

# INLAND REVENUE BOARD OF REVIEW DECISIONS

Inland Revenue Appeal No. 1 of 1995

## IN THE SUPREME COURT OF HONG KONG HIGH COURT

IN THE MATTER of an Appeal by way  
of Case Stated pursuant to section 69 of  
the Inland Revenue Ordinance, Chapter  
112 from the decision of the Board of  
Review BR 6/93 on the application of the  
Commissioner of Inland Revenue

BETWEEN

Appellant                    THE COMMISSIONER OF INLAND REVENUE

and

Respondent                COSMOTRON MANUFACTURING COMPANY LIMITED

Before the Hon Mr Justice Findlay, in Court

Date of hearing: 16 November 1995

Date of handing down of judgment: 21 November 1995

### JUDGMENT

#### The Background

The respondent operated a factory in Hong Kong where it employed a work force of some 123 people. A majority of the workers had been with the respondent for more than 10 years. In 1988, the respondent became aware that the owner of the building in which it had its factory intended to demolish it. In the financial year 1987/1988, the respondent established a long service payment reserve fund reserve of \$1,500,000. This was included in the audited accounts of the respondent for the year ended 31 March 1988. Notice to quit was given to October 1989. By early 1990, the respondent's employees became aware of the fact the building would be demolished and the factory closed. The respondent operated its business until 9 March 1991. Until this time, the long service employees of the respondent stayed with the respondent, and became redundant when the

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factory closed. Employees who were recruited during the final year of operation, almost without exception, resigned shortly after starting work. During the financial year 1990/1991, the respondent operated its business profitably. When the respondent closed its business, it gave notice to all its employees and made severance payments to them as required by law; a total sum of \$2,937,981. The respondent sought to treat this sum as a deduction in its profits tax return. The assessor disallowed this. The Commissioner upheld the assessor's decision in part. The respondent appealed to The Board of Review, which allowed the appeal. The Commissioner now appeals to this court by case stated.

### The Question

The question of law is stated as follows -

“Whether, as a matter of law and on the facts found by it, the Board was correct in concluding that severance payments made according to the Laws of Hong Kong on the termination of the business of the Taxpayer should be allowed as deductions for profits tax purposes.”

### The Statutes

The relevant provisions of the Inland Revenue Ordinance, Chapter 112, are sections 16(1) and 17(1)(b).

Section 16(1) 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 . . .”

Section 17(1)(b) says -

“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) . . .

(b) any disbursements or expenses not being money expended for the purpose of producing such profits;

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....”

Under section 31B of the Employment Ordinance, Chapter 57, an employer is bound to pay a severance payment to an employee who has been employed under a continuous contract for a period of not less than 24 months and is dismissed by reason of redundancy.

### The Issues

The Board allowed the appeal because it decided that the severance payments should be deductible as expenses. It came to the conclusion that the paramount purpose for incurring the expense of the severance payments was the production of assessable profit.

The Commissioner, through Miss Shine, argues that the severance payments were not incurred for the purpose of the carrying on of the respondent's business, but for the purpose of winding up the respondent's business.

### The Purpose

In order to qualify as deductible expenses, the liability to pay the severance payments must have been incurred in the production of profits for any period. I stress that one must look, not simply at the payment, but also at the underlying liability to pay. This, I think, is clear because it may be that a businessman, who is in the process of closing up his business, incurs all manner of expenses, such as for rent, wages and electricity, which are undoubtedly incurred for the purpose of the production of profits, but he does not actually pay these until after he has closed down. It cannot possibly be said that he has made the payments for the purpose of producing profits - he knows he will make no more profits in that business - but he incurred the obligation to pay for that purpose, and that it is deciding factor.

It is clear from the judgment of the Privy Council in **Commissioner of Inland Revenue v Lo & Lo** (1984) HKTC Vol. 2 34 that, for the purposes of section 16, deductions are not confined to sums actually paid by the taxpayer, but “an expense incurred” includes a sum which there is an obligation to pay; that is to say, an accrued liability which is undischarged. Their Lordships made it clear in that case that they regarded a liability as accrued although, in certain circumstances, it would not be payable.

The obligation under section 31B of the Employment Ordinance, Chapter 57, is an obligation that an employer is bound to undertake if he wishes to do business, and employ workers in that business. It is an unavoidable part of the expenses of conducting a business in order to make a profit. It is just as much an expense in the

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production of profits as the payment of wages, or rent, or for electricity consumed in manufacturing.

It makes no difference, in my view, that the obligation is imposed on him by law, rather than incurred consensually. Many expenses of running a business to make a profit are imposed by law; licence fees, minimum wages, workers' compensation payments and rates, but no one doubts that these expenses are deductible against profits.

