Court of Appeal upheld upfront lump sum spectrum utilisation fees as capital in nature and not deductible

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In brief

The Court of Appeal (COA) handed down its judgment[1] on *China Mobile Hong Kong Company Limited v. The Commissioner of Inland Revenue (CIR)* on 3 November 2022. This is an appeal by the taxpayer against the decision of the Court of First Instance (CFI) which previously ruled that the upfront lump sum spectrum utilisation fees (Upfront SUFs) paid by the taxpayer to the Telecommunications Authority (TA) were capital in nature and non-deductible.

In this appeal, in addition to the same eight grounds argued before the CFI, the taxpayer advanced a new primary argument that the CFI had failed to take proper account of its manner of earning profits. However, such primary argument was rejected by the COA as it was raised for the first time only in the COA and was not previously argued before the Board of Review (Board). Thus, it would be unfair to the CIR to allow the taxpayer to run this argument in this appeal.

For the other arguments, the COA generally agreed with the CFI's analyses and upheld the CFI's decision that the Upfront SUFs paid by the taxpayer were capital in nature and thus non-deductible. The taxpayer's appeal was dismissed accordingly.

In detail

Background of the case

Further to our previous News Flash on the CFI judgment[2], below is a recap of the key facts of the case:

- The taxpayer is a mobile telecommunications and related services provider in Hong Kong. Since 1996, the taxpayer has paid annual spectrum utilisation fees (Annual SUFs) to the TA for the use of 2nd Generation (2G) frequency bands assigned to it for its operations.
- In 2009, auctions for 4th Generation (4G) and certain unallocated 2nd Generation (2G) frequency bands were completed and the taxpayer was the successful bidder of some of these frequency bands. According to the terms of the auctions, the taxpayer was required to pay Upfront SUFs to the TA for the 4G and 2G frequency band licenses for a period of 15 and 12 years respectively.
- The taxpayer classified the Upfront SUFs as non-current intangible assets in its audited financial statements and amortised them on a straight-line basis over the relevant license periods.
- The taxpayer sought to deduct the Annual SUFs and amortisation of the Upfront SUFs for the years of assessment 2009/10 to 2011/12. The assessor subsequently raised additional assessments disallowing the deduction of the amortisation of the Upfront SUFs on the basis that such fees were capital in nature.

The taxpayer appealed against the assessments to the Board and CFI, both of which unanimously dismissed the taxpayer's appeals and held that the Upfront SUFs were capital in nature and not deductible. The taxpayer then lodged an appeal against the CFI's decision to the COA.

The COA's judgment

In the appeal to the COA, the taxpayer relied on a new primary argument, together with the same eight grounds of appeal pursued before the CFI. A summary of the COA's analyses in its judgment is as follows.

Primary argument: The CFI's failure in taking proper account of the taxpayer's manner of earning its profits

- The taxpayer argued that the CFI had fundamentally misdescribed the way it provided its services to generate profits and had failed to consider the nature of the services provided by the taxpayer in the course of its trade, which was to meet the continuous and constant demand of use of spectrum in the provision of mobile telecommunication services to its customers.

- The fees, whether Upfront SUFs or Annual SUFs, are the direct costs for a mobile network operator of providing airtime services to its customers as part of its income operating process. They were paid by the taxpayer to use the specific bands of the spectrum for satisfying the daily demand of its customers and was recovered by the taxpayer charging its customers by reference to airtime for their usage of its mobile telephone network. Therefore, the Upfront SUFs should be revenue in nature and deductible.

- The COA, however, noted that the taxpayer's contention above was raised for the first time only in this appeal. The 'accepted facts' replied upon by the taxpayer were neither evidence included in the Statement of Agreed Facts placed before the Board nor considered by the COA as providing evidential support for the new inference that the taxpayer charged its customers for the customers' use of spectrum.

- According to the provisions under section 69AA of the Inland Revenue Ordinance, the COA must not receive any further evidence, or reverse or vary any conclusion made by the Board on questions of fact unless it is found that the conclusion is erroneous in point of law.

- As the new contention was not argued before the Board, the COA considered that it would be unfair to the CIR to allow the taxpayer to run this argument in this appeal as the CIR had been deprived of the opportunity to adduce evidence and make submissions on findings and inferences of fact that should be made.

- Based on the above reasons, the primary argument of the taxpayer was rejected and not allowed to be raised in this appeal. It is noteworthy that the COA did not make any comments on this primary argument from a technical perspective.

Other arguments: The same eight grounds of appeal previously rejected by the CFI

In respect of the eight grounds of appeal pursued by the taxpayer, the COA generally agreed with the CFI's analyses. We summarise below the key points of the COA's judgment.

