Case No. D99/01

Profits tax – whether fines can be deducted as outgoings and expenses under section 16 of the Inland Revenue Ordinance (‘IRO’) – whether the taxpayer requires to show that an item of expenditure or outgoing is ‘necessarily’ incurred.

Panel: Benjamin Yu SC (chairman), James Julius Bertram and Kenneth Leung Kai Cheong.

Dates of hearing: 26 June and 4 July 2001.
Date of decision: 12 November 2001.

The taxpayer is the sole proprietor of Company B and at all relevant times, Company B carried on a construction business. The taxpayer objected against the profits tax assessment for the year of assessment 1998/99 for the adjustment of the fines incurred in respect of the abuse in the Noise Control Ordinance (‘NCO’). The assessor was not satisfied that the fines were deductible and the taxpayer objected to the assessment.

It was the contention of the taxpayer that the breaches of the environmental regulations were unavoidable and fines were incurred for the purpose of directly or indirectly earning assessable profits, and should be tax deductible.

Held:

1. Prima facie, the statutory provisions of Hong Kong bear closer similarity to the Australian Income Tax Act, and from that point of view, one may argue that the Board should regard the Australian authorities as more persuasive. The English Act, which is couched in terms of ‘loss connected with and arising out of’ the trade may be said to be imposing a different test. However, the Board has noted what Scrutton LJ said in the von Glehn case which would suggest that this may be a distinction without a difference. More importantly, Lord Hoffmann’s explanation of the Warnes case and the von Glehn case suggests that the question does not depend so much on the precise test formulated in the statute, but the presumed intention of the legislature (CIR v EC Warnes & Co Ltd 12 TC 226 and CIR v Alexander von Glehn & Co Ltd 12 TC 232 considered).

2. A taxpayer can only claim deduction for fines he paid if he can establish, both as a matter of fact and as a matter of law, that the fines were outgoings or expenses which

were incurred in the production of the profits. Further, in deciding whether fines can, as a matter of law, be regarded as outgoings or expenses one has to look for the intention of the legislature. As advocated by the courts in England, Australia and New Zealand, the Board agrees that one should start with the presumption that the legislature would not normally sanction deduction as to do so would undermine the intention of the legislative provision which imposes the statutory obligation and the levying of the fines. To allow fines to be deducted as business expense would no doubt encourage business traders into believing wrongly that they could regard the fines merely as a business expense item. On the other hand, disallowing deduction would have the merit that business traders are treated in the same manner as all other members of the community who break the law and incur the penalty of a fine (FCT v Midland Railway Company of Western Australia Ltd (1952) 85 CLR 306, CIR v EC Warnes & Co Ltd 12 TC 226, CIR v Alexander von Glehn & Co Ltd 12 TC 232, McKnight v Sheppard (1999) STC 669, Herald and Weekly Times Ltd v FCT (1932) 48 CLR 113, Madad Pty Ltd v FCT 15 ATR 361, Mayne Nickless Ltd v FCT 15 ATR 752, Nicholas Nathan v CIR [1989] 3 NZLR 103, British Columbia Limited v Her Majesty The Queen [1999] 3 SCR 804, Strong v Woodifield 5 TC 215, Commonwealth Taxation Board of Review Decision Case No 102 (1955) 5 CTBR(NS) 599, Commonwealth Taxation Board of Review Decision Case No 68 (1965) 12 CTBR(NS) 378, FCT v Snowden and Wilson Pty Ltd (1958) 7 AITR 308 considered).

3. The Board does not find much difficulty in reconciling this approach with the position of the Revenue in seeking to tax income from illicit activities. One can see very little reason why a person who derives income from illicit activities should be allowed to rely on his own illegality in evading his obligation to pay tax. The Board sees no inconsistency in the law saying at the same time that a person cannot rely on his own illegality in seeking to claim a deduction. The Board also tends to think that it is open to the courts and indeed this Board to start with a presumption of what the legislature may have intended. After all, this is but a rebuttable presumption. The Board and the courts must still strive to find the intention of the legislature by the normal process of construction (British Colombia Limited v Her Majesty The Queen distinguished).

4. The Board found nothing in the IRO to rebut the presumption. The Board finds, therefore, that as a matter of law, fines are not deductible under section 16 of the IRO. This renders it unnecessary for the Board to decide whether, as a matter of fact, the fines were incurred for the production of the income. The Board should, however, record that if it be necessary for the Board to determine that issue, it would hold that if the fines can be regarded in law as business expenses, they were indeed incurred in the production of the income.

