INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D60/91

Profits tax – deduction of legal expenses – whether legal expenses had been incurred in the production of assessable income.

Panel: Howard F G Hobson (chairman), Colin Cohen and Archie William Parnell.

Dates of hearing: 29 and 30 October 1991.
Date of decision: 24 December 1991.

The taxpayer was a limited company which claimed to deduct from its assessable profits a substantial amount which it had incurred by way of legal expenses. It was claimed by the taxpayer that the legal expenses had been incurred in the ordinary course of the business of the taxpayer which had been required to defend proceedings brought against it by a former director of the taxpayer. At the hearing of the appeal, evidence was produced which indicated that there had been a dispute with regard to the shareholding of the company and the legal proceedings related to this dispute.

Held:

The legal expenses had not been incurred in the ordinary course of business of the taxpayer but related to a dispute relating to a contract to sell and transfer shares in the taxpayer. Accordingly the Board held that the expenses had not been incurred by the taxpayer in the production of its taxable profits and were not an allowable expense.

Appeal dismissed.

Cases referred to:

Strong & Co of Romsey Ltd v Woodifield [1905] 5 TC 215
Hammond Engineering Co Ltd v CIR [1975] 50 TC 314
Magna Alloys & Research Ltd v FCT [1980] 11 ATR 276

Doris Lee for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

This appeal arises in consequence of the refusal of the Deputy Commissioner of Inland Revenue (DCIR) to allow the deduction from the company's assessable profits of legal expenses incurred in defending legal proceedings brought by a former director against the Taxpayer and two related companies, as well as against Mr B, one of its directors.

1. FACTS

The Taxpayer, which carried on a professional consultancy business, was incorporated as a private company in Hong Kong in late 1980. Mr B has been a director at all times.

In the absence of a profits tax return, an estimated assessment was raised on the Taxpayer for the year of assessment 1989/90. The Taxpayer objected and in the accounts accompanying the return, a sum of $656,253, was shown as an extraordinary item for legal costs incurred in defending legal proceedings. The grounds of objection stated that these legal costs 'were entirely related to defending a litigation brought by [the Taxpayer's] ex-director for disbursement of remuneration. The case was between [the Taxpayer] and [the Taxpayer's] ex-director who sued the [the Taxpayer] for dishonesty. The ex-director claimed that [the Taxpayer] promised to offer good prospects to him if he could work for [the Taxpayer]. As the legal fee was incurred in defending an employment dispute it is an expense incurred in the ordinary course of business of our client and is therefore allowable for tax purposes'.

The several solicitors' and accountants' invoices submitted with the objection were all addressed to the Taxpayer or its solicitors, save for one by foreign lawyers made out to Mr B.

A copy of the statement of claim in two consolidated actions also accompanied the objection. In that document the Plaintiff, the ex-director, alleged, inter alia, that in 1982 Mr B 'in his personal capacity and/or acting as director of and agent of [the Taxpayer] and [the Taxpayer] orally offered to enter into a contract with the Plaintiff ... [whereby] the Plaintiff ... would receive 50% of the profits made by [the Taxpayer] in which the Plaintiff and the first defendant [Mr B] would each hold 50% of the shares': this was a breach of contract claim. There was also an allegation that [the Taxpayer] had dismissed the Plaintiff as a director and employee without notice and three months remuneration in lieu (that is $60,000) was claimed. There were also allegations of misrepresentation by Mr B. It is clear from the next pleading that the statement of claim was amended twice but we were not shown a copy of that amended pleading.

The defendants' amended defence, a copy of which also accompanied the objection, admitted the liability for the said remuneration but claimed certain set-offs. Mr B denied the breach of contract and misrepresentation allegations.

The quantification of the claim relating to the shares and 50% of the profits depended on valuations of the Taxpayer's based information to be provided by the defendants.

