INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D95/89

Profits tax – forfeiture of deposit – whether capable of being deducted against assessable profits.

Panel: Robert Wei QC (chairman), Stanley G Elliott and Albert Ho Chun Yan.

Date of hearing: 20 June 1989.
Date of decision: 22 January 1990.

The taxpayer successfully tendered to the Hong Kong Government for a tenancy of crown land. When making the tender, the taxpayer made a payment of six months' rent which was forfeited by the Government when the taxpayer chose not to enter into a tenancy agreement with the Government. The taxpayer sought to deduct the forfeited payment against its assessable profits. The Commissioner in his determination stated that the underlying cause of the expenditure was the taxpayer's breach of contract and not the production of profits and that the taxpayer's interest in the tender and resultant lease was a capital asset and that any amount forfeited was capital in nature.

Held:

The intention of the taxpayer when it submitted its tender was to obtain a capital asset. It decided not to proceed with the project because it was too onerous. The obligation of the taxpayer was in the nature of a capital obligation and accordingly the expense was a capital expense.

Appeal dismissed.

[Editor's note: The taxpayer filed an appeal against this decision but subsequently withdrew the appeal.]

Cases referred to:

Atherton v British Insulated and Helsby Cables Limited [1926] 10 TC 155
Mallett v The Staveley Coal and Iron Company Limited [1928] 13 TC 772

Lee Kang Bor for the Commissioner of Inland Revenue.
Taxpayer represented by its partner.

Decision:

1. This appeal concerns the profits tax assessment raised on the Taxpayer for the year of assessment 1985/86. The Taxpayer claims that it should be allowed a deduction for the sum of $432,000 equivalent to six months' rent tendered for the tenancy of a lot of crown land, which sum it forfeited when, as the successful tenderer, it chose not to enter into a tenancy agreement with the Government.

2. No witness was called at the hearing of the appeal. Documentary evidence consists principally of the statement of facts contained in the determination of the Commissioner of Inland Revenue and of the documents attached thereto. Further documents such as representations of the Taxpayer and correspondence between the parties had also been filed for the purposes of the appeal.

Facts

3. The Director of Lands by a tender notice invited tenders for a tenancy of a lot of crown land subject to the terms and conditions specified in the tenancy agreement.

4. The tender notice contains, inter alia, the following terms:

> '5. Tender will only be accepted from persons or corporations who will occupy the premises for their own use, and no assignment, underletting or parting with the possession of the premises or any part thereof or any interest therein will be permitted.
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> 6. Tenderers must forward with their tender a cheque or a cashier order for an amount equivalent to six months' rent tendered made payable to the Government … All cheques and cashier orders will be retained uncashed until a decision has been made on the tenders submitted. If a tender is accepted, the cheque or cashier order submitted therewith will be treated as the deposit referred to in special condition no 2 of the third schedule of the tenancy agreement annexed hereto …
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> …
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> 9. If a tender is accepted, the successful tenderer shall be the tenant, and he will be notified of the acceptance of his tender by a letter posted to him at or delivered to the address stated in his form of tender and he shall within seven days of being called upon by the Director of Lands so to sign or execute the tenancy agreement in the form annexed hereto and the plan annexed to the tenancy agreement and shall pay the first year's rent due under the tenancy agreement … If the tenant shall fail to sign or execute the tenancy agreement and plan within the time limit as aforesaid, the Government may either enforce

or cancel the tender. On cancellation the sum forwarded with the tenant's tender as a deposit shall, without prejudice to the Government's right of action for damages for breach of contract, be wholly forfeited to the Government and the Government shall be at liberty to grant a tenancy of the premises or invite tenders or otherwise deal with the premises at such time and in such manner as the Government shall deem it.

10. … possession of the premises will be given to the successful tenderer within three calendar months of the date on which the tenancy agreement is signed executed …

11. The successful tenderer shall accept the premises in such state and condition as existing on the date on which possession of the premises is given.'

5. The Taxpayer commenced business in Hong Kong in 1978 and at all material times declared its business as building maintenance contractors. From 1983 it had also been in receipt of rental from a carpark. In August 1985 the Taxpayer submitted its tender for a tenancy of the said lot of crown land on terms contained in a form of tender and including the following:

'… I/We … hereby offer to rent the lot of crown land … at an annual rent of … $864,000 for a term of three years certain and thereafter quarterly at a revised rent and subject to the terms and conditions as are set out in the said tender notice and the said tenancy agreement.

2. If this tender is accepted, then until the said tenancy agreement is signed or executed, this tender together with the written acceptance thereof shall constitute a binding agreement between me/us and the crown.

3. A cheque for $432,000 certified good until [date mentioned] is forwarded herewith as a deposit if my/our tender is accepted.

4. I understand that the use of the site is restricted to the purposes as set out in the first schedule of the said tenancy agreement.'

