INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D61/94

Profits tax – deductibility of severance payment against profits when business closed.

Panel: William Turnbull (chairman), Colin Cohen and Terence Tai Chun To.

Dates of hearing: 14 July, 1 September 1993 and 21 July 1994.
Date of decision: 9 January 1995.

The taxpayer was a limited company which paid severance or termination payment to its employee when the business of the taxpayer was closed. The assessor refused to allow these payments to be deducted as expenses of the business. The assessor maintained that the payments were not expenses incurred in the production of assessable profits. The taxpayer argued that the severance or termination payments were made in accordance with the Employment Ordinance and enabled the taxpayer to operate profitably prior to the closing of its business.

Held:

The paramount purpose for incurring the expenses which were the subject matter of the appeal was the production of assessable profit. The long service or redundancy payments acted as an incentive for the workers to continue to work in a loyal and diligent manner up to the time when the business was closed. Accordingly the payments were deductible and the appeal was allowed.

Appeal allowed.

[**Editor's note**: The Commissioner has filed an appeal against this decision.]

Cases referred to:

Strong & Company of Romsey Limited v Woodifield 5 TC 215
CIR v The Anglo Brewing Co Ltd 12 TC 803
Godden v A Wilson's Stores (Holdings) Ltd 40 TC 161
D13/70, IRBRD, vol 1, 21
D36/87, IRBRD, vol 2, 414
D38/88, IRBRD, vol 3, 365
D4/83, IRBRD, vol 2, 41
Report of the Third Inland Revenue Ordinance Review Committee
CIR v Swire Pacific Ltd [1979] HKTC 1145
CIR v Lo & Lo [1984] 2 HKTC 34

Maria Tsui for the Commissioner of Inland Revenue.

Taxpayer represented by his managing director.

Decision:

This is an appeal by a limited company against a profits tax assessment for the year of assessment 1990/91 wherein the assessor has refused to allow the Taxpayer to deduct certain severance or termination payments made when the business of the Taxpayer was closed. The facts are as follows:

1. The Taxpayer was incorporated in Hong Kong as a private company in March 1967 and commenced business on 16 April 1968. The Taxpayer carried on business as a manufacturer.

2. The Taxpayer operated a factory in Hong Kong where it employed a workforce of approximately 123 persons. Many of the employees had been employed by the Taxpayer for many years and the majority had been working for periods of more than 10 years with a significant number having more than 15 years of service and in some cases more than 20 years of service.

3. The factory which the Taxpayer operated was situated in a factory building which for convenience we will describe in this decision as 'the factory building'.

4. In 1988 the Taxpayer became aware of the fact that the owner of the factory building intended to redevelop the same. This became known to the Taxpayer because its managing director, Mr X, was also a director of the landlord company. The landlord was the ultimate holding company of the Taxpayer. In the financial year 1987/88 the Taxpayer established a long service payment fund reserve of $1,500,000. This was included in the audited accounts of the Taxpayer for the year ended 31 March 1988. Mr X was also aware that the landlord did not propose to demolish the factory building before the end of 1990. However notice to quit was given by the landlord to the Taxpayer in October 1989.

5. By early 1990 the workers who worked in other factories in the factory building as well as the employees of the Taxpayer became aware of the fact that the factory building would be demolished and the factories therein closed. This was caused by a number of events which included the fact that the landlord had given notice to quit in October 1989 and had conducted a ground floor site investigation in February 1990.

6. The Taxpayer continued to operate its factory until March 1991 when its factory was finally closed and its employees discharged. Throughout the financial year commencing 1 April 1990 up to the closure of the factory on 9 March 1991 the long service employees of the Taxpayer remained loyal and continued to work for the Taxpayer until they were made redundant when the

factory closed. However those employees who were recruited during the final year of operation of the factory almost without exception resigned from their employment shortly after starting work and showed no loyalty to the Taxpayer.

7. During the financial year 1990/91 the Taxpayer was able to continue its business profitably.

8. When the Taxpayer closed its factory it gave notice to all of its employees in accordance with its contractual and legal obligations to them. It paid to all of its employees their full entitlement to severance pay under the laws of Hong Kong which amounted to a total sum of $2,937,981.

9. Production at the factory of the Taxpayer ceased on 9 March 1991 and the last sale by the Taxpayer took place on 20 March 1991.

10. With a few exceptions all of the employees of the Taxpayer were made redundant in the months of December 1990 and January and February 1991.

11. The Taxpayer filed a profits tax return for the year of assessment 1990/91 in which it declared a loss of $1,908,708. In its profit and loss account for that year it included as an expense the long service payments of $2,937,981.

