Case No. D26/06

Profits tax – whether lump sum payment payable in installments to obtain the right to lease factory premises for a period of 50 years is a deductible item – sections 16(1)(b) and 17(1)(c) of the Inland Revenue Ordinance (Chapter 112) ('the IRO') – if such lump sum payment is not a deductible item whether industrial building allowances ('IBR') under section 34 of the IRO or commercial building allowances ('CBA') under section 33A of the IRO should be allowed

Panel: Michael Seto Chak Wah (chairman), Edward Cheung Wing Yui and Chow Wai Shun.

Date of hearing: 12 July 2004.
Date of decision: 9 June 2006.

The appellant was incorporated as a private limited company in Hong Kong. On 12 October 1995, the appellant leased, from a PRC Entity, an existing factory building and an extension to that factory building ('the Factory Premises') for a period of 50 years. The appellant paid HK$528,000 to a Mr F in consideration for Mr F surrendering his interest in the extension so that the PRC Entity can lease the Factory Premises to the appellant. It was provided in an agreement between the appellant and the PRC Entity ('the Rental Agreement') that the total payment for the tenancy period of 50 years was to be RMB 800,000 payable in six instalments. The first instalment of RMB 300,000 was payable upon the signing of the Rental Agreement and the second to sixth instalments of RMB 100,000 were each payable in June of each year from 1996 to 2000.

The HK$528,000 payment and the RMB 800,000 payment ('the Sum') were classified in the audited financial statements of the appellant for the years of assessment 1995/96 to 1998/99 as fixed assets and depreciated accordingly with the unpaid instalments of the RMB 800,000 payment treated as capital commitment in the balance sheets of the appellant. Beginning from the year of assessment 1999/2000, the appellant changed its accounting method and thereafter the Sum was treated in the accounts as prepayment and portions of the Sum were treated as annual rentals.

By letter dated 15 November 2000, the appellant applied under section 70A of the IRO for correction of profits tax assessments for the years of assessment 1995/96 to 1998/99 on the ground that rental payment for the Factory Premises was wrongly treated as capital asset. The assessor maintained his view that depreciation or amortization charges in respect of the Sum could not be allowed as a deduction. On 30 January 2002, he issued a Notice of Refusal to correct the 1995/96 to 1998/99 assessments under section 70A(2) of the IRO. No valid objection was

lodged in respect of that Notice of Refusal and therefore the 1995/96 to 1998/99 profits tax assessments therefore became final and conclusive.

For the years of assessment 1999/2000 to 2001/02, the assessor treated the Sum as capital in nature and therefore refused to allow any deduction. The appellant appealed.

The issue before the Board is whether the Sum is a deductible item under section 16(1)(b) of the IRO and alternatively in the event that the Board rules that the Sum is of a capital nature and therefore not deductible, whether IBA under section 34 of the IRO or CBA under section 36 of the IRO should be allowed.

Held:

1. The Sum is in the nature of a lump sum payable by instalments. It was paid in order for the appellant to obtain the right to sue the Factory Premises for 50 years. The right so acquired conferred upon the appellant substantial enduring benefits. The Sum was incurred to establish, replace or enlarge the profit yield structure of the appellant's business. The Sum is therefore a premium paid for the acquisition of an interest in land or a premium intended to secure the Factory Premises for future use.

2. The Sum is therefore of a capital nature and thus precluded from deduction pursuant to section 17(1)(c) of the IRO.

3. The change of accounting treatment beginning from the year of assessment 1999/2000 does not change the nature of the Sum.

4. The burden of proof is on the appellant to convince the Board why IBA or CBA should be given.

5. In the present case, the Appellant paid out the Sum to acquire a right to sue the Factory Premises for 50 years and there is no transfer of tile. The Sum cannot be said to be incurred capital expenditure on the construction of a building or a structure. Therefore no IBA or CBA should be given.

Appeal dismissed.

Cases referred to:

Wharf Properties Limited v CIR [4 HKTC 310]
Lo & Lo v CIR [2 HKTC 34]

Henriksen v Grafton Hotel, Limited [24 TC 453]
Strick (HM Inspector of Taxes) Regent Oil Company Limited [43 TC 1]
CIR v Wattie and another [1988 STC 1160]
MacTaggart v BE Strump 10 TC 17

Lau Kam Cheuk of Messrs S Y Leung & Co, Certified Public Accountants, for the taxpayer.
Lee Yun Hung for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal against the Determination of the acting Deputy Commissioner of Inland Revenue dated 16 April 2004 whereby :

(a) Profits tax assessment for the year of assessment 1999/2000 under Refund Number 1-1105993-00-9 dated 11 April 2002 showing assessable profits of $303,849 with tax payable thereon of $48,615 was confirmed.

