# Case No. D64/98

**Profits tax** – compensation for early termination of distributorship agreement – whether liable to profits tax– section 68(4) of the Inland Revenue Ordinance.

Panel: Christopher Chan Cheuk (chairman), Berry Hsu Fong Chung and Michael Seto Chak Wah.

Dates of hearing: 9 April and 7 May 1998.
Date of decision: 22 July 1998.

The taxpayer entered into an exclusive distributorship agreement with a supplier of goods in 1984. The agreement was periodically renewed. In 1995 the supplier requested for early termination of the agreement. The taxpayer was compensated by a sum of US$1,550,000. The assessor raised additional profits tax assessment on the sum and the taxpayer objected to it.

Held:

(1) Section 68(4) of the IRO puts on the taxpayer the onus of proving that the compensation represents the price paid for the loss or sterilisation of a capital asset and is therefore a capital and not a revenue.

(2) The termination of the distributorship agreement was a loss of the taxpayer's capital asset and a destruction of its profit-making structure of enduring nature.

**Appeal allowed.**

Cases referred to:

London and Thames Haven Oil Wharves Limited v Attwoll (1966) 54 TC 491
CIR v Fleming & Co (Machinery) Ltd (1951) 53 TC 57
Glenboig Union Fireclay Co Ltd v CIR (1992) 12 TC 427

K A Lancaster for the Commissioner of Inland Revenue.
Hui Wing Kuen of Messrs Wing K Hui Consultants Limited for the taxpayer.

**Decision:**

**Appeal**

1. This is an appeal by the Company A ('the Taxpayer') against the determination made by Mr WONG Ho-sang, the Commissioner of Inland Revenue on 24 October 1997 in respect of the additional profits tax assessment for the year of assessment 1995/96 arising from a lump sum payment for early termination of an exclusive distributorship agreement.

**Proceeding**

2. The Taxpayer was represented by Mr HUI Wing-kuen of Wing K Hui Consultants Limited. Apart from the Appeal Bundle, Mr HUI also produced a summary of the trading accounts and also a summary of the profit and loss accounts of the Taxpayer which are collectively marked as Exhibit 'A1'. Mr LANCASTER produced the Taxpayer's report of directors and accounts for the year ended 31 December 1996 which is marked as Exhibit 'R1'.

**Issue**

3. The issue before us is whether the lump sum payment that the Taxpayer received is a capital receipt or a trading receipt.

**Facts of the Case**

4. The Taxpayer was incorporated in Hong Kong on 11 December 1979. The major shareholder and the managing director of the Taxpayer was Mr B who before the incorporation used to work in the trading department of one of the biggest hongs in Hong Kong. After many years of service he left the hong and established his own business, that is, the Taxpayer company which at the beginning carried on whatever type of trade that was available.

5. In about 1984 through the introduction of his mother-in-law he came to know Mr C, the president of Company D and entered into an agreement with Company D for exclusive distributorship of the latter's products in Hong Kong ('the 1984 Agreement'). As they did not know each other the Agreement was for a trial period of one year from 1 November 1984. We must add that at that time Company D was hardly an international enterprise and was little known outside Country E.

6. After the trial period Company D and the Taxpayer continued with the exclusive distributorship arrangement without entering into any further formal written agreement until 1987 when a formal agreement was drawn up to appoint the Taxpayer as the exclusive distributor of Company D's products in Hong Kong and Macao for a period of three years with retrospective effect from 1 November 1986 ('the 1986 Agreement'). The reason for entering into such formal contract was that there had been rumours that the whole

corporation of Company D would be sold and taken over by another company. A provision was built in for compensation that could be found in Clause 7.2 of the 1986 Agreement.

7. By a letter dated 14 September 1989 Company D extended the Agreement for another three years up to 31 October 1992 and by another letter dated 13 August 1992 the Agreement was further extended to 31 October 1995.

8. In around August 1994 Company D, the whole of the corporation was acquired and taken over by Company F, a worldwide company incorporated in Country E with its own international network for distribution including Hong Kong. By a letter dated 13 March 1995 Company D which was then under the control of Company F extended the 1986 Agreement for another three years as from 1 January 1995 with some modification and additional terms to be observed by the Taxpayer.

