Hong Kong Tax Alert

13 June 2025
2025 Issue No. 13

MTRCL's annual payments to KCRC for the service concession to run KCRC's railway operations for 50 years held to be non-deductible capital expenditures

- *the Court of First Instance (CFI) now grants MTRCL leave to appeal against the decision of the Board of Review (BOR) that the annual payments, together with the upfront payment, were all part of the consideration for MTRCL's acquisition of the service concession from KCRC. The service concession was an advantage of an enduring nature relating to the enlargement of the profit-earning structure of MTRC's business. It was therefore a long-term asset acquired by MTRCL in the merger. As such, the annual payments were deferred consideration for the acquisition of the service concession and were thus non-deductible capital expenditures.*

Clients who have any questions on the capital-versus-revenue nature of an item should contact their tax executive.

Facts

In April 2006, the Government and MTR Corporation Limited (MTRCL) entered into a Memorandum of Understanding relating to the key terms for the proposed merger of the MTRCL and Kowloon-Canton Railway Corporation (KCRC).

One of the key terms was the expansion of the existing franchise under the MTRC Ordinance to provide for the right to operate both railways for an initial period of 50 years which was extendable.

Other relevant key terms included:

(1) MTRCL would be granted a Service Concession by KCRC to make use of the latter's assets to operate the existing and new KCRC railway lines under construction, as well as KCRC's other transport-related businesses such as bus operation (KCRC System).

(2) Under the Service Concession Agreement (SCA), MTRCL would be granted the right to use certain KCRC assets and railway land to operate the KCRC System. It would be responsible for the operation, maintenance and improvement of the KCRC System, including replacement of the concession assets, during the Concession Period as defined in the SCA. MTRCL would exercise control over all the operational arrangements of the two networks as an integrated whole and be responsible for the performance of the total system. Upon expiry or termination of the Service Concession, MTRC would be required to return an operating KCRC System to KCRC that would meet the prevailing operating standards. Under the Service Concession arrangement, KCRC would not be disposing of the railway system to MTRCL, and MTRCL would not be acquiring the KCRC assets (except for certain low value items such as spare parts and consumables).

On the financial terms, the relevant provisions of the SCA subsequently executed provided that:

"[1] Upfront Payment

*On the Merger Date, [MTRCL] shall pay to KCRC an amount totaling HK$42.5 billion, being the agreed fee for the right to operate the Service Concession and the consideration for the Purchased Rail Assets (the **Upfront Payment**).*

[2] Fixed Annual Payments

*2.1 On the day immediately preceding each anniversary of the Merger Date…[MTRCL] shall pay to KCRC, in arrears, a fixed amount of HK$750 million for the right to use and operate the Concession Property for the operation of the Service Concession in respect of the 12-month period…(each a **Fixed Annual Payment**)…*

[3] Variable Annual Payments

*3.1 [MTRCL] shall pay to KCRC, in arrears, a variable annual payment in respect of each financial year of [MTRCL]… for the right to use and operate the Concession Property for the operation of the Service Concession (each such payment a **Variable Annual Payment**. The Variable Annual Payment…shall be calculated on a tiered basis by reference to the amount of KCRC System Revenue for that financial year…"*

Issue in dispute

The Commissioner of Inland Revenue (CIR) determined that the amortization of the Upfront Payment (referred to below as "Concession Upfront") and the Fixed Annual Payments (FAPs) and Variable Annual Payments (VAPs) claimed for deduction in the tax returns of MTRCL for the years of assessment 2007/08 to 2017/18 were non-deductible capital expenditures.

The MTRCL appealed against the CIR's determination to the tax tribunal of the Board of Review (BOR).

BOR decision

Deductibility of FAPs and VAPs

Before the BOR, MTRCL conceded that the Concession Upfront was non-deductible capital expenditure.

On the other hand, the CIR conceded that the part of the Upfront Payment that was attributable to MTRCL's acquisition of the Purchased Rail Assets which were short-lived items such as spare parts and consumables was a deductible revenue expense.

Therefore, the issue in dispute before the BOR only related to the deductibility of the FAPs and VAPs.

FAPs and VAPs paid for the Service Concession or the use of Concession Property

The BOR found that the Service Concession was a long-term asset acquired by MTRCL from KCRC by way of it making the Upfront Payment, FAPs and VAPs.

The Service Concession, once granted, would entitle MTRCL to access, use and possess the Concession Property for the operation of the railways and related services.