(b) Profits tax assessment for the year of assessment 2000/01 under Charge Number 1-1092195-01-5, dated 11 April 2002, showing assessment profits of $200,969 with tax payable thereon of $32,155 was confirmed.

(c) Profits tax assessment for the year of assessment 2001/02 under Charge Number 1-1084290-02-0, dated 6 February 2003, showing assessable profits of $352,625 with tax payable thereon of $56,420 was confirmed.

The agreed facts :

2. Mr Lau Kam-cheuk ('Mr Lau') on behalf of the Appellant and Mr Lee Yun-hung ('Mr Lee') on behalf of the Respondent have respectively confirmed during the hearing that the facts as stated in the Determination of the acting Deputy Commission of Inland Revenue dated 16 April 2004 were agreed facts and we find them as facts.

3. Facts upon which the Determination was arrived at :

(a) The Appellant has objected to the profits tax assessments raised on it for the years of assessment 1999/2000 to 2001/02. The Appellant claims that the annual amortisation charge on the cost of acquiring certain rights in the use of factory premises should be an allowed deduction.

(b) The Appellant was incorporated as a private limited Company in Hong Kong on 2 May 1980. At all relevant times,

(1) the directors of the Appellant were Mr A and Mr B;

(2) the issued and fully paid capital of the Appellant amounted to $300,000; and

(3) there has been no change in the mode of operation of the Appellant.

(c) The principal activities of the Appellant, as described in its directors' reports, were 'Diecasting in P.R.C. and Property Holding for Investment and for Rental income'.

(d) On 12 October 1995, the Appellant entered into two agreements 'the Transfer Agreement' and 'the Rental Agreement' for the purpose of leasing an existing factory building ('the Factory') and an extension to the Factory located in Village C of Town D, City E, PRC. The Factory and the extension are collectively referred to as 'the Factory Premises'.

(e) (1) The extension was originally constructed by a Hong Kong trader, Mr F with land contributed by Village C, which extension was resumed by Village C in 1995.

Subsequently Mr F agreed to surrender his interest in the extension to the Village C Committee ('the PRC Entity') which in turn leased it to the Appellant for a tenancy from 12 October 1995 to 12 October 2045. In return, the Appellant agreed to pay Mr F a sum of five hundred and twenty eight thousand Hong Kong dollars (HK$528,000).

(2) The Rental Agreement was entered into between the Appellant and the PRC Entity. The terms of the Rental Agreement include, among other things, the following

(i) The PRC Entity leased the Factory Premises to the Appellant for 50 years from 1995 to 2045.

(ii) The total payment for the tenancy period of 50 years was to be RMB800,000 payable by six instalments. The first payment of RMB300,000 was to be paid upon the signing of the Rental Agreement and the second to sixth instalments of RMB100,000 each were payable in June of each year from 1996 to 2000.

(iii) During the tenancy period of 50 years, the Appellant had to pay a monthly management fee of RMB800.

(iv) Upon the expiration of 50 years and should it be required to be continued, the tenancy would be renewed subject to mutual agreement. If not, the Factory Premises will be returned to the PRC Entity unconditionally.

(f) In the audited accounts of the Appellant for each of the years of assessment 1995/96 to 1998/99,

(1) the payments made by the Appellant pursuant to the Transfer Agreement and the Rental Agreement were included in the balance sheet of the Appellant as 'Land Use Right Overseas' and placed under the heading 'Fixed Assets';

(2) 'Land Use Right and Other Fixed Assets are depreciated at 30% p.a. based on reducing balance method.'; and

(3) the Appellant did not claim any of the depreciation charges in respect of the Factory Premises as allowable deductions.

(g) The following schedule shows how the depreciation charges in respect of the payment for the tenancy for each of the years of assessment 1995/96 to 1998/99 were arrived at

				Depreciation	
	(a)	**(b)**	**Closing balance**	**Charged for the year**	
Year ended	**Balance b/f**	**Addition**	**(at cost)**	**30% of [(a)+(b)]**	**Blance c/f**
	$	$	$	$	$
31-3-1996	-	806,000 [$528,000+Rmb300,000]	806,000	241,800	564,200
31-3-1997	564,200	92,600 [The 2nd payment of Rmb100,000]	898,600	197,040	459,760
31.3.1998	459,760	92,764 [The 3rd payment of Rmb100,000]	991,364	165,757	386,767
31-3-1999	386,767	100,311 [The 4th payment of Rmb100,000]	1,091,675	146,123	340,955
				750,720	

				======	

(h) In respect of all relevant years of assessment, it was agreed between the assessor and the Appellant that only 50% of the profits from the diecasting operation in PRC should be chargeable to profits tax in Hong Kong.

