Case No. D36/87

Board of Review:

H. F. G. Hobson, *Chairman*, A. C. Hill and Joseph Ming Lai, *Members.*

1 October 1987.

Profits tax—Sections 16(1) and 17(1) of the Inland Revenue Ordinance—whether "severance payments" and "payments in lieu of notice" be allowable as deductions when business ceased to operate.

The Appellant closed down his cafe business and sold the assets and surrendered the tenancy of the premises from which the business operated. Under the Employment Ordinance he had to pay his redundant staff severance payments and payments in lieu of notice. The Appellant claimed that they were deductible from his assessable profits for the year 1982/83. The Commissioner disallowed on grounds that the payments were made in consequence of a decision to cease business and could not be considered an outgoing and expense incurred in the production of profits and were disallowed by section 17(1) of the Inland Revenue Ordinance.

The Appellant contended that severance payments were made in discharge of a statutory obligation imposed by the Employment Ordinance. In respect of payments in lieu of notice, the Appellant contended that it was cheapter to make these payments rather than continue the business and pay rent and other overhead and consequently by his action the Appellant cut down those trading profits which would be allowed as deductible expenses.

Held:

Both payments did not rank for deductions.

Appeal dismissed.

Cases referred to:

Board of Review Decision D13/70
Board of Review Decision D4/83
CIR vs Swire Pacific Limited HKTC 1145
CIR v. The Anglo Brewing Co Ltd 12 TC 803
Godden v. A. Wilson's Stores (Holdings) Ltd 40 TC 161
Strong and Company of Romsey Ltd v. Woodfield 5 TC 215

Pauline Fan for the Commissioner of Inland Revenue.
Mak Hing-cheung of Messrs Mak Hing-cheung & Co for the Appellant.

Reasons:

On the 4 March 1983 Mr. A (the "Taxpayer") closed down the cafe business, of which he was the sole proprietor and sold the assts (but not the business) and surrendered the tenancy of the premises from which the business operated.

By virtue of section 31B(2) of the Employers Ordinance, Cap. 57, he had to pay his redundant staff a total of $66,430.50 (the "Severance Payments") and in addition he paid them a total of $13,060 in lieu of notice (section 7).

The relevant facts are not in issue. The Commissioner of Inland Revenue took the view that these payments are not deductible from the Taxpayer's assessable profits for the year 1982/83 because they were made in consequence of a decision to cease business, and as a corollary to refrain from earning profits, consequently neither type of payment could be said to be an outgoing or expense incurred "in the production of profits" (s. 16(1)IRO) and were disallowed by s. 17(1) IRO.

1. SEVERANCE PAYMENTS

1.1 Taxpayer's submissions

As regards the Severance Payments Mr. Mak Hing-cheung, the Taxpayer's representative, argued (in effect) that the payments were merely a culmination of a statutory obligation which every business had imposed upon it and likened that obligation to provident schemes where by reason of s. 16A(1) contributions are deductible. He argued that similarity in purpose not only between such schemes but also pension funds (both of which are herein called the "Contractual Schemes") on the one hand and the Statutory severance requirement on the other is to be found in the fact that s. 31F(C) of the Employment Ordinance provided that s. 31B severance payments did not apply to persons entitled to a pension, gratuity or annual allowance and s. 31 stipulates that severance pay entitlements shall be reduced to the extent of any provident fund payments. (We should mention that sub-section (C) of s. 31(F) was deleted in 1985, however it was in force during the relevant period). Moreover in common with Contractual Schemes severance pay entitlement is predicated on a long period of employment (24 months): both the Contractual Schemes and the Statutory obligation are, according to Mr. Mak, founded on a desire to offer financial protection for employees. Accordingly, it was submitted, the statutory obligation should itself be viewed as though it were a provident scheme.

Nor, Mr. Mak argued, should the fact that the statutory obligation was not an approved scheme, be a deterent because the IRD's own Information Pamphlet on Approval of Retirement Schemes states "it is possible for schemes which are valid for other purposes to be established without approval by the Commissioner." We would say straightaway that we cannot accept this last argument: the quoted passage is preceded by the sentence "It is stressed that these notes only refer to approval under the Inland Revenue Ordinance", we therefore understand the first quoted passage merely to state that even though a scheme may not be approved by the Commissioner that fact would only affect the tax position and not the respective rights of the parties to the unapproved scheme.

It was next submitted that the severance obligation should be viewed as payment for past services because it is calculated according to the length of service; it is an accruing obligation and, Mr. Mak contended is capable of being charged as a contingency in an employer's accounts.

Mr. Mak referred us to the 1979 HK Supreme Court Swire Pacific decision (HKTC p. 1145). There the Taxpayer successfully appealed against an assessment which disallowed a claim to deduction of cash payments (called retirement grants) made to its workers who had gone on strike to reinforce their demand to certain financial compensation for the Taxpayer's proposed merger with another Company. The Board of Review found as a fact, inter alia, that (a) the payments were made to end the strike thereby avoiding potential damage claims by its customers and (b) the Taxpayer indeed made profits during the 3½ months period from settlement of the strike to the consummation of the merger. However it follows from this recital that in the Swire case the payments (which were not made pursuant to the Employment Ordinance) were not made on the closing down of the business and though undoubtedly it was the prospect of potential redundancies on the merger taking place that triggered the strike, factually the case is distinguishable.

Finally Mr. Mak (in different words) adopted the contention quoted from D4/183 at 1.3 below.