9. About seven months later, in October Company F on behalf of Company D requested for early termination. A settlement was readily reached between the parties. The Taxpayer was compensated by a sum of US$1,550,000 which was paid by two instalments on 15 December 1995 and 5 April 1996 respectively. For tax purpose the said sum was converted into Hong Kong currency as $11,981,500. The assessor raised additional profits tax assessment on this sum. The Taxpayer objected to it and the Commissioner determined and upheld the assessment which forms the subject matter of the present proceedings.

**Law**

10. The point we have to consider is whether the payment of US$1,550,000 (equivalent to HK$11,981,500) received by the Taxpayer is a revenue receipt or a compensation for loss of capital asset. Mr Lancaster had quoted to us sixteen leading cases and Mr Hui for the Taxpayer also made reference to them. We do not intend to cite all of them but to give a brief review on some of the issues that have been found to be helpful.

11. In London and Thames Haven Oil Wharves Limited v Attwoll (1966) 43 TC 491 at 515 Diplock LJ had this to say:

> *'I start by formulating what I believe to be the relevant rule. Where pursuant to a legal right, a trader receives from another person compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits (if any) arising in any year from the trade carried on by him at the time when the compensation is so received, the compensation is to be treated for income tax purposes in the same way as that sum of money would have been treated if it had been received instead of the compensation.'*

12. In other words, we have to see for what purpose the money is received; if it is for the loss of profits per se, it will be revenue income but it will be otherwise if it is paid for the loss of a profit-making structure as described by the Lord President (Cooper) in CIR v Fleming & Co (Machinery) Ltd (1951) 53 TC 57 at 61:

> *'The problem thus belongs to a type exemplified by a number of recent cases in which broadly speaking, the line has been drawn in the light of varying circumstances between, (a) the cancellation of a contract which affects the profit-making structure of the recipient of compensation and involves the loss by him of an enduring trading asset; and (b) the cancellation of a contract which does not affect the recipient's trading structure nor deprive him of any enduring trading asset, but leaves him free to devote his energies and organisation released by the cancellation of the contract to replacing the contract which has been lost.'*

Simply, it means that the sum is a capital receipt if it is a compensation of the loss of an ***'enduring trading asset'***.

13. The Lord President (Clyde) in Glenboig Union Fireclay Co Ltd v CIR (1922) 12 TC 427 at 448 asks the following question as a test?

> *'Can that compensation be said to be part of the* ***"profits arising from the trade or business"*** *of the Company, or of the* ***"annual profits or gains arising or accruing"*** *to the Company from its trade?'*

14. Section 68(4) of the Inland Revenue Ordinance puts the burden of proof on the Taxpayer. Therefore it is necessary for the Taxpayer to show us at least what Lord Russell said in CIR v Fleming & Co (Machinery) Ltd (1951) 53 TC 57 at 63: '*When the rights and advantages surrendered on cancellation are such as to destroy or materially to cripple the whole structure of the recipient's profit-making apparatus, involving the serious dislocation of the normal commercial organisation and resulting perhaps in the cutting down of the staff previously required, the recipient of the compensation may properly affirm that the compensation represents the price paid for the loss or sterilisation of a capital asset and is therefore a capital and not a revenue.'*

## Revenue's Submission

15. We intend to consider the Revenue's submission first but this does not mean that we put the burden of proof on the Commissioner. On the contrary, we want to test the strength of the Taxpayer's case and to examine whether the Taxpayer can overcome the criticisms raised.

16. Mr Lancaster for the Revenue invited us to examine a detail analysis of the different agreements, to which we are grateful. His submissions can be briefly summarised as follows:

(i) Each of the Agreements is for a short period of two to three years without an express right for renewal.

(ii) Company D owned the trademark and maintained it. The mark did not belong to the Taxpayer. Whatever money was spent by the Taxpayer it was not used to build up the goodwill of the Taxpayer but for promotion of the products of Company D which are nothing but trading assets.

(iii) The Taxpayer was not responsible for all the defective products; the Taxpayer was no more than any other trader and had no interest in the intrinsic value of the trade name.

