Case No. D4/83

Board of Review:

L. J. D'Almada Remedios, *Chairman*; Stephen C. C. Cheung, M. W. Kwan & R. E. Moore, *Members.*

3 June 1980.

Profits tax—change in mode of operation—whether cessation of business—whether severance pay a capital expenditure.

The appellant was a company which provided taxis for hire by the general public. Prior to 1979 the appellant employed drivers who were paid a basic salary and received an agreed part of the daily takings. From 1st January 1979, drivers were no longer employed by the appellant but paid the appellant a fixed hire charge for the use of the taxis and retained the daily takings. The appellant made severance payments to the drivers whose employment ceased at the end of 1978. The appellant was assessed to profits tax on the basis that the severance payments were not a deductible expense on the grounds that they were paid on cessation of the appellant's business and were not incurred in the production of profits or alternatively that they were capital expenditure and not deductible. The appellant appealed on the grounds that if there had been a cessation of business the severance payments were required by statute and were therefore part of the employees' entitlement under their contracts of service through which the profits were derived and that in any event there had been no cessation of business merely a change in the mode of operation and the severance payments were of a revenue nature.

Held:

(1) The business continued by a different mode of operation.

(2) The severance payments were not capital expenses and since they were made during the continuance of the business were deductible.

Appeal allowed.

Wong Ho-sang and A. J. Halkyard for the Commissioner of Inland Revenue.
Lawrence Lo of Mak Hing Cheung & Co. for the appellant.

Reasons:

The Company carries on business as taxi operators. From the incorporation of the Company in 1965 up to the end 1978, the Company employed taxi drivers to drive the taxis available for hire by the general public. From the 1st January 1979, drivers were no longer employed. The taxis were hired out to drivers on a shift basis and so far as the public were concerned were available for hire in the same way. Many, but not all, of the drivers were ex-employees. The Revenue takes the view that this change amounted to a cessation of the

Company's former business and a commencement of a new business of deriving income from the hiring out of taxis. As one of the issues that arises in this appeal is whether there was a change of business, it would be convenient if we set out our findings on the modus operandi in which the Company derived income before and after the material date.

Before 1st January 1979

Taxi drivers were employed by the Company. They earned a basic salary per day. Out of the daily takings from each taxi, the first $50 would go to the Company. The balance of the daily takings in excess of $50 would be divided equally between the Company and the driver of the taxi. The daily "takings" would not include tips which the driver would be entitled to keep. Petrol for and maintenance of the taxi would be paid by the Company. The Company would also be responsible for fines payable on traffic summonses. Premia for comprehensive Motor Insurance and Workman's Compensation Insurance would also be paid by the Company.

After 30th December 1978

The taxis were hired out to the taxi drivers of the Company on a shift basis and the taxis had to be returned to the Company's premises daily at the end of each shift. At the end of each day the driver paid to the Company a fixed sum as hiring charge. The daily takings of the taxi were no longer shared but retained by the driver. The driver paid for the petrol. If an accident occurred, the costs of repairs to the taxi if below $500 (which the policy of Insurance does not cover) would be borne equally. If the damage were above $500, the driver would have no liability and the Company would claim on the insurance policy. The Premia for comprehensive motor insurance and Workman's Compensation Insurance would still be borne by the Company. Taxis were hired to former employee or if they were no longer driving for the Company, the taxis were hired to regular drivers who were required to drive 20 days a month. Maintenance, repairs and garaging for the taxis were still borne by the Company.

Common Features:

The taxi drivers were required by contract to drive the taxis for hire by the public. The Company remained responsible for the Vehicle's maintenance, repair, cleaning, garaging, licensing and insurance. It still retained its fixed assets and such other staff as it had as employees and there was no change in the Company's personnel or their terms of service, apart from the taxi drivers, the Company continued to function as owners and operators of a public taxi service before and after 1979.

Severance Payments:

Prior to the change, the Company was advised by the Labour Department that as the drivers were no longer to be employees of the Company, they were entitled to severance payments under the Employment Ordinance. The Company, therefore, paid a total of $359,121 as severance payments to the drivers.

The Issue:

Are the severance payments deductible expenses or outgoings in the computation of the Company's profits? The Revenue says they are not because they are compensation paid on cessation of the Company's business and not an expense or outgoing incurred in the production of profits; alternatively, if there was no cessation of business, the outgoing or expense was a capital expenditure and not deductible. The Company meets that argument by saying, firstly, that even if there was a cessation of business (which is denied), the Company was fixed with a statutory obligation under the Employment Ordinance to make such payments and, as such, the payments became the employees' entitlement under the contract of service by reason whereof the payments were for services rendered by the employees in the production of profits. Secondly, the Company maintains that there was no cessation of business but merely a change in the system or method in the operation of a continuing business and that the severance payments were of a revenue nature.

It is clear that for an expenditure to be deductible it must be of a non-capital nature incurred in the production of income. Payment by way of remuneration to employees are among the prime costs of carrying on a business and, in principle, are allowable deductions because they are made for the purpose of earning the profits. Bonuses paid at an employer's discretion are a proper charge against the profits of his business. Pensions, allowances or gratuities paid by the employers to their servants on retirement may be deductible (even though the contract of employment gives the employee no right to any such payment) in ascertaining the profits of the trade or profession of the employer, because the expectation of receiving such payments on retirement attracts persons into the service of the employer at smaller salaries than they would otherwise demand: **Smith v. Incorporated Council of Law Reporting** (1914) 3 K.B. 674. The same principle applies to a payment made to a servant or director whose services are dispensed with: **Mitchell v. B.W. Noble Ltd.** (1926) 11 T.C. 372. It was held in that case that a sum paid to avoid an action for wrongful dismissal is an allowable deduction as having been expended for the purposes of trade.

