Case No. D28/06

Profits tax – franchise fee – whether capital – whether expenditure on the purchase of patent rights or rights to know-how – Inland Revenue Ordinance ('IRO') section 16E (1)

Panel: Michael Seto Chak Wah (chairman), Chow Wai Shun and Winnie Kong Lai Wan.

Date of hearing: 7 March 2005.
Date of decision: 16 June 2006.

The appellant paid franchise fees for the non-exclusive licences to operate two stores for seven years.

The main issue is whether the franchise fees was of a capital nature.

Held:

1. The Board found that the franchise fees was paid once and for all. By payment of it, the appellant obtained the advantage of being able to establish the business with a guaranteed annual gross income and maintain it for the whole term of the franchise. The Board found it of a capital nature.

2. The Board also found that the franchise was not rights with proprietary interest but a licence only. Therefore, the appellant was not entitled to the relief under section 16E(1) of IRO which provides for deduction of capital expenditure on the purchase of patent rights or rights to know-how.

Appeal dismissed.

Cases referred to:

CIR v Lo & Lo (1984) 2 HKTC 71
Heather v PE Consulting Group [1973] Ch 189
John Smith & Son v Moore [1921] 2 AC 13
CIR v Tai On Machinery Works Ltd (1969) 1 HKTC 411
Wharf Properties Ltd v CIR [1997] STC 351

Sun Newspapers and Associated Newspapers Ltd v FCT (1938) 61 CLR 337
Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd [1964] AC 948
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] KB 184
Mitchell v BW Noble Ltd [1927] 1 KB 719
W Nevill & Co Ltd v FCT (1937) 56 CLR 290
CIR(NZ) v Wattie [1998] STC 1160

Taxpayer represented by his brother.
Ng Yuk Chun for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal against the determination of the Deputy Commissioner of Inland Revenue dated 24 November 2004 ('the Determination') whereby:

(1) Profits tax assessment for the year of assessment 1999/2000, dated 11 June 2004, showing assessable profits of $270,443 was confirmed;

(2) Personal assessment for the year of assessment 1999/2000 under charge number 6-2217137-00-9, dated 11 June 2004, showing net chargeable income of $196,546 with tax payable thereon of $22,912 was confirmed;

(3) Additional profits tax assessment for the year of assessment 2000/01, dated 11 June 2004, showing additional assessable profits of $99,557 was confirmed;

(4) Additional personal assessment for the year of assessment 2000/01 under charge number 6-2231411-01-5, dated 11 June 2004, showing additional net chargeable income of $99,557 with additional tax payable thereon of $16,925 was confirmed;

(5) Profits tax assessment for the year of assessment 2001/02, dated 30 March 2004, showing assessable profits of $317,033 was confirmed; and

(6) Additional personal assessment for the year of assessment 2001/02 under charge number 6-3420682-02-5, dated 30 March 2004, showing additional net chargeable income of $400,000 with additional tax payable thereon of $68,000 was confirmed.

The Appellant claims that the franchise fees he paid to Company A for the operation of two B stores, the business of which was under his sole proprietorship, should be allowable for deduction in ascertaining the assessable profits of the stores.

2. At the hearing before us the Appellant chose to be represented by his brother while he himself gave oral evidence. The Commissioner was represented by the senior assessor, Miss Ng Yuk-chun.

3. At the end of the hearing on 7 March 2005, this Board adjourned the appeal to enable the Appellant to respond to the Commissioner's written submissions helpfully provided by Miss Ng. The Appellant replied by a letter dated 23 March 2005. The Board had considered all relevant materials before it, including the Appellant's reply after the hearing, in coming to this decision.

The facts and evidence

4. The basic facts which are contained in the Determination are not in dispute and we find them as facts. For the purpose of our decision, the relevant facts are stated below.

(1) At all relevant times, Company A had the exclusive right to grant franchises for the operation of B Stores in Hong Kong and Macau.

(2) On 13 August 1999 the Appellant as the Franchisee entered into a Store Franchise Agreement ('SFA') with Company A whereby Company A granted to him a non-exclusive licence to operate the xxx Store for a maximum term of seven years. Among other things, the Appellant was required to pay to Company A a franchise fee of $370,000 and a monthly store charge at 57% of the gross profit of the store.