Following a request by the Board on the second day of the hearing Mr B produced some other copies of pleadings including a High Court Judgment of Barnett J delivered in June 1990. It is clear from the latter that by an earlier judgment the trial judge had found against Mr B 'for breach of contract to sell and transfer to [the Plaintiff] 2,500 shares and had ordered the damages to be assessed' but had dismissed the misrepresentation allegations. Without the benefit of a full set of pleadings and the earlier judgment, the judgment of Barnett J, it is not easy to follow but so far as we can gather, it was to serve as the matrix for quantification (not the final figures) of the damages to be paid by Mr B to the ex-director. Though reference is made to the dismissal in the earlier judgment of claims against the Taxpayer, we cannot be sure that these were dismissed in their entirety. There is however no doubt that Barnett J was concerned with assessing damages against Mr B, not the Taxpayer: 'The damages I am called on to assess are the value of a 50% shareholding in [the Taxpayer] at 5 March 1984'.

2. SUBMISSIONS

2.1 The Revenue's submission:

The foregoing are the primary facts. Turning now to the submissions we should mention that Mr B represented the Taxpayer and he was furnished, somewhat belatedly, with copies of the cases to which the DCIR's representative referred. In the latter's submission, after referring to sections 16(1) and 17(1) of the Inland Revenue Ordinance (IRO) and the pleadings which we have already mentioned, she argued that the litigation in question was concerned partly with an employment dispute and partly with a dispute between Mr B and a potential shareholder. The former dispute entailed claims financially trivial when compared with the latter and that consequently the legal fees referrable to the former must have been negligible. She produced figures to show that the total of legal fees paid by the Taxpayer down to the year of assessment 1989/90 was $1,356,122: these were not disputed by Mr B. She then went on to argue that the paramount purpose of defending the action was to protect Mr B, not the Taxpayer, from the breach of contract damages. Hence, the fees concerned should be looked upon as Mr B's own expenses, not the Taxpayer's. Despite Barnett J's judgment being handed down in mid-1990 we were advised by Mr B that the quantification of damages had still not been finalized. It follows that we cannot be sure that the damages against Mr B are substantially greater than those payable by the Taxpayer; the indicia in the judgment of Barnett J suggests they would be but we are unsure.

In support of her contentions the DCIR's representative referred to passages from the following cases:

Strong & Co of Romsey Ltd v Woodifield [1905] 5 TC 215

Hammond Engineering Co Ltd v CIR [1975] 50 TC 314

Magna Alloys & Research Ltd v FCT [1980] 11 ATR 276

2.2 Taxpayer's submission:

The Taxpayer, represented by Mr B, made no submission other than to reiterate the grounds of objection set forth above.

3. AUTHORITIES

In the Strong case damages and costs were awarded against the taxpayer, a brewery which owned public houses, for injuries sustained by a customer when a chimney fell. The then current English tax law on the subject provided (l) that '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 wholly and exclusively laid out or expended for the purposes of such trade manufacture adventure or concern' (rule 1 of cases 1 & 2 of schedule D) and (2) prohibited any deduction being for 'loss not connected with or arising out of' the trade (rule 3 of the first case to the said schedule). Their lordships found that the damages and costs were not 'really incidental' to the Strong's trade, or as expressed by Lord Davey 'were not expended for the purpose of enabling a person to carry on and earn profits in the trade' ... It is not enough that the disbursement is made in the course of, or arises out of, or is connected with the trade or is made out of the profits of the trade. It must be made for the purpose of earning profits.

The Hammond case involved an action by a widow (who during the course of the action suffered from mental disorder) against the company and its directors and others in which she and her husband held shares. There was a settlement in favour of the widow, part of which plus all the costs were paid by the company. The special Commissioners although finding that if the action had not been defended the very existence of the company would have been endangered, held that the nature of the threat changed, after a receiver of the widow's affairs was appointed by the Court of Protection. Accordingly, the amounts borne by the company were not laid out wholly and exclusively for the purpose of the company's trade. The Commissioners in effect found that the said threat was occasioned by the widow's irrational behaviour but upon the receiver being appointed, that behaviour ceased to have any further influence. On appeal Templeman J upheld the Commissioners in these words 'it was in my judgment open to the Commissioners to conclude, after seeing the witnesses, that the indemnities and the sum paid thereunder were granted and paid exclusively for the purposes of the trade, or alternatively were wholly or partly granted and paid for other purposes, such as the securing of the positions of the shareholders and directors personally'.