5. Much of the evidence adduced before the Board went to the question whether the fines were necessarily incurred, in the sense that the taxpayer had no option but to conduct himself in the way he did, with the result that the fines were unavoidable. Since section 16 does not require a taxpayer to show that an item of expenditure or outgoing is 'necessarily' incurred, it seems to the Board that it would be wholly academic for the Board to decide on this question either. None of the cases shown to the Board suggests that it would make any difference to the court's approach even if the fines were an inevitable part of the business. Should the Board be found to be wrong on this, the Board should record its view that the taxpayer has not shown to its satisfaction that the breaches were inevitable. As it is the Board's view that the suggested issue does not really call for its determination, the Board will not in the circumstances elaborate on the reasons for coming to this view.

Appeal dismissed.

Cases referred to:

FCT v Midland Railway Company of Western Australia Ltd (1952) 85 CLR 306
CIR v EC Warnes & Co Ltd 12 TC 226
CIR v Alexander von Glehn & Co Ltd 12 TC 232
McKnight v Sheppard (1999) STC 669
Herald and Weekly Times Ltd v FCT (1932) 48 CLR 113
Madad Pty Ltd v FCT 15 ATR 361
Mayne Nickless Ltd v FCT 15 ATR 752
Nicholas Nathan v CIR [1989] 3 NZLR 103
British Columbia Limited v Her Majesty The Queen [1999] 3 SCR 804
Strong v Woodifield 5 TC 215
Commonwealth Taxation Board of Review Decision Case No 102 (1955) 5 CTBR (NS) 599
Commonwealth Taxation Board of Review Decision Case No 68 (1965) 12 CTBR (NS) 378

FCT v Snowden and Wilson Pty Ltd (1958) 7 AITR 308

Ng Yuk Chun for the Commissioner of Inland Revenue.
Au Sze Kung of Messrs S K Au & Co, Certified Public Accountants, for the taxpayer.

Decision:

The appeal

1. This is an appeal by Mr A, trading as Company B ('the Taxpayer'), against the determination of the Commissioner of Inland Revenue dated 15 February 2001 whereby the Commissioner increased the profits tax assessment on the Taxpayer for the year of assessment 1998/99 from $2,125,219 to $2,580,932 with tax payable thereon of $387,139.

2. At the time of the determination, a number of issues were raised by the Taxpayer in objection to the profits tax assessment on his firm's business. These included issues concerning the deductibility of certain interest expenses and whether certain bank interest income should be exempt from tax. Those issues have since been resolved between the parties. What remains in issue between the parties is the deductibility of the fines (totalling $636,000) which were incurred by the Taxpayer as a result of breaches of the NCO and the Factories and Industrial Undertakings Ordinance ('FIUO') during the relevant year of assessment. The Taxpayer claims that they should be allowed as deduction under section 16 of the IRO. During the hearing, we were further told that the Taxpayer did not pursue his claim for deduction in respect of fines imposed under the FIUO. The only question, therefore, which the Board is asked to consider is whether fines incurred by the Taxpayer for breach of the NCO can be deducted as outgoings and expenses under section 16 of the IRO.

3. There is no dispute on the facts stated in the determination. We set out below the facts which are relevant to this appeal.

(a) The Taxpayer is the sole proprietor of Company B ('the Firm'). At all relevant times, the Firm carried on a construction business.

(b) In his tax return for the year of assessment 1998/99, the Taxpayer declared that the Firm derived assessable profits of $932,348, which were arrived at after charging, among other things, environmental and industrial fines of $636,000 ('the Fines').

(c) The assessor raised on the Taxpayer the following profits tax assessment for the year of assessment 1998/99:

	$	$
Profit per return		932,348
Add: The Fines	636,000	
Bank interest income	556,871	
		1,192,871
Assessable profits		2,125,219
Tax payable thereon		318,782

(d) The Taxpayer, through Messrs S K Au & Co ('the Representatives'), objected against the profits tax assessment for the year of assessment 1998/99 in the following terms:

(i) Adjustment of bank interest income $556,871

...

(ii) Adjustment of the Fines

'The amounts were incurred in respect of the abuse in Noise Control Ordinance ("the NCO"). [The Firm] is a large construction company engaged in construction work. To meet the construction work schedules, it was unavoidable to abuse the regulation related to the environmental protection affair in some occasions. This expense was regarded as inherent expense to be incurred to produce the assessable profit.'