(3) On 29 March 2001 the Appellant as the Franchisee entered into another SFA with Company A whereby Company A granted him a non-exclusive licence to operate the yyy Store for a maximum term of seven years. Among other things, the Appellant had to pay to Company A a franchise fee of $400,000 and a monthly store charge at 63% of the gross profit of the store.

(4) In the profit and loss accounts of the two stores for the relevant years of assessments which were submitted by the Appellant together with his individual tax returns, the franchise fees and the store charges were deducted in arriving at the assessable profits of the stores. The assessor, however, raised on the Appellant assessments for the relevant years of assessment disallowing the deduction of the franchise fees.

(5) The Appellant objected, via his representative, to the assessments, arguing that:

(a) since the franchise fee included ' know-how, fixturisation, merchandising and inventory, lease of equipment, training, bookkeeping and financial reports, rent of the shop premises, etc.' and the fee would not be refundable upon early termination or expiry, it was a direct cost in production of the assessable profits; and

(b) on the basis that the franchise right was ' of similar nature of patent right, that is, the right to do or authorize the doing of anything that would, but for that right, be an infringement of a patent' , the expenditure incurred was deductible under a special provision notwithstanding that capital expenditure is generally non-deductible.

(6) The Deputy Commissioner confirmed the assessments.

5. We have also looked at the two SFAs attached to the Determination in detail, which contained more or less the same standard terms. The SFAs provide, inter alia, that:

(1) Company A acknowledged receipt of the franchise fee at the time when the relevant SFA was executed. The fee would not be refundable except in the following cases:

(a) where Company A was of the opinion that the franchisee failed to evidence an understanding of its training programme satisfactory to Company A and hence discontinued participation of, or declined to certify, the franchisee; or

(b) where Company A was unable to make available to the Appellant the designated store within a certain period of time.

(2) The store charge was a monthly payment for the SFA, the use of the designated store, the equipment of the store and continuing services to be provided by Company A under the SFA including, inter alia, provision of training, maintenance of certain equipment, financial statements, audits, drawing of cheques, merchandise reports, finance and indemnities against all fire and casualty loss or damage to the stores and the equipment.

(3) The Appellant would occupy and use the stores as a licensee and Company A had the right to revise the percentage of the store charge as a result of a rent revision upon exercising an option or renewal of the existing tenancy agreement

between Company A and the landlord in respect of the store or as a result of changes in market conditions.

(4) Company A assured the Appellant a gross income, that is, gross profit after deduction of the store charge, of $400,000 per calendar year. In the event that there might be any shortfall in this assured gross income, there would be a corresponding reduction in the store charge.

6. The Appellant, while giving oral evidence at the hearing, admitted that he did sign the two SFAs appended to the Determination but stated that his understanding of the terms from his conversation with a representative from the Franchise Department of Company A, particularly regarding the purpose of the franchise fee, was not entirely identical to what the SFAs had stated. No evidence whatsoever was submitted to support, nor was any witness from Company A called to corroborate, this assertion. We take the view that we do not have any basis to challenge the validity of the SFAs and we will therefore interpret the terms therein as we find them.

The Appellant's case

7. In his notice of appeal, the Appellant adopted more or less the same line of argument as in his objection. In summary, the Appellant argued that the franchise fee was a direct cost in production of the assessable profits which should be deductible under either the general provisions (sections 16 and 17 of the Inland Revenue Ordinance ('IRO')) or a special provision for purchase of a patent right or know-how (section 16E of IRO).

The issue

8. The issue to be decided by the Board in the present case is whether the franchise fees paid by the Appellant to Company A for the operation of the two stores are deductible in ascertaining the assessable profits of the stores.

The statutory provisions

9. Sections 16 and 17 of IRO provide exhaustively for the deductions: CIR v Lo & Lo (1984) 2 HKTC 71.

10. Section 16(1) of IRO provides:

'*In ascertaining the profits in respect of which a person is chargeable to tax under this Part [IV] 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... including...

...

(ga) the payments and expenditure specified in [section] ... 16E... as provided therein.'

11. Section 17(1) of IRO provides:

'*For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part [IV] no deduction shall be allowed in respect of*

...

(c) any expenditure of a capital nature...'

