

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D89/96

Profits tax – allowable deductions – ‘Agency Right Fee’ – whether taxpayer entitled to deduct the sum of agency right fee in ascertaining profits – sections 16(1a) and 17(1) of the Inland Revenue Ordinance.

Panel: Ronny Wong Fook Hum QC (chairman), Felix Chow Fu Kee and Benny Wong Man Ying.

Date of hearing: 25 September 1996.

Date of decision: 13 January 1997.

The taxpayer is a private limited company engaged in trading of travelling bags, brief cases and chemicals. The taxpayer sought to deduct from its assessable profits a sum of DM700,000 as ‘Agency Right Fee’ in the profits tax returns for the years of assessment 1992/93 and 1993/94. The sum was paid to Company C in accordance with the terms of a purchase agreement between the taxpayer and Company C.

Held:

1. A proper solution is to approach the matter broadly and applying common sense in ascertaining the purpose of payment in question. Wharf Properties Ltd v CIR followed.
2. The principal purpose of the payment of DM700,000 was for ‘transfer of information’ and gaining access to connections with suppliers cultivated by Company C. Spreading payment of the price does not detract the purpose of such payment. Therefore, the payment in question was capital in nature and the deduction was rightly disallowed.

Appeal dismissed.

Cases referred to:

Pitt v Castle Hill Warehousing Co Ltd [1974] 49 TC 638
British Insulated and Helsby Cables Ltd v Atherton [1926] AC 205
Wharf Properties Ltd v CIR [1996] HKRC 90-076
Wharf Properties Ltd v CIR [1994] 1 HKRC 100,652

J Smith for the Commissioner of Inland Revenue.

Choi Kin Sang of Messrs Au Choi Yuen & Co for the taxpayer.

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Decision:

The Background

1. Company A is a company incorporated in a European country, Country B. It is the major shareholder of:

- a. Company C and
- b. The Taxpayer

2. At the material times, Mr D, Mr E, Mr F and Mr G were the directors of Company C. Mr F and Mr G were also directors of the Taxpayer.

3. The Taxpayer is a private limited company incorporated in Hong Kong on 12 May 1989. According to the report of its directors for the year ended 31 December 1992, the Taxpayer was engaged in the trading of travelling bags, brief cases and chemicals.

4. By an Agency Contract dated 30 August 1989, Company C appointed Company H as its purchase agent for all goods to be imported by Company C or its affiliated companies. Under Clause 6 of the Agency Contract, Company H was allowed to include a commission of 2-6% of the net value of the goods in the purchase price. The Agency Contract was valid as from 1 September 1989. It may first be cancelled on 31 August 1994 by 12 months' notice.

5. By an agreement dated 21 February 1991 ('the Cancellation Agreement'), Company C and Company H agreed to cancel the Agency Contract on the following terms:

- a. The Agency Contract be cancelled after 1 January 1992.
- b. Company C was to pay commission only for the orders placed before 19 January 1991.
- c. Company C was to pay Company H an indemnity of DM700,000 as follows:

Amount in DM	Date
50,000 plus 14% Value Added Tax on 700,000	5-1-1992
100,000	5-2-1992
100,000	5-3-1992

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150,000	30-6-1992
50,000	5-1-1993
50,000	5-2-1993
50,000	5-3-1993
150,000	30-6-1993

6. On 15 September 1992, Company C entered into an agreement ('the Purchase Agreement') with the Taxpayer.

- a. The Purchase Agreement referred to Company C's cancellation of the Agency Contract and its development of relationships with entrepreneurs in the Far East.
- b. Company C was to transfer to the Taxpayer 'all documents on possible places to buy and information concerning suppliers and purchase conditions.'
- c. Company C was to support the Taxpayer in transferring the existing business relationships.
- d. 'As a price', the Taxpayer was to pay DM700,000 ['the Agency Right Fee'] to Company C as follows:

