19/84

No. 59 of 1982

IN THE PRIVY COUNCIL

ON APPEAL

FROM THE COURT OF APPEAL OF HONG KONG

BETWEEN:

THE COMMISSIONER OF INLAND REVENUE — Appellant

- and -

LO AND LO (A FIRM) — Respondent

CASE FOR THE APPELLANT

RECORD

1. This is an appeal by leave of the Court of Appeal of Hong Kong given on the 12th day of October 1982 from an Order of the Court of Appeal of Hong Kong (Leonard, V.P., Cons and Zimmern, JJ.A.) dated the 28th day of September, 1982 dismissing with costs the Appellant's appeal from an Order of Hunter, J. in the High Court of the Supreme Court of Hong Kong dated the 18th of March, 1982. Hunter J. had allowed an appeal by the Respondent taxpayer from a decision of the Inland Revenue Board of Review (which Board is established under the Inland Revenue Ordinance, Chapter 112 of the Laws of Hong Kong to hear appeals from assessments to taxation by the Commissioner of Inland Revenue). The Board of Review had upheld an assessment to profits tax by the Appellant, the Commissioner of Inland Revenue (hereafter described as "the Commissioner"), upon the Respondent, Lo and Lo (a firm of Solicitors, which are hereafter referred to as "the taxpayer") assessed as a partnership under Section 22 of the Inland Revenue Ordinance in respect of the year of assessment from the 1st of April, 1977 to the 31st of March, 1978 in the amount of $778,284.00 - being profits tax charged under Section 14 of the Inland Revenue Ordinance upon assessable profits for that year of assessment which were assessed by the Commissioner at $5,255,226.00. The taxpayer disputed the Commissioner's assessment of assessable profits and claimed that in computing the said assessment the Commissioner should have allowed a deduction claimed by the taxpayer in the amount of $770,000.00 in respect of liability in future years to disburse moneys to employees under a staff retirement benefits scheme.

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2. Appeals to the High Court from the Board of Review only lie in respect of questions of law and are conducted by way of a Case Stated by the Board of Review to the High Court under Section 69 of the Inland Revenue Ordinance. In the Case Stated the Board of Review posed the following questions for the consideration of the High Court:

p.10,l.35-p.11,l.15 (i) Whether on the facts found it is open to the Board of Review to hold that the amounts claimed to be deducted in ascertainment of the chargeable profits for the year of assessment 1977/78 do not come within the deductions permitted under Section 16(1) of the Inland Revenue Ordinance, Cap. 112.

(ii) Whether it was open to the Board of Review on the evidence accepted by them to hold that the Appellant had not incurred the liability to make retirement payments in the future by the documents dated the 3rd January, 1977.

(iii) Whether the Board of Review erred in law in failing to follow the decision in Commissioner of Inland Revenue v. Titaghur Jute Factory Co. Ltd (1978) STC 166.

(iv) Whether the Board of Review erred in rejecting the submission "that a provision for a known liability is deductible if there is a binding obligation to make some future payment which arises out of liability to which the taxpayer is definitely committed as a result of events which have occured in the basis period and to which the expense is therefore presently attributable although not finally ascertained nor paid."

3. In the High Court Hunter, J allowed the p.39 - taxpayer's appeal and answered the questions of law posed as follows:

Question (i) : "No"
Question (ii) : "No"
Question (iii) : "The error was in failing to follow and apply the reasoning in "Owen" and "Titaghur" - which were references to the decisions of the House of Lords in the cases of Owen v. Southern Railway of Peru (1956) 36 Tax Cas. 602 and Inland Revenue Commissioners v. Titaghur Jute Factory Co.

: Ltd (1978) STC 166.

Question (iv) : "I would prefer to express the error as in (iii) above with particular reference to the views of Lords Radcliffes and MacDermott than to endorse this precise proposition."

4. The Commissioner appealed from this decision to the Court of Appeal. His appeal was dismissed. The Questions raised by this appeal are as follows:

(a) Can a sum represented by a provision in a taxpayer's accounts in respect of a liability which is contingent and future in the year of assessment constitute an "outgoing (or) expense incurred during the basis period for that year of assessment...in the production of profits" for the purposes of Section 16(1) of the Inland Revenue Ordinance?

and

(b) If the answer to (a) be "yes"; must the sum so represented be referable, or exclusively referable, to the basis period for the year of assessment?