(e) Upon the assessor's request, the Representatives provided the following information:

(i) By letter dated 10 February 1998, the Hong Kong Housing Authority ('HKHA') notified the Firm that its tender for the construction project at Site C ('the Project') was accepted. The conditions of contract attached to the letter contain, inter alia, the following clauses:

Clause number	**Particulars**	
47	Period of time after acceptance of tender within which the notified date for commencement shall occur	four weeks
49	Time for completion of the works	eight months
52	Amount of liquidated damages for the works	$42,000 per day

(ii) The Fines were incurred in connection with the Project, details of which are as follows:

Date of event	Contrary to	Amount of fine $
17-4-1998	Sections 6(2)(a) and 6(5) of the NCO	20,000
5-7-1998	Sections 6(1)(a) and 6(5) of the NCO	50,000
5-7-1998	Sections 6(2)(a) and 6(5) of the NCO	50,000
16-8-1998	Sections 6(1)(a) and 6(5) of the NCO	100,000
16-8-1998	Sections 6(2)(a) and 6(5) of the NCO	100,000
20-8-1998	Regulations 10(3) and 20(1) Factories and Industrial Undertakings (Woodworking Machinery) Regulations made under the FIUO	8,000
20-8-1998	Regulations 10(4) and 20(1) Factories and Industrial Undertakings (Woodworking Machinery) Regulations made under the FIUO	8,000
10-9-1998	Sections 6(1)(a) and 6(5) of the NCO	100,000
10-9-1998	Sections 6(2)(a) and 6(5) of the NCO	100,000
13-9-1998	Sections 6(1)(a) and 6(5) of the NCO	50,000
13-9-1998	Sections 6(2)(a) and 6(5) of the NCO	50,000

(f) The Representatives also put forth the following arguments to support their claim that the Fines should be allowable expenses:

(i) ' [The Fines] involved [the Project] ... which was taken over by [the Taxpayer] from another construction company .... The said company was declared bankruptcy in the High Court at that time. The progress of work was delayed in that circumstances and in the interest of [the Taxpayer], overtime works had to be carried out to meet the schedule in order to avoid the loss of assessable income and bore the heavy compensation for breach of contract imposed by [HKHA].

The advantage for which the expenditure was incurred was identified as mentioned above. In FCT v Midland Railway Company of Western Australia Ltd (1952) 85 CLR 306 ... the character of the business or undertaking and the relation which the expenditure or the liability to make it bore to the carrying on of the business or the gaining of assessable income.

Moreover, ... the amount of such expenditure is less than 1/2% of the total turnover in that year of assessment and it should be treated as within the limits of human conducts to accept this expenditure incurred for the purpose of directly or indirectly earning assessable profits, and should be tax deductible.'

(ii) ' [The Firm], in fact, had tried every effort to apply for approval from the Environmental Protection Department for carrying out construction work beyond normal working hours in order to meet the schedules deadline and avoid heavy losses for breach of contract. But regret to say that the application was rejected.'

(g) In reply to the assessor's enquiries, HKHA stated that the Taxpayer was obliged to observe the NCO and the FIUO in accordance with clause 30 of the conditions of contract in relation to the Project which reads as follows:

'30. The Contractor shall conform in all respects with:

(a) the provisions of any enactment,

(b) the regulations or bye-laws of any local or duly constituted authority, and

(c) the rules and regulations of such public bodies and companies as are referred to in Clause 29,

and any additions or amendments thereto during the continuance of the Works, which are applicable to the Works, and shall keep the Employer indemnified against all penalties and liabilities of every kind for breach of any such enactment, regulations, bye-laws or rules.'

(h) The assessor was not satisfied that the Fines were deductible. The Taxpayer objected to the assessment.

The evidence

4. At the hearing of the appeal, the Taxpayer called one witness, Mr D. He was the construction manager of the Firm. Mr D is a civil engineer. Before giving his viva voce evidence, Mr D had produced a letter, the purport of which was to summarise his evidence to the effect that the occasional breaches of the environmental regulations were, whilst inadmissible, unavoidable. Early on in his evidence, Mr D declared:

> 'I'm not here to say that we didn't do wrong, we did do wrong, and we were penalized for it.'

Mr D stated that the fines related to two HKHA projects, one at Site C and another at Site E. He said that for these two projects, work was prohibited on Sundays and after 7 p.m. on each day. He said that there were three types of situations in which the Firm incurred the environmental fines:

(a) Concrete pours: Mr D explained that the rate of concrete pouring would depend on the delivery of the concrete, the weather and other factors. If one gets to a critical point of a beam or column, one sometimes has to make a decision to continue pouring in order not to compromise the integrity of the structure. He stated that the Firm worked past the 7 p.m. deadline and breached the environmental regulations in order not to compromise the integrity of the structure or the safety of the work force.

(b) Delivery of heavy plant: Mr D testified that some heavy equipment such as lift cranes and drilling equipment had to be delivered on slow moving vehicles and these can only be delivered on a Sunday or late at night. It was only when the traffic was less heavy, that is, during nightime or on Sundays, that the Firm could obtain permission to use the road to deliver the equipment to the site. However, this meant that there was a breach of the NCO.