12. The assessor refused to allow the sum of $2,937,981 as a deduction and added the same back to the Taxpayer's returned loss together with the sum of $92,400 being a bonus payment which was not allowable. Accordingly the assessor on 18 November 1991 issued a tax assessment to the Taxpayer made up as follows:

Year of Assessment 1990/91
(Basis period: year ended 31 March 1991)

	$	$
Loss per return		(1,908,708)
Less: Long Service Payment	2,937,981	
Bonus as agreed	92,400	3,030,381
Assessable Profit		$1,121,673
Tax Payable thereon		$185,076

'**Assessor's Note:**

As all the staff and workers are laid off due to cessation, the long service payment is severance pay. Such payment is neither for employee's past service

nor future service and it will not give any future benefit to the company. As a result, it is not an outgoing or expense incurred in the production of profits and it is not deductible under section 16(1) of the Inland Revenue Ordinance (the IRO).'

13. The Taxpayer objected to this assessment and the matter was referred to the Commissioner of Inland Revenue.

14. By this determination dated 31 March 1993 the Commissioner upheld the principle on which the assessor had assessed the Taxpayer to profits tax but reduced the assessable profits from $1,121,673 with profits tax payable thereon of $185,076 to assessable profits of $957,055 with tax payable thereon of $157,914. The reason for deducting the sum of $164,618 from the assessable profits of the Taxpayer was because the Commissioner was of the opinion that certain payments made to employees before January 1991 were not severance payments and should be allowable as expenses.

15. By notice dated 20 April 1993 the Taxpayer duly gave notice of appeal to this Board of Review.

At the hearing of the appeal the Taxpayer was represented by its managing director, Mr X, and the accountant of the Taxpayer was called to give evidence.

The evidence of the accountant was to the effect that the Taxpayer had a stable workforce of loyal employees who had continued to work for the Taxpayer until they were made redundant when the factory was closed. During the final year of operation some new workers were recruited but they resigned shortly after being recruited. Under her supervision, notice of termination of service had been served on the employees and long service redundancy payments had been made to the employees in accordance with the Taxpayer's contractual obligations to them and the laws of Hong Kong.

The representative for the Taxpayer submitted that this was an unusual case because the workers had known so long in advance that the Taxpayer would be closing its factory. In such circumstances he submitted that the workforce would not be prepared to work loyally until the end. However they knew that they would receive long service payments if they worked diligently until the factory was closed. If, however, they either resigned or were dismissed because they did not perform their services properly then they would not be entitled to any long service payments. He said that the Taxpayer had continued to operate its factory until the last possible time because the Taxpayer was making good profits and it was in the interests of the Taxpayer to carry on for as long as possible. He said that in the last year of operation the Taxpayer had actually made larger profits because it had been able to convert its work in progress and raw materials into finished products without wastage or loss.

He said that if severance pay had not been paid to the employees then they would have sought new employment when they heard that the factory would be closed down and he pointed out that the loss of a few key workers could jeopardize the operation of the factory and it would not be possible to recruit new staff when it was known that the

factory would close down in the near future. If this had happened then the Taxpayer would have been forced to close its factory prematurely and there would have been no profit and the possibility of even being insolvent.

The representative for the Taxpayer drew our attention to the wording of section 16(1) of the IRO which allowed the deduction of outgoings and expenses incurred during the basis period if such expenses are incurred in the production of profits for any period of time and not necessarily the basis period. He pointed out that severance pay was a payment made in respect of past services and the quantum of severance pay depended upon the length of time that a person had worked for the employer.

The representative for the Commissioner said that in his determination the Commissioner had allowed payments made to six employees to be deducted because they were not severance payments. However with regard to the remainder she submitted that they were severance payments made to the employees of the Taxpayer on the termination of the business of the Taxpayer and should not be allowed as deduction for profits tax purposes. She referred us to sections 16(1) and 17(1)(b) of the IRO and said that expenses could only be deducted insofar as they were 'expended for the purpose of producing such profits', that is, profits in respect of which a person is chargeable to profits tax. She said that from the foregoing it was clear that in order to be deductible the payment must be incurred in the production of chargeable profits and that it was not enough that the payment was made in the course of, or arises out of, or is connected with the business. She said it must be made for the purpose of earning the profits.

She referred us to the following cases and authorities:

Strong & Company of Romsey Limited v Woodifield 5 TC 215
CIR v The Anglo Brewing Co Ltd 12 TC 803
Godden v A Wilson's Stores (Holdings) Ltd 40 TC 161
D13/70, IRBRD, vol 1, 21
D36/87, IRBRD, vol 2, 414
D38/88, IRBRD, vol 3, 365
D4/83, IRBRD, vol 2, 41
Report of the Third Inland Revenue Ordinance Review Committee

The representative for the Commissioner submitted that the severance payments did not act as inducements for the employees to continue working until the factory was closed. She said that the payment was something which every employee is entitled to receive under the Employment Ordinance and was not a voluntary payment by the Taxpayer. She said that severance payments were not payments for the employees' past services but were made in order to terminate the employment upon the cessation of business. She said that the severance payments were merely a compensation required by law upon and for the purpose of the closure of the business and as the business ceased there were no ongoing profits which could arise from the severance payment.