(i) By letter dated 15 November 2000, Messrs G ('the Representatives') applied on behalf of the Appellant under Section 70A of the Inland Revenue Ordinance ('the Ordinance') for correction of the profits tax assessments for the years of assessment 1995/96 to 1998/99 on the ground that 'rental payment for (the Factory Premises) was wrongly treated as capital asset (land use right)', and therefore the rental payment by six yearly instalments should be allocated over 50 years by applying Rule of 78 at conversion rate at FIFO

$$\frac{n\,(n+1)}{2} = \frac{600 \times 601}{2} = 180{,}300'$$

(j) In the same letter, the Representatives provided the following details in respect of payments made under the Transfer Agreement and the Rental Agreement :

(1) The new lease commenced on 13 October 1995 and expired on 12 October 2045 with a duration of 50 years.

(2) Rental was paid by six yearly instalments as follows :

		RMB		HK$
1995/96	Right to use unexpired tenancy	569,782	=	528,000.00
	1st Payment	300,000		278,000.00
1996/97	2nd Payment	100,000		92,600.00
1997/98	3rd Payment	100,000		92,764.38
1998/99	4th Payment	100,000		100,311.36
1999/00	5th Payment	100,000		88,495.56
2000/01	6th Payment	100,000		
		1,369,782	('the Sum')	

(3) Starting from the year of assessment 1999/2000, rental allocation in respect of the Factory Premises was charged as an expense in the accounts of the Appellant and such rental allocation was made by applying the Rule of 78 at conversion rate at FIFO :

$$\frac{n\,(n+1)}{2} = \frac{600 \times 601}{2} = 180{,}300$$

(4) A schedule of rental payable for each year of assessment calculated under the Rule of 78 was supplied to the Inland Revenue.

(k) The rental allocation method as referred to in Fact (j)(3) would result in the following allocation of the Sum for each of the 600 months of the tenancy period of 50 years in respect of the tenancy :

Month	Fraction of Sum allocated	Numerator of the fraction
1st	600 / 180,300	600
2nd	599 / 180,300	599
3rd	598 / 180,300	598
4th	597 / 180,300	597
.	.	.
.	.	.
.	.	.
598th	3 / 180,300	3
599th	2 / 180,300	2
600th	1 / 180,300	1
	1	180,300

(l) Following this allocation process, the Representatives calculated that the following amounts should be treated as expense for use of the Factory Premises

	RMB		HK$

1995/96	27,236	=	25,239
1996/97	53,651	=	49,717
1997/98	52,557	=	48,703
1998/99	51,463	=	47,690
			171,349

(m) In the Appellant's 1999/2000 profits tax return submitted in November 2000, the Appellant reported assessable profits of $280,072 for the year ended 31 March 2000.

In the accounts of the Appellant,

(1) the following two items relating to the Sum were treated as prior year adjustments to its accumulated profits :

(i) the accumulated depreciation provided for in respect of the Factory Premises amounting to $750,720 [see Fact (g)] was written back;

(ii) the total amount of 'rental' payable [as calculated under the Rule of 78, see Fact (k)] amounting to $171,349 [see Fact (l)] was deducted.

(2) an amount of $46,676 calculated under the Rule of 78; was charged as expense of the Appellant.

(3) the Sum, after deducting the expenses allocated under the Rule of 78, was reclassified from 'Land Use Right Overseas' to 'Prepayment'.

(n) The Representatives advanced the following contentions in support of the amounts claimed [see Fact (i)] as deduction for the years of assessment 1995/96 to 1998/99

(1) 'In accordance with SSAP 2.114 re classification of lease between Finance (Capital) and Operating (Revenue) Lease, the classification depends on the extent to which risks and rewards incident to the ownership of a leased asset lied with the lessor or the lessee. Payment of rental by means of a lump sum or by intervals does not fall within the scope of classification.

A lease is classified as a Finance Lease if it transfers substantially all the risks and rewards incident to the ownership whereas a lease is classified

as an Operating lease if it does not transfer substantially all the risks and rewards incident to the ownership.

However, the characteristic of land and building is that it normally has an indefinite economic life and if title is not expected to pass to the lessee by the end of the lease term, the lessee does not receive substantially all the risks and rewards incident to the ownership. A lump sum payment for such a leasehold represents pre-paid lease payments and are amortized over the lease term in accordance with the pattern of benefits provided.

