Case No. D62/87

Profits tax – deductions – payment to extortionist to prevent disruption of business – whether payment capital or revenue – s 16 of the Inland Revenue Ordinance.

Profits tax – accounts of taxpayer – classification of payment as capital item – whether taxpayer could subsequently assert payment is for something else.

Panel: Andrew K N Li (chairman), James Chu Yuen Wo and Karl Kwok Chi Leung.

Date of hearing: 14 September 1987.
Date of decision: 8 February 1988.

The taxpayer company operated a sizing and dyeing factory on land in the New Territories which it owned. There was a dispute between the taxpayer and the previous owner of the land. In order to resolve this dispute, the previous owner and his family intimidated the taxpayer's employees, blocked access roads to the factory and smashed furniture in the taxpayer's office. An injunction against the previous owner had been obtained, but disruptions continued. There was also a threat that the taxpayer would lose a well from which the factory drew water.

The taxpayer and the previous owner settled their differences under an agreement whereby the taxpayer agreed to pay the previous owner $400,000 by way of an up-front payment of $100,000 and ten monthly instalments of $30,000 each. In return, the previous owner agreed to cease his disruptions. The purpose of the payment was to 'buy peace' so as to enable the taxpayer's business to continue smoothly.

In its accounts, the taxpayer showed the payment as being made for additions to factory structures.

The Commissioner disallowed the taxpayer's claim to a deduction for the $400,000 payment, and argued that the payment was capital. The parties agreed that $50,000 was attributable to construction costs of a podium, and the decision of the Board is concerned with the balance of $350,000.

Held:

The payment was on revenue account and therefore deductible.

In determining whether a payment is capital or revenue, the decision is to be made from a practical and business viewpoint rather than by looking merely at the juristic classification of the legal rights employed or exhausted in the process. Relevant criteria are:

(a) The nature of the payment. Here, the payments were a lump sum payable by instalments.

(b) The lasting nature of the benefit obtained. Here, the peace obtained was short-term since the taxpayer's Crown lease could be terminated after the first year on three month's notice. There was no enduring benefit: freedom from unlawful disturbances could not be said to be an 'advantage' for the enduring benefit of the taxpayer's trade.

(c) The recurrence of the benefit obtained. Here, the benefit obtained was recurrent in the sense that it enabled the taxpayer's operations in future to be carried on without disturbance.

The statement in the taxpayer's accounts as to the purpose of the payment was of no evidential effect as it was clearly incorrect.

Appeal allowed.

Cases referred to:

Anglo-Persian Oil Co Ltd v Dale (1911) 16 TC 253
British Insulated and Helsby Cables Ltd v Atherton [1926] AC 205
Pitt v Castle Hill Warehousing Co Ltd [1974] 1 WLR 1624
Tucker v Granada Motorway Services Ltd [1979] STC 393

Mrs Jennifer Chan for the Commissioner of Inland Revenue.
Mr Lam Wai Hay of W H Lam & Co for the taxpayer.

Decision:

This is an appeal by H Limited ('the Company') against its profits tax assessment for the year of assessment 1981/82 as determined by the Commissioner. That determination increased the assessment showing net assessable profits of $325,869 with tax payable thereon of $53,768 to $423,869 with tax payable thereon of $69,938.

The issue involved is in essence whether a sum of $350,000 paid by the Company to one Mr W was an expenditure of a capital nature within section 17(1)(c). If so

it could not be deducted. The Company maintains that it was revenue in nature and deductible.

The sum of $350,000 was part of the sum of $400,000 the Company paid to Mr W. No issue arises as to the balance of $50,000. It is common ground that it was capital in nature; it represents payment for the construction cost of a large podium and ranks for industrial building allowance.

Save for an agreed amendment to the formulation of the Company's claim, Mr Lam Wai Hay of Messrs W H Lam & Co, who represented the Company before us, agreed to the facts set out in the Commissioner's Determination. Mr K the secretary for the company, Mr S a director of the Company and the father of Mr K, and Mr Y a director of the Company gave evidence before the Board. Mrs Jennifer Chan appeared for the Revenue.

On the basis of the materials before us, we find the following facts.

The Facts

The Company carried on business as a 'Sizing and dyeing factory' on land in the New Territories. We shall refer to these premises as 'the Lot'.

