUFs for the 2G frequencies were payments to maintain the existing 2G services to its customers.

(b) The Upfront SUFs were determined by the highest valid bid for that frequency band in the 4G Auction and the 2G Auction. On the other hand, the annual SUFs were calculated by reference to (i) the bandwidth assigned for the first 5 years, and (ii) thereafter the 'Network Turnover' of the taxpayer, which is defined as '*revenue arising from or attributable to the provision of any telecommunications services over any telecommunications network using the frequency bands to which that fee relates*' (paragraphs 4.2 and 4.6 of Hong Kong Third Generation Mobile Services Licensing: Information Memorandum (July 2001)).

(c) In particular, the annual SUFs payable by the Taxpayer for the use of the original 2G spectrum of 23.2MHz were to be determined as follows:

(i) for the period from 30 September 2006 to 29 September 2011, $145 for every 1 kHz or part of every 1 kHz of the spectrum assigned for use; and

(ii) for the period from 30 September 2011 to 29 September 2021, $1,450 for every 1 kHz or part of every 1 kHz of the spectrum assigned for use or 5% of the network turnover in the year concerned (whichever was the higher).

See section 4, Telecommunications (Level of Spectrum Utilization Fees) (Second Generation Mobile Services) Regulation (Chapter 106AA).

With all these differences, it would not be surprising that the nature of the Upfront SUFs and the nature of the annual SUFs are different.

64. As to the third point, we are of the view that the 'circulating capital test' does not assist the Taxpayer.

(a) The 'circulating capital test' may not be correct or at least is subject to criticisms. In ABD Pte Ltd v Comptroller of Income Tax [2010] 3 SLR 609, Andrew Pahng Boon Leong JA said:

'*49. The **third** test centres on the distinction between **fixed** and **circulating capital**. As Prof Tiley helpfully observes (Revenue Law ([3] supra) at p 445) [original emphasis by Andrew Pahng Boon Leong JA in Bold]:*

Expenditure on the fixed capital of a business is capital expenditure, not revenue. Fixed capital is retained in the shape of assets which either produce income without further action, eg shares held by an investment company, or are made use of to produce income, eg machinery in a factory. Circulating capital is that which the company intends should be used by being temporarily parted with and circulated in the business only to return with, it is hoped, profit, eg money spent on trading stock.

50. However, as the learned author then proceeded to – both pithily as well as perceptively – observe (Revenue Law at p 445):

> *The difficulty with this test is that it sometimes begs the very question at issue.*

51. I would tend to agree with the view just expressed (see also Singapore Taxation ([43] supra) at p 90 (where the test is stated by the learned authors to be "of limited usefulness only") as well as Whiteman ([43] supra) at para 6-09 (where the learned authors observe that "[t]his distinction however has its own problems, as it is not possible to draw an exact

line of demarcation between fixed and circulating capital). The distinction between fixed and circulating capital does not, with respect, represent an advance – in ***substance*** *at least – over the test in Atherton ([44] supra) and may even be said, in some cases at least, to (as Prof Tiley has observed) assume the very thing (viz, the distinction between capital and revenue) that has to be proved. Indeed, in Van den Berghs ([47] supra), Lord Macmillan observed thus (at 443) [Original emphasis by Andrew Pahng Boon Leong JA in Bold]:*

> *I have not overlooked the criterion afforded by the economists' differentiation between fixed and circulating capital which Lord Haldane invoked in John Smith & Son v. Moore [[1921] 2 AC 13] and on which the Court of Appeal relied in the present case, <u>but I confess that I have not found it very helpful. Circulating</u> capital is capital which is turned over and in the process of being turned over yields profit or loss. <u>Fixed</u> capital is not involved directly in that process, and remains unaffected by it. [Emphasis added by underlining]*

52. This unfortunate result is, perhaps, not surprising. Absent the elaboration that is to be found in cases such as Atherton, there appears to be no real guidance in this particular test. Indeed, it is suggested that the ***application*** *of the test might – on occasion at least – compound the problem, especially if the fact situation is a borderline or marginal one. That having been said, there is nevertheless case law which has applied this test, the seminal decision being that of the House of Lords in John Smith and Son v Moore [1921] 2 AC 13. In that case, Viscount Haldane observed thus (at 19-20) [Original emphasis by Andrew Pahng Boon Leong JA in Bold]:*

> *My Lords, it is not necessary to draw an exact line of demarcation between fixed and circulating capital. Since Adam Smith drew the distinction in the Second Book of his Wealth of Nations, which appears in the chapter on the Division of Stock, a distinction which has since become classical, economists have never been able to define much more precisely what the line of demarcation is. Adam Smith described fixed capital as what the owner turns to profit by keeping it in his own possession, circulating capital as what he makes profit of by parting with it and letting it change masters. The latter capital circulates in this sense.*'

(b) The difficulties in the 'circulating capital test' can be illustrated by an example. Suppose a company has purchased a factory or a piece

of machinery without any borrowings or increase in share capital, that would not make the payment for the factory or for the machinery as revenue in nature. By applying common sense, the payment must be capital in nature.