Lease payment under an Operating lease should be recognised as an expense in the Income Statement on a straight line basis over the lease term unless another systematic basis is representative of the time pattern of the user's benefit. Your opinion of a lump sum payment is regarded as capitalized rent is departure from SSAP and S.17(1)(c) of (the Ordinance) is not applicable.

Moreover, S.16(1)(b) states explicitly rental payment for producing assessable profit is allowable deduction and I couldn't see there is any provision in (the Ordinance) that a lump sum rental payment is capital in nature.'

(2) '(The Transfer Agreement and Rental Agreement were) for leasing factory premises (**廠房**)for a term of 50 years. It was not a GRANT OF LEASEHOLD INTEREST in land……'

(3) 'In accordance with (the Ordinance) 16(1)(b), rent paid by any tenant of land & building occupied by him for purpose of producing profit, (the Appellant) wished to explain that (it did not) erect or construct any factory premises in PRC for manufacturing. Instead (it) only rented factory premises for production. It is ridiculous that no factory rent was paid for income producing in absence of self-owned factory premises. Treatment of lump sum lease payment is clearly shown on SSAP 2.114 paragraph 11……'

(4) 'In absence of distinction of lease as capital or revenue in (the Ordinance) and Companies Ordinance, the SSAP is additional document which may be of some assistance.'

(o) The assessor maintained his view that depreciation or amortization charges in respect of the Sum could not be allowed as a deduction. On 30 January 2002,

he issued a Notice of Refusal to correct the 1995/96 to 1998/99 assessments under section 70A(2) of (the Ordinance).

(p) No valid objection was lodged by the Appellant in respect of the Notice of Refusal. The 1995/96 to 1998/99 profits tax assessments therefore became final and conclusive.

(q) In the profits tax returns submitted by the Appellant, it reported assessable profits of $177,418 for the year ended 31 March 2001 and $329,111 for the year ended 31 March 2002. The above profit figures were arrived at by the Appellant after deducting the following amounts of expenses [as calculated under the Rule of 78];

Year of Assessment	Amount Claimed
2000/01	$45,662
2001/02	$44,648

(r) The assessor was of the view that the amounts allocated under the 'Rule of 78' could not be allowed as deductions. On divers dates, he raised on the Appellant the following profits tax assessments for 1999/2000 to 2001/02 by adding back, among other things, the amounts of $46,676, $45,662 and $44,648 [see Facts (m)(2) and (q)] in the respective years of assessment

(1) Year of assessment 1999/2000

Assessable profits	$303,849
Tax payable thereon	$48,615

(2) Year of assessment 2000/01

Assessable profits	$200,969
Tax payable thereon	$32,155

(3) Year of assessment 2001/02

Assessable profits	$352 625
Tax payable thereon	$56,420

Copies of the relevant computations are attached to the Determination as Appendices D, D1 and D2.

(s) The Representatives lodged objections against the above assessments on the ground that 'PRC factory rent' as calculated under the Rule of 78 was 'an

inevitable outgoing for producing chargeable profit' and therefore should be allowed as deduction.

(t) In support of the objections, the Representatives advanced the following further contentions

(1) '……(the Appellant is) not the owner of (the FactoryPremises), hence the lump sum payment is another form of rent for the residue of the original tenancy.'

(2) '……according to DIPN No.40 a prepaid operation expense should be allowed as a deduction on the basis that the expense had been incurred.'

(3) The tenancy in respect of the Factory Premises is an operating lease because of the following reasons

(i) 'A lump sum payment by 6 years represents the prepaid lease payments, to be amortised over the lease term (S SAP 2.114 paragraph 11).'

(ii) 'It is not a lump sum PREMIUM……'

(iii) '(Your Department) accepted it was a "Tenancy Agreement for use of premises by 50 years". There is no transfer of title. How can it be twisted to be a capitalized rent.'

(iv) 'There is no limitation of lease term and mode of payment for an operating lease under (the Ordinance).'

(v) 'Even though (the Appellant) acquired instead of leased, of course not, (the Appellant is) still entitled to I.B.A. and the prepaid rent is amortised by 25 years.'

(u) The assessor noted that, according to the allocation method [see Facts (j) and (k)] as used by the Appellant,

(1) the monthly 'rental' gets smaller and smaller as time goes by; and

(2) the total 'rent' allocated for the first 12 months of the tenancy period is about 91 times that allocated for the last 12 months [that is the 50th year].

(v) When asked why such an allocation method was considered reasonable or appropriate, the Representatives replied in the following terms

(1) 'The allocation is made in accordance with Rule 78 at conversion rate of 300/278 at FIFO basis which allocation we consider to be appropriate. Should you have any alternative method, please forward for (the Appellant's) consideration.'