(c) Remedial work: Mr D said that the occasion when the environmental condition of working on a Sunday was breached was during the typhoon period. There was rain on the Saturday, Saturday night and on the Sunday. And to ensure that a slip did not occur for the trenches, the Firm had to pump out the water and shore up the excavation on a Sunday.

5. In cross-examination, it was pointed out to Mr D, and he agreed, that the fines were all imposed in relation to the project at Site C. Contrary to what Mr D testified in chief, none of the fines related to the project at Site E. It was further pointed out to him, and he agreed, that the Firm was only fined once in connection with the pouring of concrete after 7 p.m. That was an offence which occurred at 8:50 p.m., and not, as Mr D at one stage thought, slightly after 7 p.m. When asked about the time, Mr D said that 'maybe' the concrete pour finished at 7:30, or 7:25 or 7:45 but that the workers had to clear the site, clean the mixer etc. As regards the delivery of heavy plant, Mr D was asked which section of the traffic regulations prohibited delivery of the heavy plant other than Sundays or during the night time. Neither Mr D nor Mr Au was able to assist the Board in that regard. Mr D told us that he was present on site when the offences in respect of three of the summonses took place. These three summonses related to two different dates, one on 13 September 1998 and two on 10 September 1998. Mr D pointed out that the incidents occurred over two and a half years ago and his memory was not 'fresh' on the particular days.

The law

6. Miss Ng cited a number of cases to us in support of her proposition that penalties paid for a breach of the law are not to be regarded as trading expenses and hence not allowable for deduction. These are authorities in the United Kingdom, such as CIR v EC Warnes & Co Ltd 12 TC 226, CIR v Alexander von Glehn & Co Ltd 12 TC 232 and McKnight v Sheppard (1999) STC 669, and authorities in Australia, viz Herald and Weekly Times Ltd v FCT (1932) 48 CLR 113, Madad Pty Ltd v FCT 15 ATR 361 and Mayne Nickless Ltd v FCT 15 ATR 752. There is, however, no local authority on the point. We have also looked at a decision in New Zealand, viz Nicholas Nathan v CIR [1989] 3 NZLR 103 and one in Canada, British Columbia Limited v Her Majesty The Queen [1999] 3 SCR 804.

7. We turn to consider the authorities. In CIR v EC Warnes & Co Ltd, the question was whether the £2,000 paid by the taxpayer as penalty under the Customs (War Powers) Act was 'a loss connected with and arising out of' its trade within the meaning of Rule 3, Case 1, Schedule D of the Income Tax Act 1842. Rowlatt J said:

> ' *Now, undoubtedly, this detriment, if I may use the vaguest word, is a "loss" in the sense that they have had to pay £2,000, and have not got the £2,000 which they other would have had. It is also "connected with or arising out of such trade", because they committed the offence, or what must be regarded as the offence, in carrying out their trade. But the question, really, is whether, within the meaning of this Rule, it is a loss connected with or arising out of their trade ... it seems to me that a penal liability of this kind cannot be regarded as a loss connected with or arising out of a trade. I think that a loss connected with or arising out of a trade must, at any rate, amount to something in the nature of a loss which is contemplable, and in the nature of a commercial loss. I do not intend that to be an exhaustive definition, but I do not think it is possible to say that when a fine, which is what it comes to, has been inflicted upon a trading body, it can be said that is "a loss connected with or arising out of" the trade within the meaning of this Rule.'*

8. Precisely the same question (under the same statute) arose in CIR v Alexander von Glehn & Co Ltd. Lord Sterndale MR said (at page 238):

> ' *Of course, as Mr Justice Rowlatt said, in a sense you may say that it has been connected with the trade, because if the trade has not been carried on the penalty would not have been incurred; there would not have been an opportunity for the breach of the law which took place; but in the sense in which the words are used in the Act, I do not think that this was connected with or arising out of such trade, manufacture, adventure or concern, and still less do I think that it was a disbursement under the First Rule which applies to the first*

two Cases, that is to say, "money wholly and exclusively laid out or expended for the purposes of such trade". During the course of the trading, this company committed a breach of the law. As I say, it has been agreed that they did not intend to do anything wrong in the sense that they were willingly and knowingly sending these goods to an enemy destination; but they committed a breach of the law, and for that breach of the law, they were fined, and that does not seem to me to be a loss connected with the business, but it is a fine imposed upon the company personally, as far as a company can be a person, for a breach of the law which they had committed. It is perhaps a little difficult to put the distinction into very exact language, but there seems to me to be a difference between a commercial loss in trading and a penalty imposed upon a person or a company for a breach of the law which they have committed in that trading.'