12. Section 16E of IRO provides:

'*(1) Notwithstanding anything in section 17, in ascertaining the profits from any trade, profession or business in respect of which a person is chargeable to tax under this Part [IV] for any year of assessment there shall... be deducted any expenditure incurred by such person during the basis period for that year of assessment (other than any amount which is allowable as a deduction apart from this section) on the purchase of patent rights or rights to any know-how, for use in Hong Kong in the trade, profession or business in the production of such profits."*

...

(4) In this section

...

"know-how" means any industrial information or techniques likely to assist in the manufacture or processing of goods or materials;

"patent rights" means the right to do or authorize the doing of anything which would, but for that right, be an infringement of a patent.

...'

Revenue or capital in nature

13. The parties did not dispute that the franchise fees were incurred by the Appellant in the production of the assessable profits of the stores. The question for the Board to decide is whether the franchise fees are of a capital nature which should be disallowed under section 17(1)(c) of IRO.

14. 'The question of what is capital and what is revenue is a question of law for the courts' :

Heather v PE Consulting Group [1973] Ch 189 at 217.

15. The question can often be decided with reference to whether the expenditure is itself incurred directly in acquiring a fixed asset: John Smith & Son v Moore [1921] 2 AC 13; or the expenditure is in connection with such an acquisition: CIR v Tai On Machinery Works Ltd (1969) 1 HKTC 411. In the latter case, the nature of the expenditure may even change from capital to revenue when the asset is subsequently made available for 'business' use which produces chargeable profits: Wharf Properties Ltd v CIR [1997] STC 351. This test also extends to cover expenditure for 'establishing, replacing and enlarging the profit-yielding subject': Sun Newspapers and Associated Newspapers Ltd v FCT (1938) 61 CLR 337; Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd [1964] AC 948 and Wharf Properties Ltd v CIR, above.

16. The question may sometimes be decided by considering whether the expenditure is once and for all or recurrent; but it is by no means conclusive: Vallambrosa Rubber Co Ltd v Farmer (1910) 5 TC 529 at 536.

17. In the absence of acquisition of a fixed asset, expenditure of a special nature that secures an enduring benefit for a business may be disallowed as capital: British Insulated and Helsby Cables Ltd v Atherton [1926] AC 205. While an enduring benefit need not be everlasting: Henriksen v Grafton Hotel Ltd [1942] KB 184, the fact that expenditure is incurred in obtaining a lasting benefit to a business does not necessarily mean that the expense must be of a capital nature: for examples, see Mitchell v BW Noble Ltd [1927] 1 KB 719 and W Nevill & Co Ltd v FCT (1937) 56 CLR 290.

18. It appears, therefore, that no single test is decisive, although the approach is generally accepted to be one 'from a practical business point of view, rather than upon the juristic classification of the legal rights': CIR(NZ) v Wattie [1998] STC 1160. Having said so, it is also suggested in Willoughby and Halkyard's Encyclopaedia of Hong Kong Taxation, Volume III, paragraph II [8147] that, after identifying the purpose of the payment, there are essentially three matters to be considered as identified by Dixon J in Sun Newspapers and Associated Newspapers Ltd v FCT, above at 363:

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

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

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

Purpose of incurring the franchise fees

19. This is a typical case of 'business format franchising': see 'What is Franchising?', www.british-franchise.org/whatis.asp (the website of the British Franchise Association). By paying the franchise fee the Appellant was granted a licence by Company A which entitled him to trade under the trade name of Company A. A previously untrained person in the business, the Appellant was able to make use of all necessary elements including business premises together with decoration, furniture, fixtures and equipment therein in accordance with uniform standards and specifications designated by Company A with a view to getting established in the business. In contrast, the store charge is an on-going management service fee based on a percentage of annual turnover for Company A's continuing assistance and support in the franchise network including training, advertising and a range of management services.

20. In his grounds of appeal, the Appellant argued that the franchise fee might cover the electricity charges on the stores that were shared with by Company A. On this, the representative of the Inland Revenue submitted that, since under the SFAs the store charge was paid by the Appellant for, among other things, the continuing services to be provided by Company A, it would be reasonable to infer that such share in the electricity charges borne by Company A was meant to be covered by the recurring store charge rather than the fixed franchise fee. On the overall construction of the SFAs, we accept the latter argument.

21. The Appellant further contended, in his grounds of appeal and reiterated in his subsequent reply to the submission by the representative of the Inland Revenue, that the guaranteed annual gross income was an enduring benefit since it did not guarantee him any profit. However, according to the terms of the SFAs, the guaranteed annual gross income would have a positive impact on the amount of profit (or loss) by capping the store charge. On the construction of the SFAs, this guarantee must have been given in consideration of the franchise fee.

