INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D38/88

Profits tax – deductions – audit fees – s 16(1) of the Inland Revenue Ordinance.

Profits tax – deductions – severance payments made on cessation of business – whether deductible – s 16(1) of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Dr Richard Lee and Lincoln Yung Chu Kuen.

Date of hearing: 10 August 1988.
Date of decision: 22 September 1988.

The taxpayer sold his business and made severance payments to those employees who did not take up employment with the purchaser of the business.

The IRD refused the taxpayer's claim to a deduction for these severance payments. The taxpayer appealed.

Held:

The severance payments were not deductible.

(a) Severance payments made with respect to a continuing business are deductible despite the fact that they are paid for an employee's past services. This is because such payments enable the business to operate smoothly in the future by encouraging other employees to continue working.

(b) Where, however, a business ceases, there are no ongoing profits which can arise from payments made in the course of closing down the business, including severance payments. Such payments are therefore not deductible.

(c) An effective deduction could have been obtained had the employer established a provident fund to which he could have made deductible payments which would have provided the same severance payments on termination of the business. However, that analogy does not permit a deduction in this case.

Appeal dismissed.

Cases referred to:

BR13/70, IRBRD, vol 1, 21
D4/83, IRBRD, vol 2, 41
D36/87, IRBRD, vol 2, 414
CIR v Anglo Brewing Co Ltd (1925) 12 TC 803
CIR v Swire Pacific Ltd (1979) 1 HKTC 1145
Godden v A Wilson's Stores (Holdings) Ltd (1962) 40 TC 161
Strong and Co of Romsey Ltd v Woodifield (1905) 5 TC 215

Lee Yun Hung for the Commissioner of Inland Revenue.
Than Pe of Than Pe & Co for the taxpayer.

Decision:

This appeal is by an individual taxpayer against the refusal by the Deputy Commissioner to allow the deduction of severance pay made when the Taxpayer closed his business.

The facts are simple and as follows:

1. The Taxpayer had been carrying on business for some time as an importer and exporter. He ceased business with effect from 1 January 1986 when he sold his business to a third party. A number of his long service employees did not join the service of the purchaser of the business and the Taxpayer terminated their employment and paid them severance pay which was calculated in relation to the length of service which they had had with him.

2. The Taxpayer claimed that the severance pay was deductible from the profits of his business as being an operating expense incurred in the final year of his business ending on 31 December 1985.

3. The assessor disallowed the severance pay as an allowable expense. The Taxpayer objected to the disallowance and submitted that the severance pay was paid to the employees for past services in respect of which the profits of the business were assessable to tax.

4. The matter was referred to the Deputy Commissioner for his determination and the Deputy Commissioner decided against the Taxpayer.

Taxpayer's arguments

At the hearing of the appeal, the representative for the Taxpayer submitted that, under the Inland Revenue (Retirement Scheme) Rules, an amount equal to 15% of the

emoluments of an employee can be contributed by the employer to an approved scheme. Such contributions are not subject to profits tax. Under the terms of the Employment Ordinance, the amount of severance pay may be reduced by the amount paid to an employee from a provident fund. He submitted that the difference between having a provident fund and not having a provident fund would be that contributions to a provident fund would be made during the years leading to cessation whereas the severance payments would be made at the end of the period. However, he submitted that both payments related to past services rendered by the employee.

As a second argument, the representative for the Taxpayer submitted that an analogy could be drawn between a limited company which by law must have audited accounts and a business or partnership which does not need audited accounts. He submitted that the payment of an audit fee by a limited company which is an allowable expense for tax purposes is not an expense which is wholly, exclusively and necessarily incurred for the purposes of the business operated by the company. He said that, even if severance payments had not been incurred in the production of a chargeable profit, they should be treated in the same way as audit fees which likewise were not incurred in producing a chargeable profit.

The representative further submitted that an analogy could be drawn between a company which rented living quarters for its directors and owners, which would be allowable expenses, whereas if an individual were to incur similar expenses they would not be deductible. Here again he submitted that the deduction of the rent incurred by a limited company is permitted against its assessable profits even though the rent is not incurred in earning such profits. He drew attention to other expenses which limited companies were allowed to deduct such as secretarial service fees, filing fees, etc which he said are not incurred in the production of assessable profits but which are permitted to be deducted therefrom.

The representative also drew attention to the list of items set out in section 17(1) of the Inland Revenue Ordinance which are not to be allowed as deductions against assessable profits. He pointed out that severance pay was not included in this list and that, as severance pay is so important, and as so many claims arise relating to severance pay, if it was the intention to exclude severance pay, it should have been specificially included in section 17(1).