9. It will be observed that in the two cases quoted above, the question was whether the sum in question was a 'loss connected with and arising out of the trade'. Nevertheless, it is of interest to note Scrutton LJ's approach in his judgment in CIR v Alexander von Glehn (at pages 243 to 244). He referred to Lord Davey's speech in Strong v Woodifield 5 TC 215 to the effect that it was not enough for the disbursement to be made in the course of or arose out of or was connected with the trade, it must have been made for the purpose of earning the profit. Scrutton LJ then posed the question thus:

' *Were these fines and expenditure necessary to earn the profits? The answer seems to me to be obvious, that they were not, they were unfortunate incidents which followed after the profits had been earned ... I am inclined to think, although I do not wish finally to decide it, that the Income Tax Acts are to be confined to lawful businesses, and to businesses carried on in a lawful way.'*

10. McKnight v Sheppard [1999] STC 669 is a recent House of Lords decision. There, a stockbroking firm incurred legal expenses for the purpose of defending disciplinary proceedings were deductible. The proceedings resulted in fines imposed on the firm. The Special Commissioner allowed the taxpayer's appeal in respect of the legal expenses, but not the fines. Lightman J allowed the Crown's appeal in respect of the legal expenses but dismissed the taxpayer's cross-appeal against the disallowance of the fines. The taxpayer appealed in respect of the legal expenses only and the Court of Appeal allowed his appeal. The Crown appealed to the House of Lords, contending that the legal expenses were not deductible. Lord Hoffmann delivered the leading speech. Lord Mackay, Lord Clyde, Lord Hutton and Lord Hobhouse concurred. In the course of his speech, Lord Hoffmann referred to the question of the deductibility of the fines. Of the decision of the Court of Appeal in CIR v Alexander von Glehn, Lord Hoffmann said:

' *I have no doubt that their decision was correct. But the Court of Appeal were curiously inarticulate about why the fine was not money expended for the purposes of the trade.'*

He went on to observe that the fine was

> '*as the Court of Appeal accepted, incurred in the course of the company's trade. There must therefore have been something in the nature of the expense which prevented it from being deductible. I think with great respect that the Court of Appeal had difficulty in identifying exactly what this was because they were looking in the wrong place. They hoped to find the answer in the broad general principles of what counts as an allowable deduction. But the reason in my opinion is much more specific and relates to the particular character of a fine or penalty. Its purpose is to punish the taxpayer and a court may easily conclude that the legislative policy would be diluted if the taxpayer were allowed to share the burden with the rest of the community by a deduction for the purposes of tax. This, I think, is what Lord Sterndale meant when he said that the fine was imposed "upon the company personally".*'

11. Hence, the reason that Lord Hoffmann saw for the non-deductibility of fines is purely one of presumed legislative intention. Whilst these observations by Lord Hoffmann were strictly *obiter*, they were of course entitled to great respect. We turn next to the Australian authorities.

12. In Herald and Weekly Times Ltd v FCT (1932) 48 CLR 113, the High Court of Australia held that moneys paid by a publisher and proprietor of a newspaper as damages for libel were deductible as 'wholly and exclusively laid out or expanded for the production of assessable income'. In their judgment (at page 120), Duffy CJ and Dixon J referred to CIR v von Gehn and CIR v Warnes & Co and expressed their view on the deductibility of fines as follows:

> '*The penalty is imposed as a punishment of the offender considered as a responsible person owing obedience to the law. Its nature severs it from the expenses of trading. It is inflicted on the offender as a personal deterrent, and it is not incurred by him in his character of trader.*'

13. This reasoning appears to have been adopted in subsequent Australian cases which upheld the non-deductibility of fines. We have been referred to two cases decided by the Commonwealth Taxation Board of Review, Case No 102 (1955) 5 CTBR(NS) 599 and Case No 68 (1965) 12 CTBR(NS) 378. In the first mentioned case, a cartage contractor adopted a deliberate policy of overloading his vehicles, carrying prohibited goods and over-width of loads on vehicles, in order to gain more income. Section 51 of the Australian Income Tax Assessment Act allowed deductions of 'all losses and outgoings to the extent to which they are actually incurred in gaining or producing the assessable income or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income'. The taxpayer's claim for deduction of the fines thus incurred was disallowed. The Board said (at page 601):

> *' The fines were imposed on him, and his employees, personally and not as traders. They were fined not because of the business carried on, but for breaking the law.'*

In the second case, the taxpayer was engaged in the extraction and carting of sand, crushed rock and screenings. The majority of its business consisted of carrying sand which was sold by volume rather than by weight. The weight of the same volume of sand varies according to its texture and moisture content and it was difficult to tell whether a particular load was overweight. Although the taxpayer encouraged its drivers to comply with the 'maximum load' provisions of the relevant Act, its vehicles were constantly fined for being overweight. Evidence was given that it was almost impossible to avoid breaching the law because there was no weigh-bridge facilities at the pits and to have carried loads which would have been within the prescribed weight limits under all circumstances would have threatened the profitability of the taxpayer's activities. Nevertheless, the Board held (by a majority) that the fines were not deductible.