22. In his supplement to grounds of appeal, the Appellant made reference to a copy letter from Company A dated 17 November 2004 which provided that, in case the tenancy agreement regarding one of the stores could not be renewed, there would be an option, among others, for the Appellant to terminate the existing SFA and execute another SFA without paying any additional franchise fee. The Appellant argued that it would mean that the franchise fee had been paid for the lease of the store. We cannot accept this argument. We do not find the said option carries such a meaning in light of the terms of the SFAs. According to the SFAs, the store charge covers the use of the stores, which can be varied as a result of a rent revision upon exercising an option or renewal of the existing tenancy agreement between Company A and the landlord. Instead, the option only reinforces the conclusion that the franchise fee has been paid for the right to join in the business for at least the term of the franchise.

Character of the advantage sought

23. But for payment of the franchise fee the Appellant could not have the right and the necessary structure to establish the business with a guaranteed annual gross income.

24. Although the term of the franchise was just for a period of seven years, it is of enough durability to justify its being 'endurable': Henriksen v Grafton Hotel, Ltd, above, applied.

Manner to which the advantage is to be used, relied upon and enjoyed

25. According to the SFAs, payment of the franchise fees was acknowledged when Company A executed the SFAs. The franchise fee was paid once and only once during the term of franchise.

26. In his written reply to the Revenue's submission, the Appellant claimed that the franchise fees could have been paid yearly or monthly and that Company A could have even granted him a loan to pay for the fees. He further argued that he would have to pay another sum by way of franchise fee after the initial period should he decide to renew.

27. We do not accept the Appellant's argument. The Appellant did not pay in any of the other ways he suggested. We do not agree that the means by which the Appellant could have financed the payment of the franchise fee would have been relevant. Even if he had paid the franchise fees by instalments, it would still have to depend on 'the true character of the consideration given, that is, whether on the one hand it is a capitalized sum payable by deferred instalments or on the other hire or rent accruing *de die in diem*, or at other intervals, for the use of the things': per Dixon J in Sun Newspapers and Associated Newspapers Ltd v FCT, above at 363. Having regard to the character of the franchise fee, we hold that it was paid once and for all during the term of the franchise.

Means adopted to obtain the advantage

28. By payment of the franchise fee once and for all, the Appellant obtained the advantage of being able to establish the business with a guaranteed annual gross income and maintain it for the whole term of the franchise. In contrast, the store charge is a recurrent, periodic outlay incurred as part of the cost for operating the business which is similar to a payment of rent.

29. In the light of our analysis above, we have no other alternative but to conclude that the Appellant must fail on this ground.

Section 16E(1) of IRO

30. This section provides for deduction of expenditure incurred by a taxpayer on the purchase of patent rights or rights to know-how for use in Hong Kong in the production of

assessable profits of a trade, profession or business, which would have been disallowed by section 17(1)(c) because of its capital nature. The relief is restricted to expenditure on patent rights and industrial information and techniques likely to assist in the manufacture or processing of goods and materials. The question for the Board to decide in this regard is whether the franchise fee falls within this special provision and therefore can be deducted despite our holding that it is capital in nature.

Purchase of rights

31. In his grounds of appeal, the Appellant put forward the argument that, through payment of the franchise fee, he acquired the know-how and technique in operating the stores. We find that this argument is misconceived.

32. Article 16(B) of the standard form SFA provides that the Appellant shall not use or claim any right (except as provided in the SFA) to the store system, the trade secrets, the service mark or any trademark, symbol, copyright, or advertising owned or licensed by Company A. By entering into the SFAs, Company A only made such intangibles available to the Appellant as a franchisee by way of a licence. No proprietary interest in any of such intangible rights has ever been assigned to the Appellant. In other words, there has not been any sale and purchase of such rights. This means that the special provision does not have any application to this case. We find that it is sufficient on this basis alone to dispose of this ground without further dealing with the question of whether any of such rights may qualify as ‘know-how’.

Conclusion

33. As analysed above, the Appellant fails on both grounds of his appeal. We, therefore, dismiss this appeal and uphold the Determination. It remains for us to thank the representative of the Revenue for her useful written submissions.