In the mid 1970's the Lot was leased by the Hong Kong Government to Mr W.

Agreement dated 1 March 1976

By March 1976, Mr W had built a structure on the Lot for use as factory premises. This was done according to specifications of the Company which paid for its construction. By an Agreement dated 1 March 1976, Mr W let the structure to the Company for 6 years from that date to 31 March 1982 at a monthly rental of $1,800. The Agreement provided that upon its expiry the Company would return the construction to Mr W. It also provided that it would be invalidated if the Government should retrieve the land during its term and the Company would not be compensated for any losses incurred. Pursuant to the Agreement, the Company operated a factory for sizing and dyeing at the Lot. The Agreement referred to Mr W being willing to use a construction on the Lot as 'factory premises jointly operated by both parties', that is the Company and Mr W. But in fact, Mr W had no interest in the business operated by the Company. This may have been inserted to seek to get round the prohibition against sub-letting which was apparently in the Government's lease to Mr W. Mr W and his family resided at a concrete house on the Lot adjacent to the factory. He constructed it and paid the cost of construction. The structure for the factory and the concrete house almost covered the whole Lot. Subsequently in 1979, the Company constructed a podium over a small portion of the Lot.

The Company was controlled by the family of Mr S. He and Mr W have been friends for some years. Mr W is a resident of the village and is a developer of village houses in the area.

Government's direct lease to the Company

In about August 1979, the Government's District Office discovered that Mr W had sub-let the Lot. This was apparently against a prohibition of the Government's lease to Mr W. The Government forfeited Mr W's lease. The Company approached Government direct to obtain a direct lease. The formal agreement between the Government and the Company was executed in December. The term was one year from 1 January 1980 and thereafter quarterly until determined by either party by 3 months' notice. It provided that right of way was not guaranteed. (This was partly over private land and partly over Crown land. There was no practical problem over the right of way caused by the Crown or the owner of the private land.) Although the formal agreement was entered into in late December 1979, Government must have indicated its willingness sometime before. We have before us the bill rendered to the Company by its solicitors, Messrs Chow & Howell. This shows that discussion with the District Office had commenced in late August 1979 and the Government had made an offer before 1 November 1979.

The disturbance

Mr W got wind of the Company's approaches to the District Office with a view to obtaining a direct lease. He was very angry. He went to the District Office to try to stop any direct lease to the Company. But to no avail.

From that time, he and his children caused disturbances on a number of occasions. They made a nuisance of themselves. They came to the factory asking workers totalling about 20 not to work. Once or twice Mr W's nephews joined in. Every time they came, work was interrupted a few hours at a time. These disturbances lasted several weeks. The Company then obtained an ex parte injunction in October 1979 which was continued in November 1979 as can be seen from the bill of Messrs Chow & Howell. The recitals to the Agreement dated August 1980 referred to below stated that the injunction forbade Mr W and his employees and agents to demolish the factory premises and facilities and disturb its business operation and also ensured the personal safety of the Company's personnel.

The recitals to the Agreement further stated that the disturbances nevertheless continued. The recitals referred to the parties disputing over vehicle passage and blockage of access roads and ended up in police stations several times. The oral evidence of Messrs K and S before us referred to an incident when lorries were parked to block the access road. (We do not know whether this was before and after the grant of the injunction.) This was reported to the Police but no action was taken and this did not stop the disturbances.

The most serious incident was when Mr W's children came and smashed the desk at the factory's office with a folding chair. One of his sons was taken to the police station. This was probably the incident in June 1980 referred to in the recitals to the Agreement dated August 1980. After this incident there were no further disturbances except

one. Mr W caused an embankment of concrete stones to be built on the access road to the factory so that vehicles could not pass and the Company's employees had to demolish it.

The parties started discussions with a view to finding an amicable solution. They had the assistance of mediators. Mr W wanted some benefits and 'face'. The Company of course wanted peace so that there would be no further disturbances disrupting its operations.

The Agreement dated August 1980

These discussions resulted in the Agreement dated August 1980 between Mr W and the Company. It contained lengthy recitals referring to the history of the tenancies, the injunction and the disturbances. The recitals also mentioned that a Mr C under Mr W's influence had issued a demand to recover a well which we understand from the oral evidence of Messrs K and S had been let to the Company and was one of its sources of supply of water.

