INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D50/88

Profits tax – deductions – special bonus to directors – payment expressed to be subject to a condition that the taxpayer have sufficient funds – condition not fulfilled – whether taxpayer could deduct the unpaid bonus – s 16(1) of the Inland Revenue Ordinance.

Panel: Denis Chang QC (chairman), Ambrose H C Lau and David B K Lam.

Dates of hearing: 17, 18 and 20 November 1987.
Date of decision: 17 November 1988.

The taxpayer company in its accounts made a 'special bonus' to a director. The shareholders' resolution which authorized this bonus was expressed to be subject to the company having sufficient funds to pay the bonus. In fact, owing to bad debts and the pledging of the taxpayer's deposits with its bankers, no funds were in fact available for this purpose. As a result, the bonus was never paid, nor even credited to the director's current account. Instead, the bonus was credited to an account entitled 'provision for special bonuses'.

The IRD disallowed the taxpayer's claim to a deduction for the amount of the bonus. The taxpayer appealed.

Held:

The bonus was not deductible.

(a) The taxpayer had not 'incurred' any expenses as it had not been subjected to a definite liability to pay the bonus. The bonus had been declared subject to a condition, and this condition had not been fulfilled. No right to payment had accrued to the directors.

(b) Where the shareholders and directors of a company are the same, resolutions of the directors may be treated as shareholders' resolutions.

Appeal dismissed.

Cases referred to:

7 CTBR Decision No 1
Express Engineering Works Ltd, re [1920] 1 Ch 466

INLAND REVENUE BOARD OF REVIEW DECISIONS

Lo & Lo v CIR (1984) 2 HKTC 34

J G A Grady for the Commissioner of Inland Revenue.
Stephen C Y Chuk of Chan and Chuk for the taxpayer.

Decision:

The issue in this case is whether the provisions for a 'special bonus' to a director of the Taxpayer company in its accounts for the years ended 30 June 1981 ($2,000,000) and 30 June 1982 ($1,000,000) are allowable deductions under section 16(1) of the Inland Revenue Ordinance which provides that, in ascertaining the profits in respect of which a person is chargeable to tax 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'.

It is common ground that the 'bonuses' in question were not paid during the relevant basis and have never been paid. The Revenue accepts that the mere fact that the 'bonuses' have never been paid does not make the items in question non-deductible if they were in truth expenses 'incurred' during the relevant basis period in the production of profits. It contends, however, that the fact of non-payment is a relevant factor in considering whether the expenses claimed were genuinely incurred during the relevant period.

Both the Revenue and the Taxpayer company apparently agree that an adjustment in 'the current year' might be necessary in a case where a genuine item of expenditure was incurred and deducted from the relevant profits but was not paid by the company (because, for example, the creditor for one reason or other subsequently chose to give up its entitlement via-a-vis the company).

This appeal, however, is not concerned with how such an adjustment should be made if it should ever arise in any particular case. We are concerned only with whether the original deduction from the profits in respect of the 'special bonus' was in each case an allowable deduction.

The following facts are agreed:

(1) The company was incorporated in Hong Kong as a private company in 1979. At all material times, the company was engaged in general trading.

(2) On 1 December 1982, the company through its representatives submitted its profits tax return for the year of assessment 1981/82 together with its audited accounts for the year ended 30 June 1981 and its tax computation. The accounts included an expense item of $2,031,500 in respect of director's

emolument. The notes to the accounts contained, inter alia, the following information:

'Director's Emolument

Special bonus	$2,000,000
For other office	31,500
	$2,031,500'

(3) On 26 May 1983, the company submitted its profits tax return for the year of assessment 1982/83 together with its audited accounts for the year ended 30 June 1982 and its tax computation. The accounts included an expense item of $1,036,000 in respect of director's emolument. The notes to the accounts contained, inter alia, the following information:

'Director's Emolument

For other offices	$ 36,000
Special bonus	1,000,000
	$1,036,000'

(4) In raising the 1981/82 and 1982/83 profits tax assessments on the company, the assessor allowed the deduction of the director's emoluments as charged in the company accounts per facts (2) and (3).