It is, in my view, quite wrong to say that the liability to pay the expense of severance payments is incurred for the purpose of closing up a business. It is not a businessman's aim to close up his undertaking. It may be a consequence of the closing of the business that the employees become redundant, and, therefore, the liability crystallises. The employer has always had a potential liability as an unavoidable part of conducting his business; that potential is realised by the closing of the business, but liability was not incurred for the purpose of closing the business. The employer does not undertake the obligation in order to close up his business; he undertakes it because he wishes to employ people in order to make things, so that he can sell them and make a profit. It is true that the event which triggers the payment to the employee is the dismissal by reason of redundancy because the business is shut down, but that is not the purpose for which the expense was incurred.

Once an employee has been employed under a continuous contract for a period of not less than 24 months, he acquires a right to receive a severance payment if he is dismissed by reason of redundancy, and the mirror of that is that the employer has incurred an obligation to make that severance payment if he closes down his business and his employees are made redundant.

### The Authorities

Miss Shine cited a number of authorities against the view taken by the Board.

In **Strong & Co. v Woodfield** 5 TC 215, Lord Davey said, at page 220, that "It [referring to the disbursement made] must be made for the purpose of earning the profits." That seems right, although, in the light of the **Lo & Lo** case, one might say, more precisely, certainly in the context of our legislation, that the liability to make the disbursement must be undertaken for the purpose of earning profits. That, of course, is the situation in the case before me. The legislation under which that case was decided provided that "the disbursements or expenses" must be money "wholly or exclusively laid out or expended for the purposes of" the trade, so it may be that it was right, in that case, to concentrate on the payment; that is, the discharge of the obligation rather than on the obligation itself.

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In **The Commissioners of Inland Revenue v The Anglo Brewing Co Ltd** 12 TC 803, Rowlatt, J. said, at page 812 - "So they came to the conclusion that they would make certain payments, because they were not going to carry on business any longer. Now I cannot conceive how, under those circumstances, there can be any evidence at all that the payments were made for the purposes of the trade, because that must mean for the purpose of keeping the trade going, and making it pay. There was not any such purpose at all." In that case, the payments by the employer were purely voluntary, so it is understandable that there should be a finding that there was no liability incurred for the purposes of earning profits.

In **Godden v A. Wilson's Stores** 40 TC 161, Plowman, J. held that a payment to an employee on termination of his employment representing salary due to him and estimated commission he would have earned when the employer was going out of business was not "wholly and exclusively laid out or expended for the purposes of the trade", and the Court of Appeal upheld that decision. That, again, is understandable because the question there was whether money had been "laid out or expended for the purposes of" trade, and clearly it was not. Under the terms of the statute concerned, it was not a matter for consideration whether the liability to make the payment had been incurred in the production of profits.

In **Board of Review Case BR 13/70**, the Board found that gratuitous lump sum payments to employees when the employer ceased business "were not expenses incurred in the production of profits". There was no question in that case of liability to make the payments being incurred in the production of profits.

In **Board of Review Case D36/87**, the Board found that severance payments were not deductible. The Board did not give reasons for this decision. It simply relied on earlier decisions, including the cases I have cited above. I do not agree with the Board's conclusion.

In **Board of Review Case D38/88**, the Board decided that severance payments made in a continuing business were deductible because the payments enabled the business to operate smoothly in the future by encouraging other employees to continue working, but, where the business ceased operating, "there are no ongoing profits which can arise from such payments" and "it is clear that the severance payments were made to terminate the business of the Taxpayer and not to earn profits". I cannot agree with that decision. The payments were not made "to terminate the business"; that was not the purpose of the payments. The payments were made because the employer had a legal obligation to make them; a liability he had been obliged to undertake in order to conduct his business to make profits.

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In **Board of Review Case D4/83**, the Board decided that the business concerned continued, and, therefore, the severance payments were deductible. The Board left open the question whether they would have been deductible if the business had ceased.

### Conclusion

I see nothing in these authorities that convinces me that a payment made to discharge an obligation that was incurred for the purpose of the production of profits is not deductible. It was conceded by Miss Shine that, if the employer undertakes an obligation to pay his employees a bonus if they stay with him until the business closes, the payments made to discharge that obligation would be deductible. I can see no material distinction between this situation and the situation before me, in which the employer was obliged by law, if he wished to employ workers in order to produce profits, to undertake a similar liability. Both liabilities, and consequent payments, were for the purpose of producing profits.

Accordingly, I find that the Board was correct, although, perhaps, for reasons that are not quite the same as their reasons. I confirm the assessment made by the Board.

### Costs

On the face of it, the respondent is entitled to its costs in this court. I make an order *nisi* that the appellant pay the respondent's costs in the High Court.

JK FINDLAY  
Judge of the High Court

Miss Linda Shine, instructed by the Crown Solicitor, for the appellant.  
Mr Yu Tat Ching, a director of the respondent, for the respondent.