1.2 IRD's Response

In a nutshell the submission of Mrs. Pauline Fan (the Commissioner's representative) was that it is a contradiction to claim that severance payments made as a concomitant to the closure of a business are made in pursuit of profits. She relied upon various dicta in *Strong and company of Romsey Ltd. v. Woodfield* (5 TC p. 215). That case was concerned with Rule 1 in s. 100 of the English Income Tax Act 1842 viz:—

> "no sum shall be set against, or deducted from, or allowed to be set against or deducted from such profits or gains for any disbursements or expenses whatever not being money wholly and exclusively laid out or expended for the purposes of such trade manufacture adventure or concern".

The facts of that case bear no resemblance to that before us. The Appellant taxpayer company there sought to set against its taxable income damages and costs incurred in defending an action for damages for injuries one of its hotel guests sustained. Nonetheless the Land Chancellor opined that to be deductible the disbursement must not only be made in the course of and arising out of or is connected with the trade or is made out of the profits of the trade. But must be made for the purpose of earning profits. Plainly this equates the former English statutory provisions on the subject with the Hong Kong wording "…shall be deducted all outgoings…to the extent to which … incurred … in the production of [taxable] profits …" (s. 16(1)).

She also referred to CIR -v- The Anglo Brewing Co. Ltd. (12 TC 803) which was concerned with ex gratia payments to employees on the closing down of the employer's business. On appeal by the Revenue from the finding of the Commissioners Rowlatt J made this comment:—

> "So they came to the conclusion that they would make certain payments, because they were not going to carry on the 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 purpose of the trade, because that must mean for the purpose of keeping the trading going, and of making it pay."

That Rowlatt J found for the Revenue not purely on that ground does not, in our opinion, detract from the value of the quoted dictum.

In Godden v. A Wilson's Stores (Holdings) Ltd. (40 TC 161), which Mrs. Fan cited, the Taxpayer company paid a manager a sum equivalent to 6 months salary because it decided to close down the business managed by him. The six months related to the period after closure. On appeal Polwman J decided against the Taxpayer because the payment was made in connection with the termination of the business not with a view to earning profits.

The Board of Review in Decision BR 13/70 on facts similar to those before us (save that the payments were ex gratia and not due to any statutory requirement) decided that the payments did not qualify under s. 16(1) because they were paid on termination of the taxpayer's business (moreover they were excluded by s. 17(1)(*b*)—which for our purposes is merely citing the other side of the same coin).

In Board of Review case D4/83 the business continued, albeit in a different mode of operation, and on the facts the Board held that the severance payments concerned were indeed made with a view to the taxpayer making profits. However the following comment is noteworthy:—

> "The factors in favour, of the continuation of an existing business outweigh the factors in from of a cessation and commencement.
>
> Having arrived at this view, it is our decision that the severance payments were allowable deductions in computing the Company's profits which makes it unnecessary for us to decide the vexed question of whether they would still have been deductible expenses if there had been a cessation of business. On this latter aspect of the matter the point raised by the Company is interesting. It appears to be based on the contention that by virtue of the Employment Ordinance a person who serves his employer for a stated number of years will be entitled to additional payment, depending on the length of service, if he is dismissed for redundancy. It is argued, therefore, that the employee's knowledge of this would more likely make him remain in that employment wherefore the entitlement to payment, albeit contingent, must be treated as part of his remuneration under the contract of service for which he performs services in the production of the Company's income. Whether this contention is valid is a moot question although the authorities cited to us by the Revenue do not support the Company's argument on the footing that the payments were not made for the purpose of earning profits. There is now

legislation in the United Kingdom allowing redundancy payments to be deductible on cessation of business. As it is obviously fair that payments of this nature should enter into the computation in arriving at the true profits of a company we feel that thought should be given by our legislators for inclusion in our Ordinance of some similar provision as that existing in the United Kingdom in regard to redundancy payments."

The Decision in D4/83 was given in 1980, however in December 1976 the Third Inland Revenue Ordinance Review Committee had indeed considered the self same point mentioned by the Board (seemingly the Committee's Report was not drawn to the Board's attention). The Review Committee however declined to recommend that redundancy payments on closure of a business should qualify as deductible expenses: with respect their reason for adopting that stance is difficult to follow.

1.3 CONCLUSION on Severance Pay

In our opinion the authorities cited by Mrs. Fan and their underlying logic outweigh the submissions put forward by the Taxpayer's Representative. We sympathise with the Taxpayer and others who are forced to close down their businesses for financial reasons because, unlike those businesses which retrench (Swire Pacific) they have to suffer a tax burden in addition to meeting severance payments. Nevertheless we are bound to follow the law as we see it, accordingly the appeal concerned with the severance aspect fails.

We would however add as pointed out by Mrs. Fan (to whom we are obliged for the care with which she presented the Revenue's case) that the anologies Mr. Mak sought to draw between the statutory obligation for severance and the Contractual Schemes were invalid for a number of reasons. For example severance could arise in situations not contemplated by a provident fund as where the employer moves his business from one side of the harbour to the other. We agree that whilst there may be a superficial resemblance in intent Contractual Schemes and Statutory Severance are more distinctive than similar.

2. Payments in lieu of notice

2.1 Taxpayer's submissions

On this aspect Mr. Mak's point is that it was mathematically cheaper to make these payments rather than continue to pay rent and other overheads. Consequently by his action the Taxpayer cut down those trading profits which would be allowed as deductible expenses.

2.2 IRD's submission

Mrs. Fan did not treat specifically with this subject. Her line remained the same as for severance pay, namely that the $13,060 was not made with a view to producing profits.

2.3 CONCLUSION

Again the Taxpayer has our sympathy, he had suffered $35,125 of losses during the basis period. The only taxable elements therefore were the severance payments and the payments in lieu of notice. In our view however the law is against him and accordingly we dismiss the appeal on this point. It is of little consolation to the Taxpayer to consider that it might well have been possible to have avoided this tax consequence by adopting a different approach on closing down his business.