(iv) Company D was responsible for defending all actions arising from defective products; in other words the Taxpayer did not have any permanent interest in the products.

(v) The Taxpayer had to purchase a minimum amount of goods and to maintain staff to carry out the terms of the Agreements. The Taxpayer handled products of Company D like any other goods it sold in its normal course of business.

(v) The Taxpayer had to do promotion for the goods, not for the Taxpayer's company and had to spend a sum equivalent to certain percentage of the sales on advertising the products of Company D.

(vii) Upon termination of the Agreement the Taxpayer could not impose any restriction upon Company D to import its products into Hong Kong.

(viii) Company D had the right to terminate the Agreement subject to payment of 50% of the previous sales as compensation. This amount was equivalent to approximately one year's gross profits. In return the Taxpayer did not surrender any capital asset to Company D.

(ix) The damage caused to the Taxpayer was not a 'structural' destruction as we have seen in the cited cases and there is no loss of capital asset. The only evidence before us was that the Taxpayer closed down one of its divisions, reduced the number of its staff and suffered some loss. The Taxpayer still carried on its business despite the loss of the distributorship.

**Evidence & Analysis**

17. The Taxpayer called one witness, that is, Mr B, the managing director and the founder of the Taxpayer. We have had the advantage of hearing his evidence and seeing his demeanour. We find that he is a truthful and honest witness. He is very intelligent and is very conversant with his business. He is a typical traditional Hong Kong entrepreneur who believes more in moral obligation than the piece of paper that contains the legal terms. His company has grown together with Company D. The type of relationship between the two companies has gone far beyond the four corners of the paper, upon which the contracts was written. If we had not had the benefit of Mr B's testimony, we would have made the decision otherwise.

18. We agree with the observations made by Mr Lancaster as set out in paragraph 16 above; we use his observations to test the strength of the Taxpayer's case. The witness informed us that the relationship with Company D commenced in 1984 and went on for 11 years until it was terminated on 31 December 1995. During this period there was only one formal agreement, that is, the Distributorship Agreement with effective date from 1 November 1986 which was made for the reason as set out in paragraph 6 above. Other than that we have no other formal agreements and all extensions were very casually made, with or without reference to the 1986 Agreement, usually by way of one-page letter except the last one issued by Company D under the control of Company F. All these reflect the trust and confidence that the two companies had between them until taken over by Company F. This type of trust and confidence was not built up in a day. It took years of hard work and effort coupled with the success in promoting the products Exhibit 'A1' shows that the net sales for the whole company in 1985 was only $7,081,888 while in 1995 the turnover of Company D products alone in 1995 came up to the value of $27,324,776.

19. It is not denied that the termination of the distributorship had caused great hardship upon the Taxpayer company. We were told and we have no reason to doubt that originally the Taxpayer had three divisions in its company: the one that handled the distributorship of Company D was the most profitable one, the other division was the one that handled the distribution of products of Company G and accounted for about 15% of the total turnover of the Taxpayer and the last one was the perfume and miscellaneous products section. In the last three years before termination Company D's division accounted for 50% to 60% of the total turnover and 87% to 135% of the operating profits. The damage was disastrous.

20. The adverse effect on the Taxpayer was not unexpected; Mr B told us that upon receipt of the compensation he had considered the possible option of retiring. But as a responsible employer he struggled on. In 1996, as we understand from Exhibit 'A1', the Taxpayer tried to shift its emphasis to the sale of perfume and other products but without much success. The sales handled by that division was increased to $45,876,336 from $18,178,883 in the previous year but it suffered an operating loss of $5,435,900.

21. Mr B told us that apart from financial loss, the staff in the original Company D division, all but one left the Taxpayer. The staff found that the other divisions in the Company were not suitable for them. Company G manufactured skin care products, the sale of which required personal attendance to beauty shops and salons. The sales-persons had to acquire special knowledge on the nature of the products and their application. Such knowledge and information had to be conveyed to the potential users. It was a special kind of sales, different from the toiletry products of Company D which were sold to large departmental stores, supermarket and chain-stores which ordered in large scale. Neither were those staff suitable for sale of perfume or similar products, the sale of which would be on indented basis.

