INLAND REVENUE BOARD OF REVIEW DECISIONS

**Case No. D12/90**

Profits tax – insurance agent – receipt of sum paid by principal for cancellation of contractual rights – whether payment capital or income in nature.

Panel: William Turnbull (chairman), Raphael Chan Cheuk Yuen and Patrick Wu Po Kong.

Dates of hearing: 6 and 8 March 1990.
Date of decision: 11 May 1990.

The taxpayer was carrying on business as an independent insurance agent with a contract with an insurance company whereby the taxpayer received commission payments on business introduced. Because of personal reasons the taxpayer was not able to continue to perform the services required under the agency contract and it was agreed that the taxpayer would relinquish and forfeit certain contractual rights in consideration of a cash lump sum payment. The lump sum payment was assessed to profits tax as being part of the taxable income of the taxpayer. The taxpayer appealed to the Board of Review.

Held:

On the strength of the authorities cited to the Board the payment made to the taxpayer was of an income nature and had been correctly assessed to tax.

Appeal dismissed.

Cases referred to:

Allied Mills Industries Pty Ltd v Federal Commissioner of Taxation 19 ATR 1724
Shove v Dura Manufacturing Company Limited 23 TC 779
London & Thames Haven Oil Wharves Limited v Attwooll 43 TC 491
Van Den Berghs Limited v Clark 19 TC 390
Sabine v Lookers Limited 38 TC 120
CIR v Fleming & Co (Machinery) Ltd 33 TC 57
Barr, Crombie & Co Ltd v CIR 26 TC 406
Wiseburgh v Domville 36 TC 527
Anglo-French Exploration Co Ltd v Clayson [1956] 36 TC 545

Lee Yun Hung for the Commissioner of Inland Revenue.
Sung Nee of Henny Wee & Co for the taxpayer.

Decision:

This is an appeal by a taxpayer against an assessment to profits tax of a sum which the Taxpayer claims should be a capital payment not subject to profits tax. The facts are as follows:

1. The Taxpayer commenced business in Hong Kong in January 1982 as an insurance agent and was duly registered as carrying on business under the Business Registration Ordinance. As an independent agent and not as an employee, the Taxpayer entered into a contractual arrangement with an insurance company ('the insurance company') whereby the Taxpayer was appointed as the agency manager for the insurance company.

2. The contractual arrangement between the Taxpayer and the insurance company provided that the Taxpayer would be paid commission on all business which she introduced to the insurance company and would be paid an override commission on business introduced by an agents who were recruited, trained and supervised by her.

3. Pursuant to the terms of this contract, the Taxpayer recruited, trained and supervised teams of agents which were called 'units'. Each 'unit' would comprise a unit manager and other agents and personnel working under the unit manager all of whom were recruited, trained and supervised by the Taxpayer. As in the case of the Taxpayer, each unit manager would have their own business registration certificate and act as independent agents. The unit managers and personnel were not employed by the Taxpayer nor by the insurance company.

4. No evidence was given with regard to the contractual relationship if any between the 'units' and the Taxpayer or between the 'units' and the insurance company. It would appear that there was no formal agreement between the Taxpayer and the 'units'. Under the terms of the agreement between the Taxpayer and the insurance company, it was her duty to recommend unit managers to the insurance company for appointment as agents and accordingly it is assumed that there was a formal contractual relationship between the unit managers on behalf of the 'units' and the insurance company. As no evidence was given to the contrary or at all, it is assumed that there was no formal contractual relationship between the Taxpayer and the 'units' and that the rights of the respective parties rested on the formal agreement between the Taxpayer and the insurance company on the one hand and whatever formal agreement there may have been between the 'units' and the insurance company on the other hand.

5. As at 20 December 1986, the Taxpayer had recruited and supervised seven ‘units’, each headed by a different unit manager and she was paid an override commission in respect of each ‘unit’.

6. Because of personal reasons, the Taxpayer was not able to continue to supervise two of the ‘units’ which she had recruited and over whose business she was paid an override commission. Following negotiations between the Taxpayer and the insurance company, it was agreed that the Taxpayer would relinquish and forfeit all of the vested rights, benefits and interest to future override commissions in respect of these two of the ‘units’ in consideration of a cash lump sum payment of $497,038. Thereafter the Taxpayer continued to work as before earning commission on business which she herself introduced and override commission on business introduced by the five remaining ‘units’ which she continued to supervise. She had no further connection with the two ‘units’ which she had relinquished and was no longer responsible to supervise them.

7. The Taxpayer did not show the sum of $497,038 as income for the period from 1 April 1986 to 31 March 1987 but included a note to her income and expenditure account stating that the sum had been received on 1 January 1987 ‘for transferring the goodwill and to relinquish and forfeit all rights, benefits and interest on the entitlement of the two unit agent teams’ to the insurance company.

8. This explanation and claim was not accepted by the assessor who included the sum of $497,038 as being part of the Taxpayer’s income for that year and assessed it to tax accordingly.

9. The Taxpayer objected to this assessment and the Deputy Commissioner by his determination dated 29 November 1989 decided in favour of the assessor. The Taxpayer then duly appealed to this Board of Review.