Commissioner's arguments

The representative for the Commissioner submitted that severance payments when a business was closed were not incurred in producing profits but were an expense of closing the business. He cited to us the following cases:

i. Strong and Company of Romsey Ltd v Woodifield (1905) 5 TC 215

ii. CIR v the Anglo Brewing Co Ltd (1925) 12 TC 803

iii. Godden v A Wilson's Stores (Holdings) Ltd (1962) 40 TC 161

iv. D13/70, vol 1, IRBRD 21

v. D36/87, vol 2, IRBRD 414

vi. D4/83, vol 3, IRBRD 41

At the request of the Board of Review, reference was also made to CIR v Swire Pacific Ltd (1979) 1 HKTC 1145.

Conclusion

This is a simple case and the submissions put forward on behalf of the Taxpayer, though ingenious, have no merit. Accordingly, the appeal must be dismissed.

Referring first to the submissions made by the representative for the Taxpayer, there is a fundamental difference between the payments in this case and payments made whilst a business is operating in respect of an approved, or indeed an unapproved, provident fund scheme. Payments which are made whilst a business is operating are made in respect of existing employees who are working for the company, in return for their continued services and loyalty to the company. A payment made in respect of past services to an employee who is leaving the service of an employer is made to enable the business to continue to operate and run smoothly in the future. It is not just a payment for past services of a particular employee but is also to encourage other employees to continue to work in the future. Such payments are part of the overall relationship between an employer and his employees and are an integral part of running the employer's business so that profits can be made.

A clear distinction can be drawn with payments which are paid when a business is closed. There are no ongoing profits which can arise from such payments. It may well be that, if the employer had established a provident fund and had made payments during the course of the business, such payments could have been deducted for tax purposes and could be deducted from ultimate severance payments. That is a fact of life. It is in accordance with the law and whether it seems reasonable or fair is not material. There is no equity in taxation.

The Taxpayer's submission that an analogy can be drawn with payments made by limited companies which are required to make payments or incur expenses because they are limited companies is likewise of no merit. A limited company is a method of carrying on a business and has advantages and disadvantages. With due respect to the Taxpayer's representative, it is clear to us that all of the payments to which the representative referred are in fact payments made in the course of a company carrying on its business and making taxable profits. Audit fees are clearly incurred as part of the process of making taxable profits, and this is the situation whether or not they are incurred by a limited company as a

matter of legal obligation or by a private individual as a matter of choice. Many unincorporated businesses have audited accounts and the expenses arising in relation thereto are just as much deductible expenses incurred in the course of making profits as any other such expenses. In citing the example of a company providing accommodation for its directors and owners which is tax deductible, the Taxpayer does not understand the distinction between a company remunerating its employees and a private individual carrying on business on his own account.

The two cases of CIR v Anglo Brewing Co Ltd (1925) 12 TC 803, relating to an ex-gratia payment, and Godden v A Wilson's Stores (Holdings) Ltd (1962) 40 TC 161, relating to a legal liability to pay money in lieu of notice, are of much relevance. Both of these cases clearly state that a payment made in the course of closing down a business cannot be made to earn profits. In the Anglo Brewing case, the company ceased trading and subsequently went into liquidation. Payments were made to employees which were based on length of past service. Rowlatt J in a short judgment made the following statement:

> ' But when we come to the year 1920, the whole thing that they wanted, above all things, was to be delivered from their trade, and not to carry it on; and they said: "As an incident of the deliverance of ourselves from our trade not in order to carry it on, we have got to make some payments, because we cannot turn all these people adrift; it is not a thing that we care to do." 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 trade going, and of making it pay. There was not any such purpose at all. The purpose was to wind it up, and making payments was not a question any longer.'

In the Godden case, a payment was made to a manager of a rubber estate to terminate his employment contract without due notice. The reason behind the payment was that the taxpayer had agreed to sell its rubber estates and had decided to close its business. The Court of Appeal in England held that a payment in lieu of notice arising when a company was closing its business was not a payment which was deductible as being an expense wholly and exclusively expended for the purposes of the trade of the taxpayer.

The Board of Review cases cited to us applied these principles to taxation in Hong Kong.

On the facts of the case before us, it is clear that the severance payments were made to terminate the business of the Taxpayer and not to earn profits. Accordingly, this appeal must be dismissed and the assessment appealed against confirmed.