Case No. D23/99

Profits Tax – whether assets purchased medical records or goodwill – whether plant and thus qualifying for depreciation allowances.

Panel: Andrew Halkyard (chairman), Edmund Leung Kwong Ho and Vincent Lo Wing Sang.

Date of hearing: 5 May 1999.
Date of decision: 11 June 1999.

The taxpayer and Dr Y were formerly partners in a general medical practice in Hong Kong. On 30 March 1993, the taxpayer and Dr Y entered into an agreement under which Dr Y sold to the taxpayer 'the internal fixture, furniture, equipment, patients' goodwill and the lease at Dr Y's office at a price of [1,200,000].'

The taxpayer claims that of the total price $1,200,000, $1,000,000 represents payment for patients' medical records. He further claims that these records are plant that qualify for depreciation allowances under the IRO.

Held:

The Board found that of the $1,200,000 purchase price, $1,000,000 was incurred for taking over the practice and thus the goodwill. The Board found that goodwill does not simply mean the medical records as contended by the taxpayer but the further custom (Yamouth v France, Munby v Furlong referred; D49/97, CIR v The Hong Kong Bottlers Ltd, Miles v Clarke considered; Cruttwell v Lye, Trego v Hunt applied).

Goodwill is not plant that qualifies for depreciation allowances under the IRO.

Appeal dismissed.

Cases referred to:

Yarmouth v France (1837) 19 QBD 647
Munby v Furlong (1977) 50 TC 491
D49/97, IRBRD, vol 12, 324
CIR v The Hong Kong Bottlers Ltd (1970) 1 HKTC 497

Cruttwell v Lye (1810) 7 Ves Jr 335
Trego v Hunt [1896] AC 7
Miles v Clarke [1953] 1 All ER 779

Tse Yuk Yip for the Commissioner of Inland Revenue.
Joseph S H Law of Messrs K L Young & Co for the taxpayer.

Decision:

1. This appeal concerns the availability of depreciation allowances when the Taxpayer, a medical doctor in private practice, purchased certain assets from his former partner upon cessation of their partnership practice. Thereafter, the Taxpayer carried on the practice as sole practitioner. The sole issue in dispute relates to the payment of a sum of $1,000,000 which the Taxpayer claims was for the purchase of patients' medical records owned by his former partner. The Taxpayer contends that the records are 'plant' and therefore qualify for depreciation allowances under Part VI of the Inland Revenue Ordinance.

The facts

2. The basic facts, which are agreed and which we so find, are set out in the determination of the Commissioner dated 18 December 1998. For convenience, we summarise the background facts to this appeal as follows.

3 The Taxpayer and Dr Y were formerly partners in a general medical practice carried on in Hong Kong.

4. On 30 March 1993 the Taxpayer and Dr Y entered into an agreement ('the Agreement') under which Dr Y sold to the Taxpayer 'the internal fixture, furniture, equipment, patients' goodwill and the lease at Dr Y's office at [address] at a price of [$1,200,000]. [The Taxpayer] will take over the above mentioned office on 1 April 1993'.

5. The Taxpayer claims that of the total amount of $1,200,000 described in the Agreement, $1,000,000 represents payment for patients' medical records. He further claims that these records are plant that qualify for depreciation allowances under Part VI of the Inland Revenue Ordinance.

Proceedings before the Board

6. The Taxpayer elected to give sworn evidence before the Board. On the basis of that evidence, and the documents placed before us, we find the following additional facts.

7. When the Taxpayer first joined Dr Y he was initially employed as a salaried doctor. Within a short period of time, he became a partner with Dr Y, with effect from 1 August 1982. Thereafter, the partners shared profits from the medical practice on a 50/50 basis. The Taxpayer did not pay Dr Y any initial capital contribution to join the partnership. Notwithstanding this fact, for the year ended 31 March 1993 the balance sheet of the partnership showed that the assets recorded therein (including fixtures, furniture and other plant and equipment) were financed by the partners in equal shares.

8. While the partnership operated, the Taxpayer and Dr Y had different consultation hours. Dr Y typically worked only in the morning session. The Taxpayer typically worked two sessions.