22. Clause 7 gave Company D the right to terminate the contract under different situations. Clause 7.1 states:

> *'The term of this Agreement is for three years, beginning November 1 1986. Supplier (that is, Company D) shall have the right to cancel this Agreement after the end of the contract year during the term of this Agreement or any renewal term by giving thirty (30) days advance written notice subsequent to the end of the said period unless Distributor (that is, the Taxpayer) has made and paid for the minimum purchases of products from Supplier within each contract year as set forth on Schedule C hereto.'*

A careful reading of this clause will make one realise that it was not written in the from of usual default clause. The emphasis was placed on the minimum amount of purchase. At any time Company D had the right to terminate the contract notwithstanding it was expressly stated for the term of three years if the minimum amount was not met. This clause can also be taken to have a positive meaning that as long as the Taxpayer purchased and paid for the minimum amount of goods there would not be any problem of termination. We had evidence from Mr B that the Taxpayer had no difficulty in meeting the minimum purchases. In any of the Agreement or its renewals no mention was made how the Agreement would be renewed. From the tenor of this clause together with the good relationship that had been built up between the two companies it was reasonable and legitimate for the Taxpayer to expect that it would be renewed almost automatically.

23. Question was raised why the term was for such a short period of three years. Mr B's reply was that it was due to the law in Country E. We have to accept this answer to the extent that the Taxpayer thought that it was the law and for that reason the parties did not have a longer term than three years. As I have stated earlier the express term was not as important as the confidence and mutual trust that the parties had in a profitable and successful business venture.

24. It was generally thought, and no issue was taken, that the compensation was paid under the first part of Clause 7.2 which is set out as follows:

> *'Notwithstanding anything elsewhere herein contained, at any time after the expiration of the first contract year during the term or any extended term of this Agreement upon at least six (6) months advance written notice by Supplier (that is, Company D) to Distributor (that is, the Taxpayer), Supplier may cancel and terminate this Agreement for any reason upon payment by Supplier to Distributor of an amount, in cash, equal to fifty percent (50%) of net sales of products in the territory during the immediately preceding contract year;...'*

The requirements for terminating the contract under this part of the clause are (a) that it must be after the expiration of the first contract year (and for the purpose of the extension by Company D under the control of Company F the first contract year was specifically defined in the letter dated 13 March 1995 as 1 January 1995 to 31 December 1995) and (b) that six months' prior notice in writing had to be given by Company D. The fact was that at the beginning of October 1995 during the first contract year Company D informed the Taxpayer that the former wished to terminate the Agreement and within that month the Termination

Agreement was signed. This shows that Mr B was an easy compromising and straightforward person. He did not rely on the legal terms and insisted on having six months' notice. He readily entered into negotiation and made arrangement for the smooth handover. He received a compensation of US$1,550,000 (equivalent to $11,981,500).

25. Strictly speaking the compensation was not paid pursuant to Clause 7.2 of the 1986 Agreement as Company D had not complied with the terms contained therein. It is difficult to deny that it was made with some reference to 50% of the net sale in the previous year. Mr Lancaster's observation was that the sum came up to and represented about a year's profits. According to the figures his observation could not be regarded as totally unfounded. However, if that had been what they wanted they would have written it in the contract. We do not think that some twelve years ago the Taxpayer would have thought of the problem that if they made reference to a year's profits this would not qualify the sum as capital receipt. The difference between profits and turnover is obvious: the former depends very much upon the costs. For the recipient it is more certain and advantageous to make reference to turnover. In any event the parties had to make reference to certain formula for calculation of compensation; in the present case we find it as a mere coincidence that the amount paid was roughly equal to a year's profits.

26. After considering the strength of the Taxpayer's case we find that the nine points raised by Mr Lancaster in his submission were satisfactorily answered. We are satisfied that the compensation was not profits arising from the trade. Nor did it form the annual profits or gains arising or accruing to the Taxpayer from its business. We also find that the termination of the Distributorship Agreement was a loss of the Taxpayer's capital asset and a destruction of its profit-making structure of enduring nature.

**Decision**

27. For the reasons stated above we allow the appeal and order that the additional profits tax assessment for the year of assessment 1995/96 dated 5 December 1996 be cancelled.