6. The term of the tenancy was to be subject to clause 4(f) which gives the landlord the power to terminate the tenancy agreement and resume and re-enter if the premises are required for the improvement of Hong Kong or for any other public purpose on giving to the tenant one month's notice and subject to the payment of compensation to the tenant for disturbance in certain circumstances, and also subject to special condition no 1 which allows either party to terminate the tenancy by giving at least three months' notice to expire at the end of the third year or at any time afterwards.

7. Clause 4(a) of the tenancy agreement gives the landlord the usual power to re-enter for default in payment of rent for twenty-one days or for breach of the terms and

conditions, etc, without prejudice to any right of action in respect of any antecedent breach of the terms and conditions.

8. Special condition no 2, which relates to the deposit, provides:

> ‘2. The tenant shall on the signing of this agreement deposit with the landlord the sum of dollars ... Hong Kong currency by way of deposit as security for the due payment of the rent and the rates, taxes, assessments, duties and outgoings as aforesaid and the due performance and observance by the tenant of all and singular the several agreements, conditions, terms and stipulations herein reserved and contained. The said deposit shall remain deposited with the landlord throughout the term of the tenancy and shall upon the tenant delivering up vacant possession of the premise to the landlord in accordance with the provisions herein contained and upon the tenant duly observing and performing the tenant’s obligations hereunder be refunded to the tenant but without interest. In case of default on the part of the tenant in payment of the rent and the rates, taxes, assessments, duties and outgoings hereinbefore stipulated or in performance or observance of any of the agreements, provisions, terms and conditions on the tenant’s part herein contained the landlord shall without prejudice to his other rights and remedies herein contained be entitled to retain and deduct from the said deposit as and for liquidated damages the amount of loss and damage sustained by reason of such default PROVIDED that nothing herein contained shall be so construed as preventing the landlord from recovering from the tenant damages in respect of such default over and above the said deposit PROVIDED FURTHER that the payment of the said deposit shall not be deemed or considered as a payment of rent in advance and accordingly in any action for recovery of possession for non-payment of rent or the rates, assessments, duties or outgoings aforesaid the tenant shall be deemed to be in default if the rent is not paid in accordance with the said first schedule.’

9. The first schedule to the tenancy agreement provides, inter alia, for rent and the purpose for which the premises may be used as follows:

> ‘

Rent	$ ... per annum ... The first year’s rent shall be paid in one lump sum on the execution hereof. Subject to continuation of the tenancy, the rent thereafter shall be paid quarterly in advance on the first day of each succeeding quarter ...
Purpose for which the premises may be used	Fee-paying public car park for the parking of private motor vehicles which are currently licensed for use on public streets and roads ...’

10. The Taxpayer's tender was accepted by the Government. By a letter from a district land officer to the Taxpayer, the latter was informed of the acceptance and of the retention of the sum of $432,000 as a deposit for the tenancy and was called upon to execute the tenancy agreement and pay the first year's rent within seven days from the date of the letter. The Taxpayer was further informed that subject to the payment of the year's rent and due execution of the tenancy agreement, possession of the site would be given in September 1985, on which date the tenancy would commence.

11. The Taxpayer failed to respond to the call for execution of the tenancy agreement or the payment of the year's rent. In consequence, the Government cancelled the tender and the deposit of $432,000 was forfeited. Notice of the cancellation and the forfeiture was given to the Taxpayer by letter dated 11 October 1985.

12. In its correspondence with the Inland Revenue Department and its notice of appeal given to the Clerk to the Board of Review, the Taxpayer explained its failure to execute the tenancy agreement. It had changed its mind about the viability of its plans for a carpark business at the site after paying a second visit after the tender had been accepted. In its view, the ground of one third of the entire area and the slope by the road side were in such a state and condition as to render half of the site unfit for use as a carpark; it could only use the other half for a carpark or huge expenses would have to be incurred to render the affected area fit for use. It reached the conclusion that neither alternative was a viable proposition. It therefore decided, to use its own language, to 'give up the operation and surrender the deposit'.

The Issue

13. In his determination the Commissioner of Inland Revenue gave two reasons for his decision: (l) that the underlying cause of the expenditure was clearly the Taxpayer's breach of contract and not the production of profits, and (2) that the Taxpayer's interest in the tender and resultant lease was a capital asset and that any amount forfeited to the landlord as a consequence of its failure to complete the contract is capital in nature. The Board does not propose to deal with the first reason because (1) it was not argued before the Board, and (2) in any event, in view of the Board's decision on the second reason, it is not necessary to do so. So the only issue of this appeal is whether the forfeiture of the deposit is an expenditure of a capital nature or a loss or withdrawal of capital within the meaning of section 17(1)(c) of the Ordinance.

14. On 9 September 1985, a binding contract (the contract) came into existence upon the acceptance of the tender whereby the Government was bound to grant, and the Taxpayer was bound to take up, the tenancy by the execution of the tenancy agreement. The Taxpayer was minded to be relieved of its enforceable obligation to take up the tenancy which it had found to be onerous. So it refused to execute the tenancy agreement, expecting as a result a cancellation of the tender and a forfeiture of the deposit. The Government reacted as expected; it did not choose to enforce the contract.