9. After the partnership continued for some time, each of the Taxpayer and Dr Y essentially attended their own patients.[1] Each doctor wrote up the medical records for the patients they attended. The records contained the name of the patient, contact details (although Dr Y did not invariably record these), and medical history. The records were located in a common reception area. All staff working in the practice had access to the records. In 1993 the total number of patients' records was approximately 15,000. There was no evidence before us as to the number of patients' records in 1982, the year the Taxpayer was admitted to partnership.

10. The circumstances surrounding the entry into the Agreement were as follows. Dr Y told the Taxpayer in February 1993 of his plan to retire at the end of March 1993. About this time, Dr Y asked the Taxpayer to pay him an amount of money to take over the practice. He originally wanted $1,500,000. The benchmark amount adopted by Dr Y in these negotiations was that he wanted to be paid approximately 50% of the profits derived by the practice for the year ended 31 March 1993.[2] After negotiation, this figure was reduced to $1,200,000. The Agreement was then signed and completed, the Taxpayer assumed sole ownership of all the assets of the clinic, and he then commenced practice as a sole practitioner.

11. During the negotiations described at fact 7, no agreement was reached as to how the consideration paid by the Taxpayer should be allocated between the various items referred to in the Agreement, namely, 'the internal fixture, furniture, equipment, patients' goodwill and the lease at Dr Y's office' (fact 2 refers). Rather, the consideration agreed was simply a lump sum payment referable to Dr Y's aim of obtaining an amount approximating 50% of the partnership profits for the year ended 31 March 1993. However, in his books for accounting and taxation purposes, the Taxpayer allocated the consideration as follows: $200,000 for fixtures, furniture and equipment[3] (estimated cost of replacement) and $1,000,000 for patients' goodwill (which he estimated to be the value of the patients' medical records).

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[1] If one of the doctors was absent at any time, his patient could see the other doctor if the patient agreed.
[2] The amount of net profit for the year ended 31 March 1993 was approximately $2,600,000.
[3] The assessor accepted this allocation by allowing various depreciation allowances to the Taxpayer for the year of assessment 1993/94 based on a total expenditure of this amount.

12. The 'lease at Dr Y's office' referred to in the Agreement was in Dr Y's name until 1992. Thereafter, it was in the name of both partners. In his books of account the Taxpayer did not allocate any part of the consideration of $1,200,000 to this asset.

13. When the Taxpayer commenced sole practice on 1 April 1993 he retained all the patients' medical records. He did not rearrange the records. They are still used by him in daily practice.

14. As at 31 March 1993 the Taxpayer estimated that about 40% of the patients of the clinic were 'his own' and that they would follow him if he started up a new clinic.

15. The patients' medical records were very important to the Taxpayer in conducting his practice, both (previously) as a partner and (later) as a sole practitioner. There were many good reasons for the Taxpayer retaining the patients' medical records including:

(a) They contained important information relevant to the doctor's diagnosis, such as history of medical treatment, drug allergies, record of injections and what medicine best suits the patient.

(b) Patients felt more comfortable dealing with a doctor who has knowledge of their medical history.

(c) Although the Taxpayer admitted that he could carry on his practice without the records, he stated that without them the practice could not be operated as smoothly and that his income would be lower, particularly in the first few years after 1 April 1993.

(d) The Taxpayer admitted that the records are only valuable when a patient returns for further consultation – but he fully expected that the patients would return.

Contentions for the Taxpayer

16. Mr Joseph Law of Messrs K L Young & Co, certified public accountants, represented the Taxpayer at the Board hearing. Mr Law's submission was clear and to the point. He argued that the patients' medical records represented the patients' goodwill referred to in the Agreement and that these were the most valuable tangible assets transferred by Dr Y to the Taxpayer upon cessation of the partnership. He also argued that the amount of $1,000,000 was, as a matter of substance, paid by the Taxpayer entirely for these records. Finally, he contended that the records are apparatus used by the Taxpayer to carry on his business and are therefore plant (see Yarmouth v France (1887) 19 QBD 647 and Munby v Furlong (1977) 50 TC 491). Being plant, capital expenditure incurred on their

provision qualifies for depreciation allowances under Part VI of the Inland Revenue Ordinance.