(5) The company did not report to the assessor the directors' emoluments per facts (2) and (3) in accordance with section 52(2) of the Inland Revenue Ordinance. Upon enquiry, the representatives in a letter dated 17 July 1985 stated that:

'the sums accrued for the years ending 30 June 1981 and 1982 amounting to $2,000,000 and $1,000,000 respectively have never been paid to directors as the company has never been able to realise the reported profits for the said years nor has it had any liquid funds or resources to pay the said sums. In view of the aforesaid problems, the board of directors of the company is now considering to write back the said amount of $3,000,000 in the coming year.'

(6) In a subsequent letter dated 16 October 1985, the representatives provided the following further information about the special bonuses:

(a) 'The bonuses have been approved by a directors' meeting. Two copies of minutes of directors' meeting are enclosed for your reference.'

(b) ' The special bonuses had never been paid to any directors and was only a provision.'

(c) ' As the special bonuses were only reserved in the accounts by the company, the directors are not entitled to claim such sums unless the company has available liquid funds as well as realised profits. In view of the substantial loss incurred by the company, the special bonuses have not been paid to directors so far.'

(7) In the auditors' report on the company's accounts for the year ended 30 June 1983, the auditors stated that:

' In view of the recent political turmoil happened in Nigeria, we are unable to express an opinion on the possibility of recovering the balance of bills receivable amounting to $6,098,217 due from debtors in Nigeria West Africa.'

In this connection, the company charged in its accounts and was allowed by the assessor as deductions 'dishonoured bills' in the amounts of $4,389,900 and $10,644,749 for the years ended 30 June 1982 and 30 June 1983 respectively.

(8) On 19 November 1985, the assessor raised on the company the following additional profits tax assessments for the years of assessment 1981/82 and 1982/83 under section 60 of the Inland Revenue Ordinance to disallow 'the provision for special bonus to directors':

	1981/82	1982/83
Additional assessable profits	$2,000,000	$1,000,000
Additional tax payable thereon	$330,000	$165,000

(9) On behalf of the company, the representatives objected to the 1981/82 and 1982/83 additional profits tax assessments on the grounds that:

' the company is liable to pay the special bonuses to the directors as and when the company has sufficient funds. Therefore the bonuses payable to directors are real liabilities of the company.'

(10) In a subsequent letter dated 15 January 1986, the representatives stated that:

(a) ' Our clients confirmed that there is no written employment contract for Mr X. Mr X and the other director of the company are wholly responsible for the profitable running of the company's business and are entrusted to carry out policies laid down by the board of directors on a basis deemed reasonable and fair to both the employer and the

employee. Thus special bonus required to be paid to the directors when the company is generating profits. You will notice that the company has paid a very small amount of salaries to the directors during the past few years.'

(b) 'Copies of the directors' current accounts covering the period from 1 July 1980 to 30 June 1984 are enclosed. The discrepancies between the ledger balances and the balances as stated in the balance sheets at each year represent various adjustments made to the directors' current accounts.'

The representatives also supplied copies of the minutes of the company's shareholders' meeting held on 18 February 1983 and 29 November 1982.

It is not in dispute that the only directors and shareholders of the company are and were at all material times the said Mr X and his wife, Madam X. 99% of the issued and paid-up capital of 2,000 shares of $100 each are and were owned by the husband. The company's articles have at all relevant times been in the form of Table A, article 65 of which provides that 'the remuneration of the directors shall from time to time be determined by the company in general meeting'.

According to the accounts for the year ended 30 June 1981, the (net) profits before taxation amounted to just over $10,600,000 after deducting (among other items) the 'special bonus'. Sales amounted to some $41,540,000. We find as a fact that the company, at least on paper, had a profitable year but that it had 'contingent liabilities' in respect of (i) bills discounted amounting to around US$500,000 and around $12,300,000 and (ii) letters of credit established amounting to about $1,360,000. We also find as a fact that the company had time deposits amounting to just over $8,940,000, all of which had been pledged to secure general banking facilities (in addition to securities furnished by Mr X). Bank balances amounted to only about $80,000 and cash in hand just over $6,000. The bank overdraft was in the region of $750,000. 'Bills receivable' amounted to about $1,000,000.