(2) '(The Factory Premises) will devalue as years go by. Worth to mention

(i) Depreciation and amortization are allowable deductions under Part IV of (the Ordinance). It all depends whether they are ranking assets or not.

(ii) Your Attorney General also entered into a tenancy with a lease period of over half a century, a period even longer than (the Appellant's).'

The appeal notice :

4. The objection failed. S Y Leung and Co by a letter dated 29 April 2004 gave notice of appeal on behalf of the Appellant.

'Dear Sir

Notice of Objection dated 17th April 2002 and 10th February 2003
Profits Tax Assessment 1999/2000 – 2001/2002

We are directed to refer to the Letter of Determination dated 16th April 2004. The appellant is aggrieved by the determination.

(2) We are further directed to lodge appeal to the Board of Review on the ground that the rental payment should be deductible expenses under S.16(1)(b) of I.R.O.

(3) Alternatively, the appellant has acquired interest in a factory building/premises and Industrial Building Allowances or commercial building allowance should be granted instead. I.B.A. or C.B.A. under S.34 or 36 of I.R.O should be granted if subsequently found as a capital expenditure.

(4) The appellant have applied revision under S.70A of I.R.O. to reclassify from

Land Use Right to prepayment of rent, but refused.

Yours faithfully
S Y Leung & Co'

The appeal hearing :

5. The appeal came before us on 12 July 2004.

6. Mr Lau Kam-cheuk ['Mr Lau'] of Messrs S Y Leung & Co, Certified Public Accountants represented the Appellant. Mr Lee Yun-hung ['Mr Lee'] represented the Respondent.

7. One witness, a director of the Appellant Mr A ['Witness'] was called by Mr Lau. The witness statement was supplied to the Board and the Inland Revenue on 8 July 2004.

8. No witness was called by Mr Lee for the Respondent.

9. Each of the Appellant and the Respondent submitted written closing submissions to the Board.

10. At the request of the Board each of the Appellant and the Respondent made further written submission on the details and application of (i) Rule of 78 and (ii) Departmental Interpretation & Practice Notes No 40 ['DIPN No. 40'] to the Board after the hearing. Such written submissions were made by the Appellant and by the Respondent on 19 July 2004 and 29 July 2004 respectively.

11. As permitted by the Board, the Appellant on 2 August 2004 submitted a further submission in reply to the submission of the Respondent dated 29 July 2004.

The Board's Decision

12. The issue for the Board to decide is whether the Sum is a deductible item under section 16(1)(b) of the Ordinance and alternatively in the event the Board rules that the Sum is not deductible and is of a capital nature whether industrial building allowances ['IBA'] or commercial building allowances ['CBA'] under section 34 or section 36 of the Ordinance should be allowed.

13. Section 16(1) of the Ordinance provides for the deduction of outgoings and expenses which were incurred by a taxpayer in the production of his assessable profits. Section 17(1)(c) further provides that no deduction shall be allowed in respect of any expenditure of a capital nature.

14. In the closing submission of the Appellant it was argued that the Sum was composed of 'rent expenses for the manufacturing activity for the production of profit' in nature and the Appellant is entitled to amortize the Sum per DIPN No 40 for 50 years under Rule of 78 of the accepted accounting principle and should be deductible under section 16(b) of the Ordinance. The Appellant has also drawn the Board's attention to note that the Appellant was formerly a tenant paying monthly rent.

15. The guiding principle is laid down in Wharf Properties Limited v CIR [4 HKTC310] ['Wharf case'] where Patrick Chan J, as he then was, after referring to a number of authorities on this issue, gave a detailed analysis of sections 16 and 17 of the Ordinance. At pages 335 and 336 of the case, Chan J recited the following statements of Lord Brightman in the Privy Council judgment of Lo & Lo v CIR [2 HKTC 34] :

> *'It is perfectly correct to say that sections 16 and 17 provide exhaustively for the deductions … in a sense that permitted deductions are confined to outgoings and expenses incurred in the production of profit in respect of which tax is chargeable; that such permitted deductions … expressly exclude those in s.17. In the opinion of their Lordships commercial considerations are not wholly to be disregarded in the course of this process. They are relevant for the process of deciding what can properly be treated as 'outgoings and expenses … incurred during the basis period … in the production of profits in respect of which the taxpayer is chargeable to tax.*
>
> *In other words, s.16 provides for determining the type of outgoings and expenses which are allowed as deductions in computing assessment profits as well setting out by way of inclusion the various types of deductions which are permissible. On the other hand, s.17 sets out the various types of outgoings and expenses which are not permissible.'*
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> Chan J then went on to say at page 339 :
>
> *'In my view, sections 16 and 17 are separate provisions and perform different functions. One offers inclusion for certain types of outgoings and expenses in the process of ascertaining assessable profits while the other provides exclusion of certain types of outgoings and expenses in the same process … The correct approach is that one should consider first of all whether an item of expenditure falls to be included under s.16 and then whether it is excluded under s.17. If the item does not fall within s.16, that is the end of the matter. It will not be allowed as a deduction. But even if it falls within s.16, it has still to be considered whether it is excluded under s.17. If it is excluded, it will not be allowable as a deduction. It is only when a particular item qualifies under both s.16 and s.17*