(c) Even proceeding on the basis that the 'circulating capital test' is correct, as said by Lord Pearce in BP Australia (above) at 266A:

'*Circulating capital is that which comes back in your trading operations. 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.*'

There is simply no evidence showing that the Upfront SUFs have come back '*penny by penny*' with the customers' subscription to the particular 4G and 2G mobile services operated by the Taxpayer.

65. Mr Fung SC submits that the Upfront SUFs are capital in nature. He submits that the CIR's position is supported by the authorities in Singapore and South Africa.

66. Mr Fung SC refers us to Singaporean High Court's decision in BFH v Comptroller of Income Tax [2013] 4 SLR 568. In that case, the taxpayer was having a business of operating and providing mobile telecommunications systems and services in Singapore. In 2001, it paid about S$100 million to the relevant authority for a 20-year grant of both a 3G facilities-based operator licence and a right to use the electromagnetic spectrum at a frequency of 2,100 MHz. The sole issue was whether the payment of the S$100 million as a lump sum was deductible. The High Court held that the answer was 'No'. Ang J found that

(a) resulted in the strengthening or enhancement of the taxpayer's existing telecommunications systems which constituted its profit-making business structure;

(b) provided the taxpayer with additional spectrum capacity to accommodate more customers and new services;

(c) enabled the taxpayer to develop a 3G telecommunications network and to offer 3G services, which meant new and innovative services and greater speeds for the customers; and

(d) was incurred with the purpose of strengthening the taxpayer's core business structure and providing avenues for growth of its business.

67. Mr Wong SC submits that the BFH case should be distinguished on the basis that as a result of the payment made by the taxpayer in the BFH case, the relevant authority in Singapore granted the taxpayer *a right to use* the specified spectrum under the

relevant subsidiary legislation in Singapore, but under the TO in Hong Kong the Upfront SUFs were paid for the use of the spectrum. In other words, Mr Wong SC relies upon the 'short answer' suggested by him based upon section 32I(1) of the TO to distinguish the BFH case. We have rejected that 'short answer' and refused to accept the construction of section 32I(1) proposed by Mr Wong SC. Accordingly, we do not see any valid basis upon which the BFH case can be distinguished. In our view, the CIR's position is support by the BFH case.

68. Mr Fung SC also refers us to 2 South Africa cases.

(a) In ITC 1726 (2000) 64 SATC 236, the taxpayer had successfully applied for a licence allowing it to provide 3G telecommunications services. The licence fee comprised 2 components: an initial basic cellular licence fee of R100 million payable prior to the commencement of commercial operations, and an ongoing annual licence fee of 5% of the net revenue of the licensee. The court held that the lump sum payment was capital in nature for two reasons: (1) because the licence conferred an advantage of an enduring nature; and (2) because the lump sum payment was more closely connected with the income-earning structure rather than the income-earning operations of the taxpayer. On the other hand, the annual licence fee payment was held to be revenue in nature and deductible.

(b) In ITC 1772 (2003) 66 SATC 211, the court confirmed the propositions in ITC 1726, and further held that the taxpayer in that case had rightfully conceded that the lump sum component of expenditure for a licence entitling the taxpayer to use radio stations in appropriate frequency bands was capital in nature.

69. Mr Wong SC submits that ITC 1726 should be distinguished on basis that the payment in that case was for a licence to construct, operate and maintain a nationwide cellular radio telephony service. With respect, we do not think this is a valid distinction. We have held that the subject matter of the 4G Auction and the 2G Auction was the granting of the relevant UCL, together with the right to use the specified frequency bands. The Taxpayer obtained these by paying the Upfront SUFs. In our view, the principles in ITC 1726 are applicable and in support of the CIR's case.

70. We are of the view that applying the indicia as suggested in the authorities, the Upfront SUFs are clearly capital in nature:

(a) The Upfront SUFs were incurred once and for the right to use the specified frequency band(s) and the UCLs.

(b) The Upfront SUFs were paid with a view to bringing into existence an advantage for the enduring benefit of the Taxpayer's mobile telecommunications business in Hong Kong.

(c) The Upfront SUFs were the cost of enlarging, enhancing and strengthening the permanent profit-producing business structure of the Taxpayer and its income-generating capacity.

(d) The Sun Newspapers' 3 criteria:

(i) Character of advantage sought: the Upfront SUFs were paid for the right to use the specified spectrums and the grant/amendment of the UCLs for the Taxpayer to operate its telecommunications business for a period of 15 years (in the case of 4G spectrum) and 12 years (in the case of 2G additional spectrum).

(ii) The manner in which it is to be used, relied upon or enjoyed: the Upfront SUFs were paid once and for all. There is no recurrence of paying the Upfront SUFs, as there is no legitimate expectation that there would be any right of renewal or right of first refusal of any licence or spectrum assignment upon the expiry of the licence or spectrum assignment: see Radio Spectrum Policy Framework paragraph 4.2.

(iii) The means adopted to obtain it – periodic payment or a final provision to secure future use: the Upfront SUFs were a final provision to secure the assignment of the specified spectrums and the grant of the relevant UCLs.

71. As the Upfront SUFs are capital in nature, by the operation of section 17(1)(c) of the IRO, the expenditure is not deductible. Accordingly, the appeal must be dismissed.

Conclusion

72. We dismiss the appeal and confirm the Assessments.

73. It remains for us to thank the parties for the valuable assistance rendered to this Board.