The recitals went on to state that with the benefit of the advice of the mediators the parties have agreed 'to settle the matter and prevent their relationship from deteriorating, so as to avoid further conflicts or law suits'. The recitals make clear that they had no intention of interfering with any action that may be taken by the Attorney General or the police in respect of the incident in June 1980. Whatever the 'verdict' for that incident, the recitals stated that 'the two parties are prepared to clear up the misunderstandings, have no further grievances and live in peace, mutual respect and courtesy in the years to come'.

The substantive parts of the Agreement provided as follows:

A. Mr W promised to ensure the following:

(1) Neither he nor his clansmen or employees shall interfere with the Company's operations. Mr W shall ensure that the Company has every right to utilize the tenancy from the Crown peacefully and without disturbance.

(2) They shall not block the access road.

(3) He shall surrender the key to the basement of the podium and allow the Company to use it without any disturbance.

(4) He shall use his personal influence to convince Mr C to sign the statement annexed to the agreement withdrawing his demand for the recovery of the well and to allow the Company to use the well with the Company paying an annual fee of $2,400 to Mr C.

(5) He agrees to be employed as the Company's honorary adviser. He will not carry out works to his domestic premises without the Company's consent. He

will assist in any works required of the Company by the District Office if they will not damage his residential premises.

B. If Mr W carries out the conditions in Part A, the Company will abide by the following:

(1) The Company will appoint Mr W to be its honourable adviser and provide him and his family with permanent accommodation at their residential premises on the Lot until Government recovers the same. The Company will not apply to Government for the demolition, reconstruction or re-building of such residential premises. If the Government recovers the Lot the Company shall not be responsible for compensating the loss suffered by Mr W. Any compensation granted by Government in respect of the residential premises shall be received by Mr W.

(2) The Company shall pay $400,000 to Mr W 'as consideration for Mr W's fulfilment of the 5 conditions set out in Part A including the history of W's house [sic] and the construction cost of the podium'.

(3) Payments will be made by instalments: As to $100,000 upon signature of the agreement and after Mr C has signed the annexed statement; as to the balance by 10 monthly instalments of $30,000 each starting from 2nd September 1980 for which post-dated cheques were given.

It is not clear what is meant by 'the history of W's House' in B(2) of the Agreement.

The Agreement provided for the appointment of Mr W as the Company's honorary adviser. But the witnesses before us made clear that this was in name only and was inserted for face reasons. The parties did not intend that Mr W would give any advice or do any work for the Company.

It is clear that the essence of the Agreement was this: Mr W was causing disturbances which disrupted the Company's operations. The Company wanted peace and was prepared to pay to 'buy peace' so that the disturbances would not recur and it could continue its operations smoothly.

The Revenue pointed out there was no evidence that the Company had paid the full cost of construction of the structure and that under the agreement dated 1 March 1976, upon its expiry, the Company had to return the structure on the Lot to Mr W. The Revenue submitted that Mr W and his family were claiming compensation for such structure. We reject this submission. The oral evidence of Messrs K and S was that the Company paid the cost of construction, that is the full costs. There is no evidence before us that Mr W was pressing a claim for compensation for the structure, relying on such a provision or otherwise. He was simply making disturbances to seek to get some benefits. Such a claim

would in any event be bad. Since his own title as landlord had been determined, he could no longer be entitled to the structure on the determination of his lease with the Company.

The Revenue also relied on the inclusion of the sum of $400,000 in the Company's audited accounts for the relevant years as additions to factory structures under fixed assets to support the contention that the sum was capital in nature. This was the basis of the Company's original claim for industrial building allowance. The Company had abandoned that position and now contends that the expenditure was revenue in nature. In our view, such inclusion of the $400,000 in the audited accounts is of little or no weight as the facts show that apart from $50,000, the sum of $350,000 was not in fact paid for additions to factory structures.

Capital or revenue?

There is no single infallible test. See Simon's Taxes Vol A (revised 3rd ed) paragraph A1.206. As Lord Wilberforce pointed out in Tucker v Granada Motorway Services Ltd [1979] STC 393 at 396

> 'It is common in cases which raise the question whether a payment is to be treated as a revenue or as a capital payment for indicia to point different ways. In the end the courts can do little better than form an opinion which way the balance lies. There are a number of tests which have been stated in reported cases which it is useful to apply, but we have been warned more than once not to seek automatically to apply to one case words or formulae which have been found useful in another (see Cmr of Taxes v Nchanga Consolidated Copper Mines Ltd [1964] AC 948). Nevertheless reported cases are the best tools that we have, even if they may sometimes be blunt instruments.'