She submitted that the submissions made by the representative for the Taxpayer were not founded on good evidence before the Board. She said that there was no evidence to show that the Taxpayer had as early as 1988 decided to close down the factory

or that the provision for long service pay made by the Taxpayer in its accounts for the year ended 31 March 1988 was in fact made in anticipation of the cost of future redundancy payments. She pointed out that the amount reserved had not been sufficient to cover the cost of the redundancy payments. She went on to say that there was no evidence that the employees had become aware of the impending closure of the factory as early as February 1990 or that the Taxpayer had notified its workers of the impending closure or had assured them that they would receive their statutory long service pay as severance pay. She did not accept that the severance payments or the assurance that the employees would receive severance payments had induced the employees to continue to work and said there was no evidence to indicate that the workers would have quit their jobs had there been no assurance that they would receive severance pay. She had analyzed the long service and the age of the workforce and had found that many of the workers were quite old with long service and that some 87% of the workforce were 45 years of age or older. She said that over 70% of the employees were age 55 or above and were therefore overdue for retirement. She said that in such circumstances the employees would not have been able to find alternative employment in any event and that the severance payments were not an inducement for them to continue to work for the Taxpayer.

The question which we have to decide in this case is quite clear and precise. The Taxpayer had decided to close down its factory and terminate the employment of its employees. It did so and complied with all of its contractual obligations and the laws of Hong Kong. The employees were entitled to severance pay calculated according to their years of service upon the Taxpayer closing its business and terminating the employment of its employees. The question which we have to decide is whether or not severance payments made according to the laws of Hong Kong on the termination of the business of the Taxpayer should be allowed as deductions for profits tax purposes.

We would like to praise the managing director of the Taxpayer who appeared before us and ably handled the case of the Taxpayer. He chose not to give evidence himself but to call the accountant of the Taxpayer who from her own personal knowledge was able to give evidence with regard to the closure of the business of the Taxpayer and the termination payments made to the employees. She was also able to clearly say that the notice of termination of employment had been served on the employees in accordance with the contractual obligations of the Taxpayer and the laws of Hong Kong.

Though the representative for the Commissioner tried to attack the case of the Taxpayer on the ground that there was no evidence before us to substantiate what the Taxpayer's representative had said we have no hesitation in rejecting these parts of her submissions. We find as facts that the employees of the Taxpayer knew of the impending closure of the business of the Taxpayer long before the closure took place. It is not necessary for us to give a precise date to this knowledge. The witness who gave evidence stated that the workers knew about the impending closure because they had heard about the other factories in the building closing down. Indeed it was under cross examination that the witness said that the employees knew as early as March 1990 that the factory building was going to be demolished because some other factories in the same building had earlier received notice and moved away.

The law relating to severance pay and termination and redundancy benefits is well known in Hong Kong and has been well publicized by the Hong Kong Government. Workers in Hong Kong are well aware of their rights and this applied to those employed by the Taxpayer. We find as a fact that they would have known of their rights and would have known that they were entitled to severance pay provided that they continued to work for the Taxpayer until such time as they received termination notices. They would have known that the only circumstances in which they could receive severance pay would be if they continued to work for the Taxpayer until it closed its factory. They would have known that if they resigned their employment or failed to perform their duties properly and were dismissed for cause they would forfeit whatever rights they might otherwise have to redundancy payments. In such circumstances we find as a very clear fact that the knowledge of the impending closure of the factory and of their rights to redundancy payments on the closure of the factory was a very real incentive for the employees to continue to work until the factory was closed.

It appears to us that the redundancy payments paid by the Taxpayer on the closure of its factory should be deductible as expenses when assessing liability to profits tax.

Redundancy or severance payments are calculated according to the length of service and clearly and obviously must relate to past services. If they do not relate to past services then each and every employee would be entitled to the same sum upon severance. That is not the law. The quantum of each payment directly relates to the length of service. In such circumstances it is impossible to say that severance pay is anything other than a payment related to past service. It is a reward given to a worker upon the termination of his employment in recognition of the work which he has performed previously. It can be nothing else.