15. The question is whether the expenditure or loss caused by the forfeiture of the deposit is capital in nature. As to when an expenditure is properly attributable to capital, Lord Cave, LC has this to say in Atherton v British Insulated and Helsby Cables Limited [1926] 10 TC 155 at 192:

> ‘ 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.’

16. That principle was applied in Mallett v The Staveley Coal and Iron Company Limited [1928] 13 TC 772, where it was held that two sums of money paid by the company to its lessors in consideration of the latter accepting a surrender of certain seams of coal comprised in the two leases of 1882 and 1919 were expenditure out of capital and therefore not admissible deductions from profits. Thus the principle has been held to apply to both acquisitions and disposals.

> At 783 Lord Hanworth, M R says:
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> ‘ It appears to me that the answer to that is this, that the company disposed of a liability. They have been able to get rid ... of a liability which would have hung round their necks. By this payment out-and-out they have freed themselves from what was a capital liability.’
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> At 786 Sargant, L J says:
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> ‘ In that case it seems to me that the words of the Lord Chancellor (that is, Lord Cave’s dictum cited in paragraph 15 above), in themselves applicable to the acquisition of a positive asset or advantage, are equally applicable to the case where the payment is made for the purpose of getting rid of a permanent disadvantage or onerous liability arising with regard to the lease, which was a permanent asset of the business.’
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> At 788 Lawrence, L J says:
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> ‘ In substance and in fact it was a sum paid for the purpose of getting rid of a capital asset of the company which had become burdensome to the company. In principle, such a payment seems to me to stand on precisely the same footing as a loss or profit sustained or made by a trading company on the disposal of part of its fixed capital.’
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> At 778 Rowlatt, J, whose judgment at first instance was upheld by the Court of Appeal, says:

> ‘ They (that is, the company) make these payments to get rid of the loss in the business or apprehend loss in the business – an entirely different matter – after the income and the expenditure have been put together. They are paying this money in other words in order pro tanto to go out of the business.’

17. Applying that principle to the present case, we are of the view that the Taxpayer had tendered for the tenancy with a view to using it for the enduring benefit of a carpark business, that is, the business of providing parking facilities to the public in return for fees. However, the Taxpayer subsequently changed its mind about the viability of the project and looked upon the tenancy as an onerous liability. The forfeiture of the deposit, deliberately incurred to avoid taking up the tenancy, was an expenditure incurred for the purpose of getting rid of an enforceable obligation to take on an onerous fixed asset. In our view that was an expenditure of a capital nature or a loss of capital within the meaning of section 17(l)(c). The fact that the tenancy agreement was not signed and that what was got rid of was not a tenancy but a contractual obligation to take the tenancy makes no difference. An enforceable obligation to take on an onerous capital asset is, in our view, in itself an onerous capital asset, and money expended to get rid of the obligation is an expenditure of a capital nature or a loss of capital.

18. In its notice of appeal, the Taxpayer mentioned the fact that clause 4(f) of the tenancy agreement gives the Government power to resume the site for a public purpose at one month’ s notice and contended that the carpark would not have been under ‘a long term contract’. We do not think that this carries the matter one way or the other. Quite apart from contract, the Government has statutory power to resume any land held from the crown for a public purpose at one month’s notice (see section 4 of the Crown Lands Ordinance, Cap 124). We do not think that the Government’s power of resumption can affect the nature of the term of the tenancy.

19. It follows therefore that this appeal is dismissed and that the profits tax assessment in question is hereby confirmed.

20. Paragraphs 14 to 19 above contain the decision and the reasons therefor of the majority of the Board. The dissenting decision of the third member of the Board, Mr Elliott is in the following terms:

> ‘ I do not accept the Commissioner’s submission that a binding tenancy contract was created between the Taxpayer and the Government by the acceptance of the former's tender for the tenancy.
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> Firstly, paragraph 2 of the form of tender is silent as to the interim relationship between the parties if the tenancy agreement is not ultimately signed. Secondly, the Government elected to “cancel” rather than “enforce” the tender, and thus presumably terminated the Taxpayer’s obligations save for his waiver of claim to repayment of the tender deposit. Finally, the tenancy agreement was never signed and the rights and obligations thereunder never began to run.

Thus the Taxpayer's payment of the deposit, in effect, merely purchased an option, expiring on or before September 1985, to take up the tenancy.

The Taxpayer's failure to exercise the option could have been due to any one or more of a number of causes, for example, illness, lack of funds, oversight, force majeure, or a commercial decision. That the last of these actually applied does not, in my opinion, affect the nature of the forfeited deposit.

The option acquired by payment of the deposit had such a limited period of validity that it could not constitute a permanent asset. In electing not to proceed to the tenancy, the Taxpayer was merely accepting a loss in his trading venture.

If, in the alternative, a tenancy contract was established by the Government's acceptance of the tender, the payments which would have been made under the contract would have been almost entirely, if not totally, deductible. Thus the payment by the Taxpayer to obtain release from the contract is an allowable deduction.

I believe that some of the above facts distinguish this case from the Mallett precedent and I would allow the appeal.'