Minutes described as a board meeting of directors of the company held in June 1981 were produced in evidence. The following resolution appears:

'In consideration of the sales effort contributed by Mr X to the company, it was RESOLVED THAT a sum of $2,000,000 be provided as special bonus to him in the company's accounts for the year ending 30 June 1981, the payment of which is subject to the accounts receivables being actually received by the company and no sales returns being flowed inwards.'

Mr X explained that, if any of the bills which the company had 'discounted' with the bank should be dishonoured, the company would be liable to the bank. Hence, the 'contingent liabilities' referred to in the accounts. He said that there were bills awaiting to be paid (or to be 'retired') by the company's customers in Nigeria, but that in June 1981 he

had confidence that the money would 'be received very soon'; that it was not until towards the end of 1982 that he first encountered difficulties in getting payment from the Nigerian customers; and that the company's financial standing was 'very sound' although the money was 'blocked up' by the bank because the time deposits were pledged. He said he went to the bank to ask it to release some of the moneys deposited so that the company could pay him the bonus, but the bank refused because there were still outstanding bills.

There was also produced in evidence what was described as minutes of a board meeting of directors held in June 1982 which Mr X and his wife said to have attended and at which the following resolution was recorded to have been passed:

> ' In consideration of the sales effort contributed by Mr X to the company, it was RESOLVED THAT a sum of $1,000,000 be provided as special bonus to him in the company's accounts for the year ending 30 June 1982, the payment of which is subject to the accounts receivables being actually received by the company and no sales returns being flowed inwards.'

Mr X conceded that no meeting was in fact held in June 1982 and that the meeting and resolution were 'back-dated', although he could not recall when exactly the minutes were prepared. When asked whether the earlier Board resolution was also 'back-dated', Mr X said he did not think so.

We are however not satisfied that the earlier resolution was in fact passed in June 1981 or indeed at any time during the period ended 30 June 1981. The probabilities are that no meeting was held during the said period and that the minutes were prepared subsequently, and a meeting was deemed to have been held and a resolution passed for the purpose of making a provision for 'special bonus' in the company's accounts. This, we find, was no different from what happened in relation to the admittedly 'back-dated' meeting and resolution pertinent to the $1,000,000 provision. It was on 16 October 1985 that copies of these minutes were supplied to the Revenue, followed on 15 January 1986 by copies of the relevant shareholders' resolutions. These shareholders' resolutions, considered further below, were stated to have been passed at meetings held respectively in November 1982 and February 1983 being the respective dates of the directors' reports accompanying the audited accounts for the year ended 30 June 1981 (submitted to the Revenue along with the relevant returns on 1 December 1982) and the audited accounts for the year ended 30 June 1982 (submitted to the Revenue on 26 May 1983).

We should nevertheless make it clear that our decision would have been the same even if both Board resolutions were passed at meetings duly held within the relevant periods. In our view, neither resolution, even if treated as having been passed during the relevant basis period, resulted in the company incurring an expense during the basis period. In our view, the resolutions did not give rise to any accrued liability on the part of the company for the 'special bonus'. The amounts in question, we find as a fact, were never credited to the directors' current accounts but were credited to an account entitled 'Provision for special bonuses', somewhat similar to the 'Managers' bonus account' in the Australian

case of 7 Commonwealth Taxation Board of Review Decision No 1. Whilst it is perfectly true that deductions under section 16 are not confined to sums actually paid by the taxpayer (see Lo & Lo v Commissioner of Inland Revenue (1984) 2 HKTC 34, the relevant items could not be regarded as 'expenses incurred' during the basis period unless liability had accrued during that period (ibid, pp 72, 73).

We do not read either resolution as conferring on the director a right which vested during the relevant basis period defeasible only by the occurrence of some event or events. We read the resolutions as conferring no vested right at all. They were at best mere authorisations for provision or reservation in the accounts of sums to which no right of payment had or has ever accrued, the right to payment being made subject to 'the accounts receivables being actually received by the company and no sales returns being flowed inwards.' We find as facts that, as at 30 June 1981 and 30 June 1982, the relevant accounts receivables had not or had not all been received. Neither had they all been received by the time the respective audited accounts were prepared and provision made therein for the 'special bonus'. We find as a fact that many of the relevant bills were dishonoured and some sale returns flowed inwards as further elaborated below.