As was pointed out by the representative for the Taxpayer section 16(1) makes it quite clear that outgoings and expenses can be deducted if they are incurred in the production of profits for any period and not necessarily the basis period. For ease of reference we quote section 16(1) as follows:

> *'In ascertaining the profits in respect of which a person is chargeable to tax under this Part 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 under this Part for any period, including:'*

We recognise that section 17 excludes certain expenses and section 17(1)(b) reads as follows:

> *'(1) For the purpose of ascertaining profits in respect of which a person is chargeable to tax under this Part no deduction shall be allowed in respect of:*

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

When these two provisions of the IRO are taken together it is clear that an expense which is paid in a subsequent year in respect of profits chargeable to tax in a previous year are capable of deduction. In the present case the employees worked for the Taxpayer and earned a prospective entitlement to severance pay or long service pay. Under the Employment Ordinance this entitlement to severance or long service pay would crystallize and the sum become payable upon certain future events. One of the future events would be the closure of the factory which occurred in the case before us. At that moment in time the employer is required to make immediate payment of entitlements which have accrued over a number of years on a contingent basis. In such circumstances it would appear to us quite clear that the expenses are monies which have been expended for the purpose of producing past profits. They are in no way an ex-gratia payment.

Severance or long service pay is a clear inducement for loyalty amongst employees. Severance and long service payments under the Employment Ordinance are rewards to employees who have given long and loyal service to one employer. For someone with a few months or even one or two years employment the benefits are of little interest. 'Rolling stones gather little or no moss', but once the employee stops rolling he soon acquires a contingent entitlement to substantial moss. However he is only able to make the benefits vest or become payable by continuing to work in a loyal fashion for his current employer until the benefits vest and become payable in the form of long service payments or severance payments. For any employee with a number of years of service the benefits provided by the Employment Ordinance are a very real incentive to continue working.

Long service and severance payments accrued year on year and represent a continuing and growing contingent liability of any business. The expectation which employees have of such future payments help the employer to make assessable profits during each such year.

In the present case it is quite clear that if it had not been for severance pay the employees of the Taxpayer might well have felt little loyalty to continue to perform their services. In this regard and as a matter of fact we totally disagree with the submission made by the representative for the Commissioner. Indeed we have actual evidence before us that employees with no entitlement to severance pay were not loyal till the end as opposed to long standing employees.

The representative for the Commissioner did not cite to us the decided cases of CIR v Swire Pacific Ltd [1979] HKTC 1145 nor CIR v Lo & Lo [1984] HKTC 34. We drew both cases to the attention of the representative for the Commissioner.

The Swire Pacific case related to the closure of the Tai Koo Dockyard in 1972. Shortly before the Dockyard was due to be closed the employees went on strike and to persuade them to return to work for a short period of just over three months the employer agreed to make and in due course made a very substantial payment in the form of retirement grants to workers. It was held that these retirement grants were capable of being deducted for profits tax purposes because they had been incurred to enable the company to continue

in operation for a short period of just over three months. The fact that the payments were very substantial in respect of a short period of time was not a factor which stopped their being allowable.

The Lo & Lo case referred to a firm of solicitors practising in Hong Kong who made provision for long service benefits to their employees but did not pay out the money. They claimed that the provision was capable of being allowed against their taxable profits when the provision was made even though it was not paid out at that time. The Lo & Lo case decided that liabilities can be deducted for profits tax purposes even though they may not yet have matured.

This Board had difficulty in reconciling the Swire Pacific and the Lo & Lo cases with the cases and decisions cited to us by the representative for the Commissioner. Before reaching its decision the Board invited the parties to make further representations and the Board had the benefit of Crown Counsel appearing before it in an amicus curiae role rather than as representing the Commissioner. Both Crown Counsel and the Board were conscious of the fact that the Taxpayer was not legally represented. Crown Counsel was of great help and assistance to the Board. He put forward a very short and simple test which should be applied in cases of this nature and with which the Board is in total agreement. The test suggested by Crown Counsel was:

> 'What was the paramount purpose of the expenses incurred? Were they incurred mainly and substantially in the production of profits?'

It is not possible to frame the question which we must decide in this case more succinctly or clearly.

Having heard the evidence and found the facts of this case we are able to say that the paramount purpose for incurring the expenses which are the subject matter of this appeal was the production of assessable profit. They were incurred mainly and substantially for this purpose. As we have found above the workers were induced to continue to work for the Taxpayer in a loyal and diligent manner because, if they did so, they would be entitled to long service or redundancy payments. This enabled the Taxpayer to continue to run its business profitably up to the moment when it closed down its operations. We are satisfied that if it had not been for the employees' expectation and entitlement to this payment, the Taxpayer would not have been able to carry on its business as it did. The payments were not expenses incurred to close down and terminate the business. They were payments made to satisfy contractual and statutory obligation which the Taxpayer had incurred in the course of running its business and earning its profits which were assessable to tax.

For the reasons given we allow this appeal and remit the assessment against which the Taxpayer has appealed back to the Commissioner to reduce the amount thereof by deducting from the assessable profits of the Taxpayer the expenses which the Commissioner has disallowed and which are the subject matter of this appeal.