Thus, as a matter of logic and practical reality, the BOR found that the distinction between (i) the right to operate the Service Concession on the one hand, and (ii) the right to use or the actual use of the Concession Property to operate the Service Concession on the other as submitted by MTRCL was artificial.

The BOR therefore held that the grant of the right to operate the Service Concession necessarily encompassed a grant of the right to use, possess and operate the Concession Property.

The BOR also considered that, on a proper construction of the SCA, that each FAP and VAP was not payable for the right to use the Concession Property in a particular year only (and therefore akin to yearly rent) but for the right to use the Concession Property on an "as is" basis throughout the Concession Period.

This view was partly founded on the "hell and highwater" clause contained in the SCA by which the obligation to pay the FAPs and VAPs was absolute and unconditional even if the Concession Property did not exist in the specific year or 12-month period.

Taking into account the parties' negotiations and relevant background, the BOR also found that the parties clearly understood that the FAPs were deferred non-contingent consideration and the VAPs were deferred contingent consideration of a similar nature or analogous to an earn-out, namely deferred contingent consideration calculated by reference to the future revenues of the KCRC System so as to ensure a fair valuation if the performance of the KCRC improved.

Thus, the BOR found that the FAPs and VAPs were not rent for the use of the Concession Property but deferred consideration, having the same nature as the Concession Upfront, for the acquisition of the Service Concession.

Therefore, the BOR dismissed MTRCL's appeal, holding that the FAPs and VAPs were non-deductible capital expenditures.

Main grounds for MTRCL seeking leave to appeal

Counsel for the MTRCL contends that:

(i) the BOR has failed to properly construe and understand that the FAPs and the VAPs are payable under provisions which are different from, and have different purposes to, the provisions which create the Concession Upfront; and

(ii) the different characteristics of the Concession Upfront on the one hand and the FAPs and the VAPs on the other are supported by the analogy which can rightly be drawn between the Service Concession and a lease. The analogy is that (i) the Upfront Payment is similar to a lease premium paid for the grant of the lease which is capital in nature; and (ii) the FAPs and VAPs are similar to rent payable under a lease which is revenue in nature. Reference was made to the analysis in *Commissioner of Taxation of Commonwealth of Australia v Citylink Melbourne Ltd* (2006) 228 CLR 1.

The facts of the *Citylink* case are similar to those in this case in many respects. In 1995, *Citylink* and the State of Victoria entered into a concession deed for the Melbourne City Link project. The concession commenced in 1996 and is expected to end in 2034. It may be terminated early or extended in certain defined circumstances.

In consideration for the grant of the right to design, construct, commission and operate the City Link, to impose and collect toll, maintain and repair the road and raise other approved revenues, *Citylink* is obliged to pay concession fees to the State.

The fee was set at AU$95.6 million per annum for the construction period and the first 26 years of operations. For the remaining nine years of the concession period a fee of AU$45.2 million per annum is payable. An annual fee of AU$1 million per annum is provided in the event that the concession period is extended beyond the expiry date.

On appeal, the majority of the High Court in Australia found that the concession fees were, like any periodic license fee, payable for the use of the City Link infrastructure assets that ultimately must be surrendered to the State. Thus, the concession fees were held to be deductible revenue expenses.

Regarding the BOR's rejection of the analogy between the Service Concession and a lease, Counsel argued that the BOR failed to recognize that a lease, same as the Service Concession, is also an asset.

Leave of appeal granted

The judge has granted leave to appeal to MTRCL. He is satisfied that given the parties have advanced competing (arguable) contractual interpretations of the relevant provisions of the SCA, the proposed appeal has met the threshold that it has a reasonable prospect of success.

Full ventilation of the arguments of the parties will only be made when the substantive issues of the appeal are considered by the CFI on a hearing date to be fixed.

Commentary

Although there is no single decisive test for determining the capital-versus-revenue issue, the courts have held that these factors may usefully be taken into account: (a) whether the expenditure is incurred once and for all, or is going to recur every year; (b) whether the expenditure is incurred with a view to bringing into existence an asset or advantage for the enduring benefit of a trade, a benefit is enduring for this purpose if it is of a permanent quality or has sufficient durability, it does not have to be everlasting; and (c) whether the expenditure relates to the cost of creating, acquiring or enlarging the permanent structure of which the income is to be the produce or fruit, or instead represents the cost of earing that income itself or performing the income-earning operations.