> *that it is permissible as a deduction for the purpose of ascertaining the assessable profits.'*

16. The view of Chan J was endorsed by Lord Hoffmann, who, when delivering the Privy Council judgment in the Wharf case, said at page 389 :

> *'Their Lordships think that in the absence of express contrary language, expenditure which comes within section 16 will not be deductible if it falls within one of the prohibited categories in section 17. Since sections 16 and 17 together "provide exhaustively for the deduction side of the account which is to yield the assessable profit" (Commissioner of Inland Revenue v Mutual Investment Co Ltd [1967] AC 587, 598), section 17 would serve no purpose if it did not exclude deductions which would otherwise be allowed under section 16.'*

17. In deciding whether the Sum is of a capital nature or is a revenue expense the Board reminded itself of the words of Chan J in the Wharf case in dealing with the definition of 'expenditure of a capital nature' in the Ordinance. In his words :

> *'expenditure which is itself incurred as a capital and expenditure which, although not a capital in itself, is payment of a capital nature. If the expenditure is a capital payment, it is of course caught by the section. But even if it is not a capital payment, the Court has to consider whether it is of a capital nature or revenue nature'.*

18. The Board also reminded itself of the words of Lord Hoffmann in delivering his judgment for the Wharf case at the Privy Council at pages 389 and 390 :

> *'… 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 : see Viscount Radcliffe in Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd [1964] AC 948, 960.'*

19. Chan J commented at pages 348 and 349 in the Wharf case in relation to deciding whether an item is of a capital nature :

> *'In my view, in order to decide the question of whether an expenditure is of a capital or revenue nature, one has to examine not only the status or nature of the expenditure but also the reason or purpose for which and the circumstances under which it is incurred'.*

20. Chan J went on to say at pages 348 and 349 in the Wharf case regarding the approach in determining whether a particular payment or item of expenditure can be regarded as expenses or capital in nature :-

> *'I have been referred to quite a number of authorities on the issue of whether a particular payment or item of expenditure can be regarded as capital in nature. These previous decisions seem to lay down various tests* (which tests are referred to in details in the following paragraph) *for the determination of this issue. In my view, these tests illustrate how the courts had applied various relevant considerations to the facts before them. Some of these tests came from U.K. cases and others from Australian cases. Once it is realized that these tests are only factors for consideration in determining what is the nature of a particular expenditure in the factual matrix of a particular case and that none of these tests is decisive, it is pointless or even counter-productive to try to decide whether one should follow the U.K. or Australian authorities. As McMullin J. said in the Tai On Machinery case, legislation in the different jurisdictions are similar but there are bound to be differences. It may be true that the Australian legislation is more in line with the Hong Kong legislation. Yet it can be noted that U.K. courts when they came to decide on the same or similar issue, did very often refer to Australian authorities such as the Sun Newspapers Limited and Australian courts had also referred to U.K. authorities such as the British Insulated case. I think it would be wrong not to have regard to any of these test and considerations on the ground that it was formulated in a U.K., Australian or Commonwealth case.*
>
> *In some of the previous decisions cited to me, the expenditure in question was clearly of a capital nature while in other cases, it was clearly of a revenue nature. However, there were borderline cases where it would be difficult to come to any firm conclusion one way or another. I do not propose to go into each of these cases or try to follow or distinguish any of their decisions. They turned on their respective facts and the different governing statutes. Several tests had been suggested in these authorities. None of these tests is decisive. The courts had placed greater reliance on one test in a particular set of circumstances and on another in a different set of circumstances. At the end of the day, the answer to this vexed question depends very much on the facts of each case. …It seems that ultimately it is "a common sense appreciation of all the guiding features" which would provide the answer.'*

21. The Board has reminded itself of the words of Chan J in the Wharf case when he considered the relevant authorities and saliently summarised the relevant tests to be applied in that case.