In the Magna Alloys case the taxpayer employed agents to whom points were awarded according to sales performances which could be converted into gifts; apparently

some agents passed these on to purchasers' employees. Criminal proceedings were brought against the taxpayer, its directors and some agents on the grounds that the practice led to purchasers' employees receiving secret commissions. The charges against the taxpayer were abandoned but the agents and directors were convicted of conspiracy and fined. The taxpayer paid the legal costs of all parties concerned and sought to set the payment against its profits tax. The headnote summarizes the decision of the Full Court of the Federal Court of Australia as follows:

(1) the fact that the directors may have been motivated by consideration of their own position in making the payments did not prevent the conclusion that the outgoings were reasonably capable of being seen as desirable and appropriate from the point of view of the pursuit of the business ends of the taxpayer's business;

(2) the expenditure was not of a private or domestic nature in that the criminal charges arose from commercial activities on the taxpayer's behalf. The expenditure was not of a capital nature in that the criminal proceedings imperilled neither the business nor the capital assets of the taxpayer;

(3) neither the authorities nor questions of public policy dictated that the costs of defending criminal proceedings should not be an allowable deduction.

4. INLAND REVENUE ORDINANCE

The relevant parts of appropriate sections of the Inland Revenue Ordinance reads as follows:

16(1) 'In ascertaining the profits in respect of which a person is chargeable to [profits] tax ... for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basic period for that year of assessment by such person in the production of profits in respect of which he is chargeable to [profits] tax ... for any period, including' [the following paragraphs (a) to (h) have no application]

17(1) 'For the purpose of ascertaining profits in respect of which a person is chargeable to [profits] tax ... no deduction shall be allowed in respect of ...

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

5. DELIBERATION

It will be seen that the Hong Kong criteria differs from the English provisions referred to in the Strong case above – in particular by the absence of the words 'wholly and exclusively' to be found in rule 1 of schedule D, the Hong Kong equivalent of which, that is 'to the extent to which', has a far broader effect, implying that apportionment is permissible. However the passage quoted from Lord Davey's judgment is in keeping with (b) of section 17(1). It is more difficult to make an analytical comparison of the relevant Australian tax provisions because nowhere in the Magna judgment is the deductibility section (51(1) of the 1936 Act) quoted in full. Nonetheless the criteria for deductibility appears to be expenses 'incurred in gaining or producing the assessable income' and 'necessarily incurred in carrying on a business for the purpose of gaining or producing such income'. Brennan JJ considered that the conduct of the Magna directors which was impugned by the laying and prosecution of the charges was conduct by which a part of Magna's business was carried on. He went on to say that 'True enough the allegations carried the risk of conviction and punishment only for those accused of offenses' [which during the hearing of the criminal proceedings excluded Magna] ... 'but the allegations nevertheless attacked its business methods'. He therefore held that the expenditure 'bears the character of expenditure necessarily incurred in carrying on of Magna's business'. Later he remarked 'expenditure incurred in attempting to vindicate the business methods of the Taxpayer, overcoming an obstacle to its trading which had been raised by the prosecutions is properly regarded as a cost on revenue account'.

We think it is perhaps easier to appreciate this judgment if the point is expressed in the converse. If the prosecutions of the directors had failed then Magna would have been able to continue to adopt marketing methods which themselves were an attempt to earn profits for Magna: hence the legal costs incurred could be seen to be incidental to the further pursuit of income.

6. CONCLUSION

With these remarks in mind we have no hesitation in finding that the legal costs incurred by the Taxpayer in the instant case – whether they related to defending Mr B against the breach of contract charges or the Taxpayer in relation to the Plaintiff's claim to three months remuneration – were not expenses incurred by the Taxpayer in the production of company profits.

Accordingly we dismiss this appeal.

In closing we should mention that there was a preliminary issue as to whether the Taxpayer had complied with the one month requirement in section 66(1)(a) of the Inland Revenue Ordinance. On the evidence before us we were satisfied that the company appealed within one month of receipt of the DCIR's written determination notwithstanding that the letter sending the determination was itself dated a few days earlier than one month. In other words we took the view that 'transmission' involves not merely the act of sending but also receipt by the Taxpayer.