17. In relation to the claimed acquisition of the patients' medical records, Mr Law specifically argued that:

> 'The diagnostic skill is apparently unique to a medical practitioner. A medical practitioner's goodwill would be barely handed down to another medical practitioner. When [the Taxpayer] took over the clinic, the most valuable chattels which were available to dispose to him were medical reference books and medical records. [The Taxpayer] does hold the stance that the payment of $1,000,000 is for the acquisition of the medical records which take the place of the most tangible valuable apparatus of his medical practice. The medical records are the intellectual resources with which [the Taxpayer] is able to render his service to patients in the comfortable and confident manner'.

18. Although Mr Law rightly admitted that the Taxpayer had been in partnership with Dr Y for many years before 1 April 1993, he submitted that ownership of the partnership assets was another matter and the fact remained that the Taxpayer had not made any capital contribution in 1982 to enter the partnership. He then reiterated the Taxpayer's evidence that virtually all the partnership assets (including the patients' medical records) belonged to Dr Y and that the Taxpayer had to pay for these upon cessation of the partnership.

Contentions for the Commissioner

19. The Commissioner's representative, Ms Tse Yuk-yip, rejected the Taxpayer's claim that he had incurred capital expenditure on the provision of the patients' medical records. In support of this proposition, she relied upon the following cases:

> D49/97, IRBRD, vol 12, 324 at 332-333: *'The burden is on the Taxpayer to show us what machinery or plant it purchased and what expenditure it incurred in purchasing machinery or plant. It is not sufficient simply to provide a list of [assets] and their valuation.'*
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> CIR v The Hong Kong Bottlers Ltd (1970) 1 HKTC 497 at 514: *Sub-section (2) [of sections 37 and 39B] should not be considered in isolation. To claim annual allowance, it is not sufficient to show that the claimant owned and had in use the machinery and plant for the purpose of producing profits. The claimant has to show that he incurred 'cost' or 'capital expenditure on the provision of' machinery and plant.*

20. Ms Tse also argued that, in any event, the records were not 'plant' within the meaning of sections 37 or 39B of the Inland Revenue Ordinance. She rejected Mr Law's

analogy that the patients' medical records in this case were of the same character as the barrister's books in Munby v Furlong.

Reasons for our decision

21. On the basis of the evidence before us and the facts found, the Taxpayer has not convinced us that the Commissioner's determination was wrong. Under section 68(4) of the Inland Revenue Ordinance, the burden of proving the assessment was incorrect is on the Taxpayer. We agree with Ms Tse that the Taxpayer's evidence and argument fell well short of satisfying this burden. Our analysis follows.

22. We agree with Mr Law that we are not bound to accept the labelling in the Agreement to determine precisely what the Taxpayer obtained by incurring expenditure of $1,200,000. We also agree with Mr Law that we must consider the substance of the matter. Of the total consideration stated in the Agreement, both parties accept that $200,000 was referable to fixtures, furniture, and equipment.[4] What then was the remaining $1,000,000 incurred for?

23. The Taxpayer and Dr Y agreed, between themselves, that the sole remaining asset[5] purchased by the Taxpayer was 'patients' goodwill'. However, in argument Mr Law relied upon evidence given by the Taxpayer who claimed that, although there was no reference in the Agreement to purchasing patients' medical records, the reference in the Agreement to 'patients' goodwill' had a special meaning for the Taxpayer and for doctors generally. According to the Taxpayer, the term simply refers to patients' medical records and these were owned solely by Dr Y.

24. We reject the Taxpayer's evidence in this regard. It is clear from the facts found that the bargain struck between the Taxpayer and Dr Y essentially involved a payment for taking over the practice (after taking into account an amount attributable to the value of the furniture, fixtures and equipment). The parties negotiated this payment by reference to Dr Y's benchmark figure, which approximated 50% of the net profits of the partnership for the year ended 31 March 1993. In our view, the preponderance of evidence before us shows very clearly that (disregarding furniture, fixtures and equipment) what the Taxpayer acquired (1) looks like goodwill, (2) was described as goodwill and (3) was valued on the basis that it was goodwill. To explain point (3) further, we would add that no-one would pay anything for the patients' medical records as such unless, of course, one felt sure that a significant number of the patients would return. It is this expectation of further custom – and not the records themselves – that appears to be the essence of goodwill.