(a) Fixed/circulating capital test – *'The question to ask is whether the expenditure in question is incurred in respect of fixed or circulating capital of the business.'*

(b) Once and for all/recurring expenditure test – *'The question to be asked is whether the expenditure has been made to meet a continuous demand for expenditure as opposed to expenditure made once and for all.'*

(c) Enduring benefit test – *'The question to be asked under this test is whether the expenditure payment would result in an enduring benefit for the business. The test was explained by Viscount Cave L.C. in British Insulated and Helsby Cables Limited v. Atherton'* as follows :

'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.'

(d) Profit yield structure test – *'The question to be asked under this test is whether the expenditure in question relates to the structure within which the profits are earned or whether it relates to part of the money earning process.'*

22. Litton V P in the Court of Appeal in the Wharf case said at page 383 *'Accounting guidelines cannot alter the law. Nevertheless, a construction of the statutory provisions which in effect accords with accepted international standards of accountancy for the treatment of interest charges is, at least some indication of the right approach'.*

23. The agreed facts show that the Sum was described in the audited financial statements of the Appellant for the years of assessment 1995/96 to 1998/99 as 'land Premium' for 'Land Use Right' which was classified as 'Fixed Assets' and depreciated accordingly with the unpaid instalments of 'Land Premium' treated as 'Capital Commitment' in the balance sheets of the Appellant. The Appellant has failed to show why in its accounts for the years prior to 1999/2000, the Sum was shown in a way which is inconsistent with the treatment of rent incurred for the production of assessable profit. The Board agrees with the argument of the Respondent that the change in accounting treatment starting from the year of assessment 1999/2000 when the Sum was thereafter treated in the accounts as 'Prepayment' and portions of the Sum were treated as 'annual rentals' does not, in itself, change the nature of the payments.

24. In deciding whether the Sum is rental expenses or are payments of a capital nature, we remind ourselves of the following extracts from Encyclopedia of Hong Kong Taxation (Taxation of Income, Vol 3 by PG Willoughby and A J Halkyard) which is relevant in the determination of the issue before the Board.

> '[8779]
>
> *"rent paid …' Rent paid for business premises is generally deductible … However, a lump sum, sometimes called a 'fine' or 'premium', paid on the grant of lease will be treated as a form of capitalized rent and therefore will be non-deductible capital expenditure (section 17(1)(c)). This will be so whether the premium is payable as a lump sum… or by instalments …Rent paid in advance may be deductible provided that it does not amount to a disguised premium (see Miramar Hotel & Investment Co Ltd and Land Crawford Ltd v Collector of Stamp Revenue [1961] HKLR 673 where a large sum by way of rent payable in advance on the grant of a lease was held to be in substance a premium for stamp duty purposes).'*

25. In the case of Henriksen v Grafton Hotel, Limited [24 TC 453] Lord Greene MR of the Court of Appeal said at page 457.

> *'If the sum payable is not in the nature of revenue expenditure, it cannot be made so by permitting it to be paid by annual instalments.'*
>
> At page 460:
>
> *(i) 'A payment of this character appears to me to fall into the same class as the payment of a premium on the grant of a lease, which is admittedly not deductible. In the case of such a premium it is nothing to the point to say that the parties if they had chosen, might have suppressed the premium and made a corresponding increase in the rent. No doubt they might have done so, but they did not do so in fact. The lessee purchases the term for the premium. There is no revenue quality in a payment made to acquire such an asset as a term of years.'*
>
> *(ii) '…It frequently happens in Income Tax cases that the same result in a business sense can be secured by two different legal transactions, one of which may attract tax and the other not. This is no justification for saying that a taxpayer who has adopted the method which attracts tax is to be treated as though he had chosen the method which does not, or vice versa'.*

26. In the Privy Council case of Strick (H M Inspector of Taxes) Regent Oil Company Limited [43 TC 1], Lord Wilberforce of the House of Lords explained the difference between 'premium' and 'rent' in the following terms [see page 55] :

> *'…in the light of the criteria stated by Dixon J. … This formulation is useful in pointing the distinction (as to which much discussion arose in the argument) between a premium paid for a lease, which produces an asset for future use, and rent paid under a lease which is for current use; the first being a capital and the latter a revenue payment.'*

27. In CIR v Wattie and another [1988 STC 1160]. It was stated, among other things that :

> *'…But in the absence of special legislation to the contrary a premium has always been recognized, in the law of New Zealand as in the law of the United Kingdom, as capital rather than revenue. The reason has probably never been better expressed than by Viscount Cave LC in the familiar passage from his speech in British Insulated and Helsby Cables Ltd v. Atherton (Inspector of Taxes) (1926) AC 205 at 213-214, 10 TC 155 at 192-193 when he 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.'*

28. In the MacTaggart v B E Strump case [10 TC 17], a premium paid has been held to be 'a capital expense, *and that no part thereof was admissible as a deduction in computing the profits of the firm' s trade*'.