At the hearing of the appeal, the Taxpayer was represented by her tax representative. The Taxpayer and a director of the insurance company were called to give evidence. The representative submitted that the Taxpayer had sold to the insurance company a part of her business and that the resulting proceeds of sale were of a capital nature. He further submitted that each of the seven ‘units’ formed a separate business and that the Taxpayer had sold two of the seven separate businesses. He submitted that the lump sum payment was an exceptional item. Neither the Taxpayer nor the insurance company had ever previously nor subsequently entered into any such arrangement for the cancellation of rights in exchange for a lump sum payment. He submitted that the lump sum payment was not in lieu of future commissions but was a cash payment for the transfer of goodwill and to cancel the right which the Taxpayer had.

The Commissioner's representative submitted that on the decided authorities, a payment such as was made in the present case could be either capital or income depending upon the facts. He submitted that it was necessary to look at the nature of the contractual rights which were cancelled or terminated and what effect that had on the capital structure of the business of the Taxpayer. He said that on the authority of decided cases amounts received in connection with the cancellation or variation of trade or commercial contracts made in the course of the carrying on of a business or trade are of a revenue nature. However, if the contract or right which has been cancelled related to the whole structure of the Taxpayer's business, then the amount received for the cancellation of the right would be of a capital nature. In the course of the submissions by the two representatives, the Board was referred to the following authorities:

Allied Mills Industries Pty Ltd v Federal Commissioner of Taxation 19 ATR 1724

Shove v Dura Manufacturing Company Limited 23 TC 779

London & Thames Haven Oil Wharves Limited v Attwooll 43 TC 491

Van Den Berghs Limited v Clark 19 TC 390

Sabine v Lookers Limited 38 TC 120

CIR v Fleming & Co (Machinery) Ltd 33 TC 57

Barr, Crombie & Co Ltd v CIR 26 TC 406

Wiseburgh v Domville 36 TC 527

This is an interesting case and the Board is much indebted to the two representatives for the research which they conducted and assistance which they gave to the Board. At first sight, it would appear that a substantial lump sum payment made in exchange for the surrender of contractual rights would constitute a capital payment. However, on the strength of the authorities cited before us, this initial assumption is erroneous. It is clear from the decided cases that where a person is carrying on a trading or agency type business, sums of money which the person receives for changing or giving up agencies or agency rights are to be construed as being payments received in the course of carrying on the business unless it is clear from the facts that the payment is of a capital nature. In the Allied Mills case, the taxpayer received a lump sum payment for compensation for termination of an agency agreement. Though the sum paid was significant and the agency was a significant part of the taxpayer's business, the Australian Court held that the money had the character of an income receipt. What was given up was the right to exploit the distributorship and thus to pursue profits. The compensation was not to be classified as consideration for the taxpayer going out of business and did not involve a parting by the taxpayer of a substantial part of its business undertaking. It was held that the

termination was entered into in the course of the taxpayer's business. We will not set out in detail what was stated in the Allied Mills case, but it is a useful summary of the many decided cases and we think that the Allied Mills case sets out the right approach to take in cases of this nature. The question to be answered is whether or not the rights or benefits which the Taxpayer was entitled to under her agreement with the insurance company comprised a capital asset of her business. It is necessary to look at all of the facts of each case and care must be taken when drawing analogies from the facts of one case to another. It is also interesting to note the clear statement in the Allied Mills case that because a transaction is unusual or extraordinary, it does not change the nature of the payment provided it is entered into in the course of carrying on of the business.

The learned Judge in the Allied Mills case cites with approval the words of Lord Evershed MR in Anglo-French Exploration Co Ltd v Clayson [1956] 36 TC 545 at 557 as follows:

> 'They seem to me to emphasise that sums received for the cancellation of an agency or of other similar agreements which have been entered into by the recipient in the ordinary course of its trade will themselves, prima facie, be regarded as received in the ordinary course of trade unless the transaction involve a parting by the recipient with a substantial part of its business undertaking.'

In our opinion, that statement is a useful and correct summary of the law.

There is further authority in the case of Shove v Dura Manufacturing Company Limited to show that compensation for the cancellation of a contract which was of an unusual nature is still income and not capital.

We have carefully reviewed the decided cases where lump sum payments have been decided to be of a capital nature. Without exception, these cases are all different from the one now before us. The Barr, Crombie case was a payment for a shipping agency company giving up almost all of its business. Likewise the Lookers Limited case was a payment for which the company gave up its entire exclusive agency arrangements and became a non-exclusive agent. The company only had one principal. In the view of the court in that case, the alteration made to the contract with the one principal was a fundamental change which affected the entire business of the company.

In the present case, if one carefully looks at the facts before us, it is clear that the business of the Taxpayer continued after the receipt of this lump sum payment much as it had done before. We cannot see any justification for finding on the facts that the rights given up by the Taxpayer were capital assets of her business. She was doing no more than accepting a lump sum payment in exchange for giving up the right to receive override commissions in respect of two out of seven 'units'. The Taxpayer had not invested any capital in acquiring these 'units' and indeed so far as we are aware, she had no formal contractual relationships with the 'units'. Her contractual relationship was with the

insurance company. In all of the circumstances, we find on the facts that the payment received was a trading receipt received in the course of the business of the Taxpayer and accordingly is subject to profits tax. For these reasons we dismiss this appeal.