Major issues	COA's analyses
1. The distinction between payment for right to use and for use	The taxpayer placed particular reliance on the judgment in *Regent Oil Co Ltd v Strick* and argued that the distinction between payment for the right to use and for the use marked the true difference in nature between capital expenditure and revenue expenditure. The COA commented that such distinction made in that judgment was in the context of premium paid for a lease and rent paid under a lease and was regarded as 'helpful, clear and intelligible' in that context. The COA also commented that, as stated in *BP Australia Ltd v FCT*, felicitous phrases from earlier judgments are not the deciding factor nor are they of unlimited application, and they merely crystallise particular factors which may incline the scale in a particular case after a balance of all the considerations has been taken. In view of the above, the COA concluded that there was no error in the CFI's approach to not recognise as decisive the distinction between payment made for the right to use the spectrum and payment made for the use of the spectrum.

2. The proper construction of the Telecommunications Ordinance (TO) and subsidiary legislation	The COA did not agree that the terms of the TO would assist in determining whether the Upfront SUFs were payable for the actual use of, or instead for the right to use, spectrum. The COA shared the CFI's view that there was no reason to believe that the legislature had such distinction in mind when enacting the relevant provisions in the TO. Even if the statutory provisions should be construed to mean that Upfront SUFs are required to be paid for the use of spectrum, it does not answer the question whether the payment is capital or revenue in nature.
3. The CFI's conclusions on the nature of Upfront SUFs	The Upfront SUFs were incurred to obtain a valuable right granted to the taxpayer to use designated spectrum exclusively for 12-15 years. They were the cost of acquiring or enlarging the profit-earning structure of the taxpayer's business. The Upfront SUFs brought into existence fixed assets of an enduring nature which were held and used by the taxpayer in its business of providing mobile telecommunications services to its customers at a profit. The spectrum itself was not consumed or used up but retained in the shape of assets and being used to produce income by providing services to the customers. They were in the nature of fixed capital, as opposed to circulating capital. The accounting treatment of the Upfront SUFs could not be determinative of the issue as a matter of principle merely because the expenditure had to be amortised over the cost of producing income.
4. The relevance of Annual SUFs	The Annual SUFs were periodical payments for the use of or the right to use spectrum for a short period only and were calculated on a different basis. The Upfront SUFs did not fulfil exactly the same business and economic function as Annual SUFs and could not be regarded as compounded Annual SUF payments.

Based on the above, the COA dismissed the taxpayer's appeal and ruled that the Upfront SUFs were capital in nature and not deductible.

The takeaway

In this appeal, the taxpayer advanced a new primary argument which was rejected by the COA on the basis that it was only raised for the first time in the COA and not previously argued before the Board. This reminds taxpayers who are contemplating undertaking legal proceedings in respect of tax disputes that appeals to the courts of Hong Kong are to be made on grounds involving only questions of law. All arguments, relevant facts and evidence need to be brought before the Board for consideration; otherwise, they would not be entertained by the courts.

The non-deductibility of lump sum licence fees or other "black hole expenditures" is an industry-wide issue. We again urge the HKSAR Government to consider enlarging the scope of tax deduction to cover such black hole expenditures such that industry players could obtain reasonable relief from such costs which must be incurred in providing quality services to consumers, and such that Hong Kong could maintain its competitiveness as a world-class telecommunication services centre.

Endnotes

1. The COA's written judgment in this case can be assessed via this link: https://legalref.judiciary.hk/lrs/common/ju/ju_frame.jsp?DIS=148417&currpage=T

2. The news flash can be accessed via this link: https://www.pwchk.com/en/hk-tax-news/2020q3/hongkongtax-news-aug2020-11.pdf

Let's talk

For a deeper discussion of how this impacts your business, please contact:

PwC's Corporate Tax Leaders based in Hong Kong

Charles Lee
+852 2289 8899
charles.lee@cn.pwc.com

Jeremy Ngai
+852 2289 5616
jeremy.cm.ngai@hk.pwc.com

Jeremy Choi
+852 2289 3608
jeremy.choi@hk.pwc.com

Rex Ho
+852 2289 3026
rex.ho@hk.pwc.com

Cecilia Lee
+852 2289 5690
cecilia.sk.lee@hk.pwc.com

Jenny Tsao
+852 2289 3617
jenny.np.tsao@hk.pwc.com

Kenneth Wong
+852 2289 3822
kenneth.wong@hk.pwc.com

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For more information, please contact:

Long Ma
+86 (10) 6533 3103
long.ma@cn.pwc.com

Gwenda Ho
+852 2289 3857
gwenda.kw.ho@hk.pwc.com

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