29. In the Privy Council case of Regent Oil Company Limited [43 TC 1], Lord Wilberforce of the House of Lords explained the difference between 'premium' and 'rent' in the following terms [see page 55] :

> *'… in the light of the criteria stated by Dixon J. … This formulation is useful in pointing the distinction (as to which much discussion arose in the argument) between a premium paid for a lease, which produces an asset for future use, and rent paid under a lease which is for current use; the first being a capital and the latter a revenue payment.'*

30. The Board reminds itself of what Lord Denning MR said in the Court of Appeal, after referring to a number of cases, stated [at page 18] :

> *'If you look at the transaction according to its legal form, the payment of the lump sum was to my mind clearly expenditure of a capital nature. It was paid by the Oil Company so as to acquire a lease for a term of years at a nominal rent. Whether described by the parties as a 'premium' or as a 'sum' it was nothing more nor less than a premium paid for a lease. If the Company had paid an annual rent for the term of years, the payments of rent, of course, would be of a revenue nature, but a premium paid at the beginning is clearly capital expenditure. It is a sum paid once for all so as to acquire a permanent asset.'*

31. In the present case the evidence of the Witness shows that two amounts were paid in respect of the Factory Premises namely HK$528,000 which was paid to Mr F as referred to in paragraph 3(e)(1) above and RMB800,000 which was paid to the PRC Entity as to RMB300,000 upon the signing of the Rental Agreement and the second to sixth instalments of RMB100,000 each of which were paid in June of each year from 1996 to 2000. In the evidence of the witness such sums were made at the request of the PRC Entity. Evidence of the Witness also shows that Mr F, a third party, invested in the erection of part of the Factory Premises referred to as the 'extension' to the Factory in paragraph 3(d) above. The 'extension' to the Factory was surrendered to the Village C in 1995 and under the Rental Agreement the Factory and the 'extension' that is the Factory Premises, were leased to the Appellant for 50 years from 1995 to 2045 in consideration for the payment of the two amounts referred to in this paragraph that is, the Sum.

32. The Board agrees with the Respondent in its submission that the Sum is in the nature of a lump sum payment payable by instalments. It was paid in order for the Appellant to obtain the right to use the Factory Premises for 50 years from 1995 to 2045. The right so acquired conferred upon the Appellant substantial enduring benefits. The Sum was incurred to establish, replace or enlarge the profit yield structure of the Appellant' s business. The Sum is therefore a premium paid for the acquisition of an interest in land or a premium intended to secure the Factory Premises for future use.

33. The change of accounting treatment starting from the year of assessment 1999/2000 from 'Land Premium' to 'Prepayment' does not change the nature of the Sum. The Sum continues to be premium paid for securing a property for future use.

34. The Board agrees with the Respondent that the Sum is of a capital nature and thus precluded from deduction pursuant to section 17(1)(c) of the Ordinance,. There is therefore no need for the Board to consider further whether the Sum satisfies the conditions stipulated in section 16(1) nor the application of DIPN No 40 and the Rule of 78.

35. The next question for the Board to decide is whether the Appellant should be allowed to claim for IBA or CBA.

36. The burden of proof again is on the Appellant to convince the Board why IBA or CBA should be given.

37. Section 34(1) of the Ordinance provides that IBA can, under certain circumstances be granted to a person incurring 'capital expenditure on the construction of a building or structure'.

38. Section 34(2) of the Ordinance provides that a person entitled to an interest in a building or structure which is an industrial building or structure and where that interest is the relevant interest in relation to capital expenditure incurred on the construction of that building or structure, IBA can, under certain circumstance be given.

39. In a similar vein, section 33A of the Ordinance provides that CBA can, under certain circumstances, be granted to a person who is entitled to an interest in a commercial building or structure and where that interest is the relevant interest in relation to capital expenditure incurred on the construction of that building or structure.

40. In the present case, the Appellant paid out the Sum to acquire a right to use the Factory Premises for 50 years and there is no transfer of title. The Sum cannot be said to be capital expenditure incurred on the construction of a building or structure, so that section 34(1) of the Ordinance is not applicable. As the Appellant is not the owner of the Factory Premises the Appellant should not be entitled to capital expenditure incurred on the construction of the Factory Premises. Section 34(2) and 33A of the Ordinance are also not applicable.

41. The Appellant has not discharged the onus under section 68(4) of the Ordinance of proving that any of the assessments appealed against is excessive or incorrect. We confirm the assessments as confirmed by the acting Deputy Commissioner.