25. It is, therefore, our view that the facts found concerning the negotiation and conclusion of the Agreement as well as the terms of the Agreement itself (which specifically refers to goodwill and is silent on the patients' medical records) indicate the reality, namely,

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[4] The Taxpayer claimed, and the assessor accepted, depreciation allowances for plant and machinery and commercial rebuilding allowance based upon a total expenditure of $200,000 (see also fact 8).

[5] Disregarding the lease (see fact 9).

that the bulk of the payment made by the Taxpayer to Dr Y was for goodwill, as that term is commonly understood, and was not made simply to acquire all the medical records of the partnership.

26. We note also that the Taxpayer produced no evidence at all, apart from his personal statement, that the general body of medical practitioners would take the reference in the Agreement to 'patients' goodwill' to simply mean patients' medical records. At the very least, we would have expected corroborative evidence of this opinion from another medical practitioner. At best, an expert witness, such as the Chairman of the Hong Kong Medical Association, could have provided supporting evidence. If necessary, we would conclude that even on an evidentiary basis the Taxpayer has not proved his case.

27. What exactly then is goodwill? Two classic definitions are those of Lord Eldon in Cruttwell v Lye (1810) 7 Ves Jr 335:

> *'The goodwill which has been the subject of sale is nothing more than the probability that the old customers will resort to the old place.'*

and of Lord Macnaghten in Trego v Hunt [1896] AC 7:

> *'It is the whole advantage, whatever it may be, of the reputation and connection of the firm, which may have been built up by years of honest work or gained by lavish expenditure of money.'*

28. In either case, it is clear that the whole concept of goodwill is much broader than that contended for by the Taxpayer. As indicated above, we do not accept that the payment for 'patients' goodwill' simply means payment for the patients' medical records. While these records undoubtedly assist the Taxpayer in conducting his practice (fact 12 refers), their retention does not ensure that the patients will return (or vice versa); nor do they represent the totality of the reputation and connection of the former practice built up by years of honest work; nor do they represent other aspects of goodwill such as that attached to the premises. In short, none of these elements is reflected in the Taxpayer's highly restricted vision of 'patients' goodwill'.

29. We note the Taxpayer's evidence and argument that all the patients' medical records kept by the partnership belonged to Dr Y because the Taxpayer did not pay any capital contribution to join the partnership.

30. We also reject this. Apart from the Taxpayer's mere assertion in evidence of this conclusion, there is no other evidence in support. Indeed, other evidence shows that partnership property was owned by the partners equally (see the accounting treatment described at fact 4; also the longer consultation hours of the Taxpayer compared with those of Dr Y, see fact 5, indicate that the Taxpayer may have made additional contributions to the partnership in ways other than making an initial capital contribution). Furthermore, as a matter of general law, records produced during the operation of the partnership (as distinct

from those in existence at the time the partnership commenced) would be partnership property (see Miles v Clarke [1953] 1 All ER 779 passim). We appreciate that none of these observations are determinative in themselves to dismiss this appeal, but we do find support in them for our view that the Taxpayer's evidence and argument as to the substance of the Agreement should not be accepted.

31. In conclusion, we are not satisfied that the Taxpayer incurred any expenditure on acquiring the patients' medical records. As indicated above, it is our view that essentially what the Taxpayer purchased from Dr Y was Dr Y's share of the goodwill of the practice as that term is commonly understood. This is an intangible asset that is different in character from the patients' medical records. Although the latter may be plant, it goes without saying that goodwill is not.

32. For all the above reasons the appeal is dismissed.

33. Finally, we compliment Mr Law on a most ingenious argument focusing upon the meaning of plant. However, on the basis of our findings and conclusions, we need not determine this issue for the purposes of deciding this appeal.