14. In Madad Pty Ltd v FCT 15 ATR 361, the taxpayer was a mattress manufacturer. It was charged by the Trade Practices Commission with engaging in retail price maintenance and fined $21,000 in penalties. Its claim for deduction of the penalty as a deduction was disallowed by the Supreme Court of Queensland. Kelly J referred, *inter alia*, to Duffy CJ and Dixon J's judgment in Herald and Weekly Times and to the von Glehn case and observed:

> *' the view could properly be taken that a penalty which is imposed as a punishment, even though the conduct penalized may have found its motive in business considerations, is not from its nature expenditure incurred in the conduct of the business. On that view a penalty could not then be said to be an outgoing incurred in gaining or producing the assessable income nor could it be said to be an outgoing necessarily incurred in carrying on a business for the purpose of gaining or producing such income. On that view, it would not be necessary to have recourse to considerations of public policy, despite the observations of Deane and Fisher JJ in the Magna Alloys & Research case which would seem to indicate that this should be the basis on which the question would be determined, although it must be observed that the question was expressly left open and, of course, it was one which differed from that of the deductibility of costs with which the court was there concerned.'*

15. In Mayne Nickless Ltd v FCT 15 ATR 752, the taxpayer ran the business of carriage for reward. During the relevant year of assessment it incurred fines or penalties mainly for parking infringements and also for speeding, overloading, defective tyres or other breaches of the road traffic regulations. The majority of the fines or penalties were imposed on the taxpayer itself. However, many fines and penalties were imposed on employees of the taxpayer. In such cases, the taxpayer commonly paid the fine or penalty on behalf of the employees. Executives of the taxpayer gave evidence that employees and subcontractors were actively encouraged to comply with traffic

and parking regulations at all times, but infringements of some traffic offences were inevitable. There was also evidence that in some cases it would be necessary for the safety and protection of the public and safety of drivers for vehicles to infringe certain parking regulations. The taxpayer claimed deduction under section 51 of the Income Tax Assessment Act 1936. The Supreme Court of Victoria rejected his claim for deduction. Ormiston J reviewed the English and Australian authorities. As regards the fines imposed on the taxpayer itself, the judge concluded (at page 767) on the authorities that:

> ' *it seems that it is the nature of the penalty and the character of the expenditure which takes such outgoings outside the expenses of trading. The fine or penalty no doubt arises out of acts performed in the course of the taxpayer' s business, but the obligation to pay the fine or penalty derives from the law itself and the need to pay a fine or penalty ought not to be characterised as being either incidental or relevant to the gaining or producing of assessable income, nor should it be characterised as an outgoing which was clearly appropriate and adapted for the purpose of gaining or producing the assessable income of a business.'*

As regards fines imposed on employees, the obligation to pay did not arise because of the law, but because of commercial considerations (see page 768), but Ormiston J held nevertheless that they were not deductible as expenses either. His reason for so deciding rested purely on public policy. He stated (at page 772):

> ' *It follows in my opinion that the policy of the law should support the enforcement of the criminal law whether that be the historical common law crime or the widening array of regulatory offences, and should strive to see that punishments for breaches of the law are not defeated or frustrated by direct or indirect means. About this there could be little argument.*
>
> *However it is questioned whether the allowance of the claimed deductions would have that effect by lightening or diluting the fines and penalties imposed. The difficulty is that in the cases to which I have referred earlier the nature of the public policy called in aid is nowhere explicitly spelled out, whether in the English cases or in the dicta in the two High Court cases...'*

Ormiston J then made reference to the Warnes case and the von Glehn case and to the dicta of Gavan Duffy CJ and Dixon J in Herald and Weekly Times and that of Dixon CJ in FCT v Snowden and Wilson Pty Ltd (1958) 7 AITR 308, 99 CLR 431 and continued (at page 773):

> ' *From this I can only conclude that the "public policy" inherent in these cases and dicta either may have been thought to be a fundamental distinction by which fines and penalties were separated from other deductible outgoings or it*

may have been predicated upon some unstated concept of preventing the frustration of the law by diluting those fines and penalties. For present purposes I care not which approach be taken. They each lead to the same conclusion. For reasons I have already expressed the cases and dicta are of sufficient authority for me to consider that I should follow them. The critical features of the fines and penalties are that they are imposed for purposes of the law in order to punish breaches thereof and that makes it undesirable that they should be deductible, whether for serious or minor regulatory offences and whether they are imposed directly on the taxpayer or on its employees or third party contractors. In the latter case the policy of the law ought not to differ whether or not the money was originally paid by the original liability fell on, persons other than the taxpayer.'