In the present case, it is useful to consider the three elements referred to by Megarry J in Pitt v Castle Hill Warehousing Co Ltd [1974] 1 WLR 1624 at 1629. He said:

> 'It seems to me that these authorities establish that in determining whether expenditure is incurred on revenue account or on capital account one must consider at least three elements. First, what is the nature of the payment? Is there a single non-recurrent lump sum, paid once-for-all, on the one hand, or are there to be current payments, made, for example, for periods commensurate with those payments? Second, what is to be obtained by the payment? Is it some asset with lasting or enduring qualities, or is it merely ephemeral, or, indeed, something which cannot be described as an asset, whether tangible or intangible? Third, in what manner is what is obtained to be used, relied on or enjoyed? Will it have a quality of recurrence which will point to an income nature, as by providing a flow of orders for goods, or will it bear a static aspect which points to a capital nature? In considering all these elements, and in looking at the case as a whole, it is the practical and business point of view that counts for more than the juristic classification of the legal rights employed or

> exhausted in the process. As Lord Upjohn said in Strick v Regent Oil Co Ltd [1966] AC 295, 345: "It is a question of fact and degree and above all judicial common sense in all the circumstances of the case." In other judgments there are references to "common sense" simpliciter, but the adjective "judicial" may be useful as indicating that the kind of common sense needed is one that is not at large, but is guided and tutored by the authorities.'

Where the passage above refers to an asset, it should similarly apply to an advantage. See the authorities referred to below.

In the present case, the test formulated by Lord Cave in British Insulated and Helsby Cables Ltd v Atherton [1926] AC 205 at 213 is useful:

> 'Where 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 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.'

In Anglo-Persian Oil Co Ltd v Dale (Inspector of Taxes) (1911) 16 TC 253 Rowlatt J explained the phase 'enduring benefit' as meaning:

> 'What Lord Cave is quite clearly speaking of is a benefit which endures, in the way that fixed capital endures; not a benefit that endures in the sense that for a good number of years it relieves you of a revenue payment. It means a thing which endures in the way that fixed capital endures. It is not always an actual asset, but it endures in the way that getting rid of a lease or getting rid of onerous capital assets or something of that sort as we have had in the cases, endures.'

We turn to consider the three elements referred to by Megarry J in relation to the sum of $350,000 in question. First, there was payment of a lum sum although it was paid as to $300,000 by 10 monthly instalments. Secondly, what was obtained by the payment was peace from the disturbances caused by Mr W. In practical terms, the peace would last for as long as the Company operated at the Lot. Under its agreement with Government, the Company had a term of 1 year certain from 1 January 1980 and thereafter quarterly until determined by either party by 3 months' notice. We understand that to date the lease has not been determined. We doubt whether freedom from unlawful disturbances could be said to be an advantage which was brought into existence within Lord Cave's test. But even if it could, it could not be said to be an advantage for the enduring benefit for the trade in the way that fixed capital endures. The benefit only endures in the sense that it relieves the Company of revenue payments, for example, the employment of a team of watchmen and security guards. Thirdly, in what manner is what is obtained to be used, relied on or enjoyed? What was obtained was peace from recurrent disturbances to the Company's operations. The

Company would enjoy such peace in that its operations could be carried on without such disturbances. This has a quality of recurrence pointing to a revenue nature.

Having regard to the above, we are of the view that the expenditure of the sum of $350,000 in question was expenditure of a revenue nature. It did not bring into existence an advantage for the enduring benefit of a trade within Lord Cave's test as explained by Roweatt J and was not expenditure of a capital nature.

Accordingly, we allow the appeal and remit the case to the Commissioner with our opinion.

If we had concluded that the expenditure was capital in nature, Mr Lam's alternative submission would arise namely that the expenditure is within section 35(1). Our view is that it plainly is not. It is not capital expenditure incurred in the construction of a building or structure and in any event none of the events specified in section 35(1) had occurred.