Amount in DM	Date
70,000	30-4-1993
70,000	15-6-1993
70,000	15-10-1993
70,000	15-1-1994
70,000	15-4-1994
70,000	15-7-1994
70,000	15-10-1994
70,000	15-1-1995
70,000	15-4-1995

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70,000

15-7-1995

- e. The Taxpayer was given the right to carry out all purchases of products of the luggage market having the East Asian continent as their area of origin. As from 1 January 1993, such business was transacted against payment of standard commission of 3% to be added on to the price.
7. Various agreements dated between February to May 1993 were entered into between Company C; divers companies in Hong Kong/Country I and the Taxpayer whereby Company C transferred to the Taxpayer their exclusive right for 'our ranges Product I, Product J and article names which still have to be determined'. The Hong Kong/Country I companies were directed to include a commission of 3% on all their prices to be paid to the Taxpayer. Credit notes were thereafter issued by those Hong Kong/Country I companies in favour of the Taxpayer for sums described as '3% Sales Discount'.
8. On 20 July 1993, the Taxpayer submitted its profits tax return for the year of assessment 1992/93 together with its financial statements for the period ended 31 December 1992.
- a. In its supporting schedules, the Taxpayer gave the following information regarding the Agency Right Fee:

'The company has entered into an agreement with Company C of which the directors of the company are also the shareholders, to take over the agreement between Company C and Company H such that the company with effect from 1 January 1993 onward, will be entitled to a commission of 3% from the vendors of Company C in the Far East as accrued to Company H between Company C per the original contract. The expected commission income arisen (sic) from the agreement will be in the range of \$800,000 to \$1,000,000 per annum.'
 - b. In its profit and loss account for the period from 1 October 1991 to 31 December 1992, the Taxpayer included as 'Operating Expenses' an amount of \$672,000 which it described as 'Amortization on Agency Right Fee'.
 - c. In its balance sheet as at 31 December 1992, the Taxpayer capitalised as an asset a sum of \$2,688,000 (\$3,360,000 - \$672,000) which it described as 'Agency Right Fee'. The sum of \$3,360,000 is the equivalent of DM700,000 referred to in paragraph 6d above.
9. The Taxpayer declared as assessable profit of \$1,303,639 in its profits tax return for the year of assessment 1992/93. In arriving at its profit, the Taxpayer deducted as an expense the sum of \$672,000 referred to in paragraph 8b above.
10. On 30 July 1994, the Taxpayer submitted a profits tax return for the year of assessment 1993/94 together with its financial statements for the year ended 31 December 1993.

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11. In its financial statements for the year ended 31 December 1993, the Taxpayer:
- a. recorded a commission income of \$700,621;
 - b. deducted as an expense a sum of \$672,000 which it described as ‘Amortisation on Agency Right Fee’;
 - c. recorded as an asset in the balance sheet a sum of \$2,016,000 (\$3,360,000 - \$672,000 x 2) being the balance of the agency right fee not yet amortized; and
 - d. recorded in the cash flow statement that it had paid a sum of \$3,360,000 to acquire an intangible fixed asset.
12. In its tax computation for the year of assessment 1993/94, the Taxpayer computed an assessable profit of \$3,183,105. In arriving at the profit, the Taxpayer added back the ‘Amortization on Agency Right Fee’ of \$672,000. Against the profit of \$3,183,105, it claimed to set off a loss of \$1,384,361 brought forward from the previous year of assessment. The loss of \$1,384,361 represents the loss computed by the Taxpayer for the year of assessment 1992/93 after deducting as an expense the Fee of \$3,360,000. Accordingly, the Taxpayer claimed that its net assessable profits for the year of assessment 1993/94 was a sum of \$1,798,744.
13. The issue before us is whether the Taxpayer is entitled to deduct the Agency Right Fee in ascertaining its profits for the years of assessment 1992/93 and 1993/94.