16. Mayne Nickless v FCT was followed in New Zealand in the case of Nicholas Nathan Ltd v CIR [1989] 3 NZLR 103. The taxpayer was an importer of goods and was fined for importing certain goods in excess of its licence. Sinclair J of the Auckland High Court held that the fines were not deductible as a matter of public policy. In New Zealand, the relevant provision (section 104 of the Income Tax Act 1976) permits deduction of expenditure or loss 'to the extent to which it is incurred in gaining or producing the assessable income for any income year or is necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income for any income year'. After referring to cases in England and in Australia, in particular, Mayne Nickless v FCT, Sinclair J said (at page 108):

' *From an overall appreciation of all the decisions, I am of the view that where a fine or penalty is imposed by the Courts resulting from a breach of the law, no deduction ought to be allowed for to do so would be to prefer business law-breakers over individuals as the business law-breaker would obtain the benefit of deductibility of the amount of the fine or penalty imposed whereas the individual would have to bear that particular expense personally. Additionally it would tend to allow, and encourage, law-breaking in some instances, to even treat it as a legitimate business option resulting in deductibility. A simple illustration is the example of a business operator who elects not to erect a safety barrier around equipment because it would cost more than that which may result from failure to provide such equipment. Once it is accepted that fines and penalties imposed by the Courts are not to be allowed as deductions for income tax purposes, there will then be equal treatment for all offenders. By that I mean an individual who cannot claim deductibility in respect of a fine will find himself in precisely the same situation as an offender who might have been able to claim a deduction by alleging that the nexus between the business operation and the imposition of fine was such that he ought to be able to claim deductibility of the amount of the fine. By precluding him from claiming that deductibility he is treated in an even-handed manner with all other members of*

the community and one can neglect the degree of criminality, the degree of seriousness of the offence, and whether the offence was committed by the taxpayer or by one of its employees or independent contractors. Fines which are disallowed as a deductible item are placed in a category somewhat analogous to the taxation imposed upon gains derived from illicit or illegal operations with the result that there is no discrimination in favour of law-breaking taxpayers.'

17. The recent decision of the Supreme Court of Canada in British Columbia Limited v Her Majesty The Queen [1999] 3 SCR 804 went the other way. The taxpayer carried on a poultry farm business. At issue was whether the $270,000 paid by the taxpayer levied for production of eggs over its quota was a deductible expense. The test for deductibility under the relevant statue (section 18(1) of the Income Tax Act 1985) was whether it was incurred for the purpose of gaining or producing business income. Five out of the seven members of the Supreme Court held in favour of deductibility. The majority (Gonthier, McLachlin, Iacobucci, Major and Binnie JJ) held that the over-quota levy was an expense incurred for the purpose of gaining or producing business income, and hence deductible. As to the argument on public policy, the majority took the view that it was for Parliament and not for the courts to decide which expenses incurred for the purpose of earning business income should or should not be deductible. Iacobucci J, delivering the judgment of the majority, noted that tax authorities are not concerned with the legal nature of an activity. Thus,

' it is well established that the deduction of expenses incurred to earn income generated from illegal acts is allowed. For example, not only is the income of a person living from the avails of prostitution liable to tax, but the expenses incurred to earn his income are also deductible.'

Iacobucci J said he did not find the English and Australian cases helpful because of the differences in the applicable taxation statutes. He also noted that the approach and conclusion he adopted was supported by the fact that Parliament has expressly disallowed the deduction of certain expenses on what appear to be public policy grounds. In this connection, he made reference to section 67.5 of the Act which prohibited the deduction of any outlay or expense made 'for the purpose of doing anything that is an offence under any of sections 119 to 121, 123 to 125, 393 and 426 of the Criminal Code or an offence under section 465 of that Act as it relates to an offence described in any of these sections'. L'Herurex-Dube and Bastarache JJ dissented. They reasoned that penal fines were not expenses incurred for the purpose of gaining or producing income in the legal sense; that absent an express indication to the contrary, there was a presumption that Parliament would not intend to encourage the violation of other laws and that statutory provisions imposing fines would be undermined if the fine could be deducted as a business expense. They drew a distinction between statutory provisions which imposed payments either as punishment for past wrongdoing or as a general or specific deterrence against future lawmaking and provisions which impose payment obligations for the purpose of compensation. In their opinion, fines imposed by statutory provisions of the former type should not be deductible. Bastarache J wrote:

' The concern is not so much one of public policy, morality or legitimacy, but one consistent with a realistic understanding of the accretion of wealth concept and the court' s duty to uphold the integrity of the legal system in interpreting the Income Tax Act.'