Notwithstanding the above indicia employed by the courts over many decades, the capital-versus-revenue issue of a case would still have to be determined in light of all its circumstantial facts, including how to interpret the terms and effect of the relevant contractual provisions.

The BOR decision in this case has not been published. The above findings of the BOR were only stated by the CFI judge in his decision to grant leave to appeal to MTRCL, without also stating the BOR's reasoning for its rejection of some of MTRCL's arguments.

On appeal, given the similarity of the facts of this case to those of *Citylink* in many respects, it would be worth noting whether or how the CFI would distinguish this case from Australian High Court's decision in *Citylink*.

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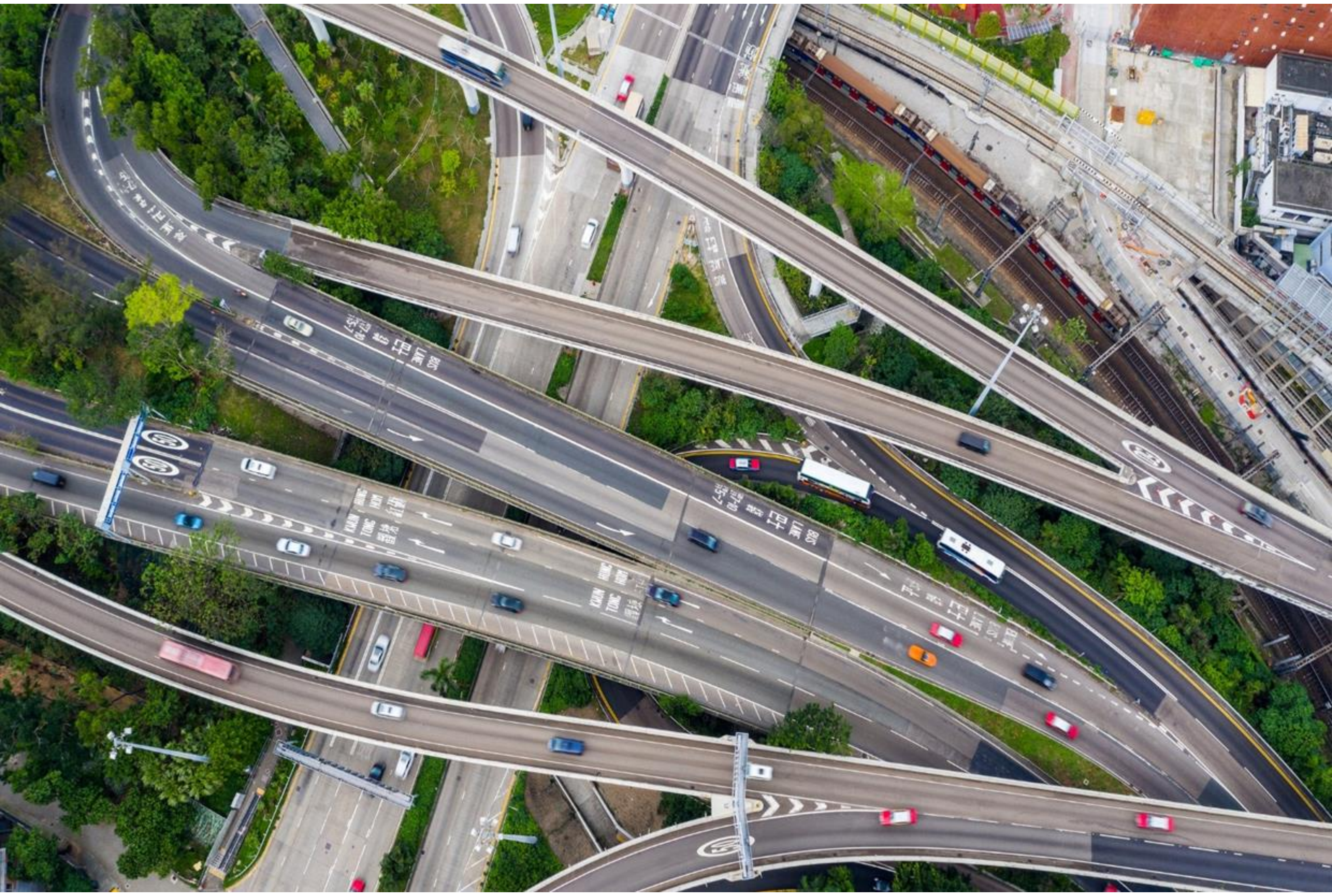

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