In the said accounts for the year ended 30 June 1982, the turnover by way of sales was some $35,400,000 less some $4,380,000 for 'dishonoured bills' and $79,750 for 'return inwards'. Mr X said in evidence, and we find as a fact, that the dishonoured items were among those bills which had formed the subject of the contingent liabilities appearing in the accounts for the year ended 30 June 1981. The contingent liabilities for the period ended 30 June 1982 actually increased to around US$700,000 and $16,700,000 in respect of discounted bills and $1,730,000 in respect of established letters of credit. We find as a fact that more bills were dishonoured as reflected in the accounts for the year ended 30 June 1983 wherein a sum of over $10,600,000 was charged for dishonoured bills.

We reject the suggestion made on behalf of the company and included in the grounds of appeal that the company had the money to pay the bonuses. The company's time deposits, which increased to $11,600,000 as at 30 June 1982, were all pledged and unavailable for payment of any bonus. The bank balance as at the same date amounted only to $59,263 and cash in hand only $1,000. It was therefore not surprising that the company's representatives should have stated in a letter dated 17 July 1985, in response to the Revenue's enquiries, that the relevant sums 'have never been paid to the directors as the company has never been able to realise the reported profits for the said years nor has it had any liquid funds or resources to pay the said sums'. We find that the condition 'subject to the availability of funds' stipulated in the shareholders' resolutions has never been fufilled. The company had never subjected itself to a definite liability. Thus, the said shareholders' resolutions never gave rise to any accrued right to payment on the part of the director. In our view, whether the shareholders' resolutions are given retrospective effect, insofar as it can be regarded as ratifying the board's acts, or given independent effect, they do not avail the company in this appeal.

In this connection we should mention the fact that the Revenue conceded before us that, since Mr X and his wife were the only directors and shareholders of the company, the rule in Re Express Engineering Works Ltd [1920] probably applied so that the two Board resolutions, if otherwise authentic, could be treated as shareholders' resolutions for present purposes.

In the Australian case 7 Commonwealth Taxation Board of Review Decision No 1, the articles of association of a private company provided that the remuneration of directors and of two joint managing directors should be determined by the company in general meeting. At a directors' meeting held on 25 June 1953, it was resolved to grant three full-time working directors specified bonuses (additional to their wages) to be paid 'as soon as the financial position ... allows, in the meantime to credit a "Managers bonus due" account with the full amount. A 'Managers bonus account' was duly credited with the sum but no action was taken to credit the respective amounts to the individual directors' accounts. The annual general meeting in October 1953 approved the above resolution of the directors. At no material time was any payment made in respect of the bonuses. The Board held that the sum was not a loss or outgoing 'incurred' in the year ended 30 June 1953 within the meaning of section 51(1) of the Income Tax Assessment Act under which all losses and outgoings could be deducted to the extent to which they were 'incurred' in carrying on a business for the purpose of gaining or producing assessable income, provided they were not of a capital nature or otherwise excluded. The decision was in line with other cases which had interpreted the use of the term 'incurred' as covering outgoings to which the taxpayer was definitively committed in the year of income even where there had been no actual disbursement, although the Board stated that it was probably going too far to say that the obligation must be indefeasible. It distinguished between obligations to which the company had completely subjected itself and those which were no more than 'impending, threatened or expected'.

Lord Brightman in the Lo & Lo case (above), while sounding a caveat (at 73) concerning the utility for present purposes of Australian and New Zealand cases that are based on different statutes, likewise distinguished between different types of rights and obligations – absolute, contingent and those which are defeasible in 'possible but unlikely' events (at 72 and 73). In the present case, we find as a fact that, when the directors contemplated making the aforesaid provisions for the 'special bonus', they were, in each case, well aware of the fact that the company did not have the cash to pay the bonuses and we are not satisfied that they believed that the company would soon be in a position to do so. On the contrary, we think they expected otherwise.

For the reasons given above, we would dismiss the appeal and confirm the relevant assessments.