The charging provisions

14. Section 16(1)(a) of the Inland Revenue Ordinance provides:
- ‘In ascertaining the profits in respect of which a person is chargeable to tax under this Part 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 [various matters set out]’.*
15. Section 17(1) provides:
- ‘For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of –*
- a. *domestic or private expenses...*
 - b. *any disbursements or expenses not being money expended for the purpose of producing such profits;*

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- c. *any expenditure of a capital nature or any loss or withdrawal of capital;...*'

Evidence of the Taxpayer

16. Mr G gave evidence on behalf of the Taxpayer.
17. Mr G told us that the payment of DM700,000 was made to cover:
- a. Transfer of information from Company C to the Taxpayer;
 - b. Costs incurred in training staff of the Taxpayer;
 - c. Costs incurred in visiting suppliers of raw materials and
 - d. Travel costs of various members of staff of Company C to Hong Kong.

Arguments of the Taxpayer

18. Reliance is placed on the views expressed by Megarry J in Pitt v Castle Hill Warehousing Co Ltd [1974] 49 TC 638 at 644

'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 payment? Is there a single non-recurrent lump sum, paid once and for all, on the one hand, or are there to be recurrent payments made, for example, for periods commensurate with these 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.'

19. The Taxpayer submits in relation to the nature of payment that the Purchase Agreement provided for quarterly payments from 1993 to 1995. The Taxpayer says that what was obtained was the right to act as the purchasing agent for Company C and such right provided the Taxpayer with the 'opportunity to generate a flow of orders for Company C which will generate commission income, that is, a flow of income'.

Submissions of the Revenue

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20. The Revenue relies on the test formulated by Lord Cave in British Insulated and Helsby Cables Ltd v Atherton [1926] AC 205 at 213

‘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 expenditure as properly attributable not to revenue but to capital’

21. The Revenue submits that the Taxpayer acquired valuable rights under the Purchase Agreement. It was the use of those rights that generated income – not the sale of them. The Revenue says that the mode of payment is not relevant as buildings and other assets purchased as fixed assets can be paid for by instalment payments.

The Authorities

22. In Wharf Properties Ltd v CIR [1996] HKRC 90-076, the Court of Appeal considered the deductibility of interest paid to banks and financial institutions in respect of moneys borrowed for the purpose of acquiring a depot for redevelopment for rental purpose. The Court of Appeal is of the view that on a proper construction of section 17(1), the Court should have regard the purpose of the loan in determining deductibility. Thus Litton VP said at 90-076:

‘It is, in my judgment, wholly artificial to enquire into the “nature” of an interest payment without looking into its purpose. To say: the purpose is to obtain (or retain) the loan is not enough. This is to give section 17(1)(c) too restrictive and artificial a meaning. It is necessary to go further and enquire into the purpose of the loan’.

23. In the first instance judgment of Chan J in Wharf Properties Ltd v CIR [1994] 1 HKRC 100,652. At page 100,675 the Learned Judge, after referring to the various tests as set out in the authorities, said this:

‘... when applying these tests, the Court has to consider all the circumstances of the case including the purpose of the expenditure, the circumstances under which it is incurred and the purpose and nature of the loans. The various tests and/or factors for considerations are to be put into the scales in order to arrive at a conclusion using a common sense appreciation of all the guiding features in this case. It would not be proper to restrict consideration to any particular matter.’

Our Decision

24. We respectfully follow the approach as enjoined by the judgments at first instance and in the Court of Appeal in Wharf Properties Ltd v CIR. No single test is

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decisive. What is required is to approach the matter broadly and applying common sense in ascertaining the purpose of the payment in question.

25. Company C terminated the Agency Contract with Company H. As recited in the Purchase Agreement, it then proceeded to develop relationships with entrepreneurs in the Far East. The evidence adduced before us on behalf of the Taxpayer pointed out clearly that the sum in question was to pay for 'transfer of information'. Such information can only be related to the suppliers cultivated by Company C. The principal purpose of the payment was to gain access to those connections. DM700,000 was 'the price' for such connections. Spreading payment of such price between 1993 to 1995 does not detract the purpose of such payment. For these reasons we are of the view that the payment in question is capital in nature and the Revenue has rightly disallowed deduction of the same.