18. Let us now return to our legislative provisions in the IRO. Section 16 provides 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...'

19. Section 17 provides:

' 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;'

20. Thus, for outgoings or expenses to be deductible under section 16, these must be incurred:

(a) during the basis period for that year of assessment;

(b) the taxpayer; and

(c) in the production of the profits in respect of which he is chargeable.

21. Prima facie, our statutory provisions bear closer similarity to the Australian Income Tax Act, and from that point of view, one may argue that we should regard the Australian authorities as more persuasive. The English Act, which is couched in terms of 'loss connected with and arising out of' the trade may be said to be imposing a different test. However, we have noted what Scrutton LJ said in the von Glehn case which would suggest that this may be a distinction without a difference. More importantly, Lord Hoffmann's explanation of the Warnes case and the von Glehn case suggests that the question does not depend so much on the precise test formulated in the statute, but the presumed intention of the legislature.

22. It seems to us that whilst none of the authorities cited is binding on us, we can derive much assistance from the various approaches adopted in the different jurisdictions. From the guidance given by the English, Australian and New Zealand courts, it seems to us that the approach we should adopt as regards sections 16 and 17 of our IRO is as follows: A taxpayer can only claim deduction for fines he paid if he can establish, *both as a matter of fact and as a matter of law*, that the fines were outgoings or expenses which were incurred in the production of the profits. Further, in deciding whether fines can, as a matter of law, be regarded as outgoings or expenses one has to look for the intention of the legislature. As advocated by the courts in England, Australia and New Zealand, we agree that one should start with the presumption that the legislature would not normally sanction deduction as to do so would undermine the intention of the legislative provision which imposes the statutory obligation and the levying of the fines. To allow fines to be deducted as business expense would no doubt encourage business traders into believing wrongly that they could regard the fines merely as a business expense item. On the other hand, disallowing deduction would have the merit that business traders are treated in the same manner as all other members of the community who break the law and incur the penalty of a fine.

23. In preferring this approach, we have not overlooked the reasoning of the majority judgment of the Supreme Court of Canada. We do not find much difficulty in reconciling this approach with the position of the revenue in seeking to tax income from illicit activities. One can see very little reason why a person who derives income from illicit activities should be allowed to rely on his own illegality in evading his obligation to pay tax. We see no inconsistency in the law saying at the same time that a person cannot rely on his own illegality in seeking to claim a deduction. We also tend to think that it is open to the courts and indeed this Board to start with a presumption of what the legislature may have intended. After all, this is but a rebuttable presumption. The Board and the courts must still strive to find the intention of the legislature by the normal process of construction. It is perhaps not insignificant that in British Columbia Limited v Her Majesty The Queen, the majority found that under the Canadian Income Tax Act Parliament has expressly disallowed the deduction of certain expenses on what appear to be public policy grounds. The case is distinguishable on the ground that the legislative scheme and provisions are different.

Conclusion

24. We return then to our IRO. We find nothing there to rebut the presumption. We find, therefore, that as a matter of law, the fines are not deductible under section 16 of the IRO. This renders it unnecessary for us to decide whether, as a matter of fact, the fines were incurred for the production of the income. We should, however, record that if it be necessary for us to determine that issue, we would hold that if the fines can be regarded in law as business expenses, they were indeed incurred in the production of the income.

25. Much of the evidence adduced before us went to the question whether the fines were necessarily incurred, in the sense that the Taxpayer had no option but to conduct himself in the way

he did, with the result that the fines were unavoidable. Since section 16 does not require a taxpayer to show that an item of expenditure or outgoing is 'necessarily' incurred, it seems to us that it would be wholly academic for us to decide on this question either. None of the cases shown to us suggests that it would make any difference to the court's approach even if the fines were an inevitable part of the business. Should we be found to be wrong on this, we should record our view that the Taxpayer has not shown to our satisfaction that the breaches were inevitable. As it is our view that the suggested issue does not really call for our determination, we will not in the circumstances elaborate on the reasons for coming to this view.

26. For these reasons, we would dismiss the appeal and, subject to the adjustments the parties agreed with regard to the deduction or exemption on interest, confirm the assessment appealed against.