> "I think that in the ordinary case a payment to get rid of a servant when it is not expedient to keep him in the interests of trade would be a deductible expense (per Rowlatt J. at p. 413)"

For these reasons it is now generally recognized that, where there is a continuing business, payments made by an employer to his retired employee are a proper charge in arriving at the taxable profits of his business.

It is implicit from these decisions that deductibility is on the premise that such payments are not of a capital nature. The position is no different and the same principle is followed in

other Commonwealth countries where similar or near similar legislation exists. In **W. Nevill & Co. Ltd. v. F. C. of T** (1937) 56 C.L.R. 290, a company introduced a system of joint management. The system did not work out satisfactory and tended to impair the efficient management of the business. In the belief that its abolition would lead to increased efficiency, the company paid a lump sum to the additional managing director in consideration of his cancelling his agreement and resigning from the company. The payment was held deductible. In the course of his judgment, Latham C. J. (at p. 300) said:

> "The payments in question were actually made *bona fide* in the course of business in the interests of the efficiency of the business. In my opinion they fall within the terms of the proposition of Viscount Cave L.C. in **British Insulated and Helsby Cables v. Atherton** (1935) A.C. at p. 443: 'A sum of money expended, not of necessity and with a view to a direct and immediate benefit to the trade, but voluntarily and on the grounds of commercial expediency, and in order indirectly to facilitate the carrying on of the business, may yet be expended wholly and exclusively for the purposes of trade'. The facts in this case show … that the expenditure was made for the purpose of increasing the efficiency of the company and therefore increasing its income producing capacity. It was not a capital expenditure, it was, in my opinion, an expenditure incurred in the course of gaining or producing assessable income."

In that same case Rich. J. remarked:

> "In such an expenditure I can see no characteristics which would make it referable to capital account … The sum is not an expense which fulfills any of the tests laid down in those authorities for an expenditure of a capital nature … In my opinion the retiring allowance is a deductible outgoing."

In the case before us, it is common ground that the main purpose of terminating the employment of the taxi drivers was to boost the Company's profits. We find no distinction, in principle, between the case under consideration and the case to which we have referred. In the **Nevill** case, McTiernan J., puts it in this way:

> "The assessable income of the company was necessarily gained through the agency of its employees and it follows that the expense of providing and maintaining such organisation is to be attributed to the operation of producing the company's income. The maintenance of this income-earning agency involves its adjustments to conditions which arise as those mentioned in the stated case. The expense incurred in effecting these adjustments is also to be attributed to the earning of the company's income. The facts show that the expenditure was incurred to adapt the managerial part of the company's organisation for making profits to conditions affecting its business and as such was incidental to its income-earning activities … There is no substance in the contention that the deduction claimed was an outgoing of capital."

The Revenue's contention is that an expenditure is of a capital nature if the objective was to improve business profits notwithstanding that no new asset was created. In support of this contention we have been referred to the recent case of **Watney Combe Reid & Co. Ltd. v. Pike** (1982) S.T.C. 733, where it was held that compensation paid tenants of "tied"

houses to obtain vacant possession, is a capital expense and not deductible. Watney Combe Reid were members of the Watney Brewery group of companies and possession was to enable the houses to come under the direct management of the management company. That case is clearly distinguishable. The payments were not to employees; they were not expenditure exclusively laid out or expended for the purposes of the taxpayer's companies' trade as required by the U.K. enactment. On the facts of that case they were expenditures on capital assets designed to make them more advantageous and were accordingly capital payments. In the case before us, the payments were not made to obtain possession of the taxis but by reason of a liability arising from the termination of employment.

We, therefore, take the view that severance payments are not capital expenses and if made during the continuance of a business are allowable deductions.

It now remains for us to deal with the question of whether, on the facts, there was a cessation of business at the end of 1978 and the commencement of a new business thereafter. This, again, is a question of fact. There is no hard and fast rule or a point of principle to be applied. In **Gloucester Carriage and Wagon Co. Ltd. v. I.R.C.** (1925) 12 T.C. 720, it was held that the manufacture and sale of railway wagons, and the hiring out of such wagons, may form a single trade:

> "If the company makes a profit by the sale of wagons manufactured by or purchased by them, they are thereby making a profit out of their business, which is, shortly, to manufacture and deal in wagons, and it cannot, in my opinion, matter that by means of the particular wagons they previously earned their profits in another way: (per Warrington, L.J. at p. 744)."

In the case with which we are concerned, the business of the Company was that of taxi operators in a public taxi service. The Company derived profits by the use and operation of their taxis. Did that business come to an end? In our view the answer is in the negative. The Company continued to operate that business but by a different mode. After 1978, the Company was still carrying on the business of owning and operating a public taxi service. It might be different if all of the taxis had been hired to another company which then operated a separate and distinct public taxi service but in this case the Company's taxis continued to ply for hire on a shift basis and the change of status of the drivers was, in substance, only a different method of remunerating them for driving the Company's taxis. The factors in favour, of the continuation of an existing business outweigh the factors in form 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 redendancy. 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.

This appeal is allowed and the case is remitted to the Commissioner to revise the assessment accordingly.