(c) If the answer to (b) be "yes"; is the sum represented by the provision made in the accounts of this taxpayer referable or exclusively referable to the basis period for the 1977-78 year of assessment?

(d) If the answer to (a) be "yes"; is the sum represented by the provision made in the accounts of this taxpayer merely a rough estimate of liability and therefore not deductible due to the taxpayer's failure properly to quantify his liability?

5. The relevant provisions of the Inland Revenue Ordinance are as follows:-

(i) The charge to profits tax is imposed by Part IV, Section 14.

"14. Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade,

profession or business in the Colony in respect of his assessable profits arising in or derived from the Colony for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part."

(ii) "assessable profits" is defined by Section 2.

"assessable profits" means the profits in respect of which a person is chargeable to tax for the basis period for any year of assessment, calculated in accordance with the provisions of Part IV."

(iii) The relevant parts of Section 16 provide as follows:-

"16.(1) 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 -

(a) sums payable by such person by way of interest...

(b) rent paid...

(c) tax of substantially the same nature as tax imposed under this Ordinance...paid elsewhere...

(d) bad debts...

(e) expenditure incurred in... repair(s)...

(f) expenditure incurred in replacement of any implement, utensil....(etc)...

(g) ...a sum expended for the registration of a trade mark, design....(etc)...

(h) such other deductions as may be prescribed by any rule made under this Ordinance."

(iv) Section 17 prohibits certain deductions.

The relevant parts of Section 7 provide as follows:

"17.(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 -

(a) domestic or private expenses including the cost of travelling between residence and place of business;

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

(c) any expenditure of a capital nature or any loss or withdrawal of capital;

(d) the cost of any improvements;

(e) any sum recoverable under an insurance or contract of indemnity;

(f) rent of...premises not occupied or used for the purpose of producing such profits;

(g) any tax paid or payable under this Ordinance other than salaries tax paid in respect of employees' remuneration;

(h) any sum paid by an employer being either an ordinary annual contribution to a fund duly established under an approved

retirement scheme or an ordinary annual premium in respect of a contract of insurance under an approved retirement scheme, to the extent that the aggregate of such payments in respect of an employee under an approved retirement scheme or schemes exceeds 15 per cent of the total emoluments of that employee for the period in respect of which the payment is made."

6. The facts of the case are set out in detail in the Record and are summarised as follows:-

The taxpayer has for many years practised in Hong Kong as a firm of solicitors. During 1975 and 1976 the taxpayer was losing employees to other firms of solicitors, in part due to there being no legal entitlement in the employees to retirement benefits. To eliminate the dissatisfaction the taxpayer issued to all its employees a circular dated 3rd January 1977 which set out their general conditions of employment. Clause 5 thereof read as follows-

"5. Any member of the staff who leaves the firm's employment after not less than 10 years' service will be entitled to a lump sum payment calculated by multiplying the number of years (complete) employed by the firm by half of his average monthly salary for the last 12 months of his employment. Naturally, this will not apply where a member of the staff is dismissed for dishonesty, serious misconduct or gross inefficiency."

The employees were considered thereafter to be legally entitled to retirement benefits. The taxpayer's assessable profits for the year of assessment 1977-78 were computed on the amount of profits arising in or derived from the Colony during the year ending on 31st December 1977. In its accounts for the year ended 31st December 1977 the taxpayer debited to the Profit and Loss Account the sum of $320,456 being "Transfer to provision for staff retirement benefits". In addition th taxpayer transferred from "Provision for Contingencies" the sum of $542,646 (which sum the taxpayer had debited to the Profit and Loss Account of the previous year but in

respect of which no deduction was claimed or allowed in ascertaining the taxpayer's assessable profits for the year of assessment 1976-77) to "Provision for staff retirement benefits". The taxpayer paid out the sum of $93,102 as retirement benefits during the year ended 31st December 1977. Therefore a balance of $770,000 stood to the credit of the "Provision for staff retirement benefits" at 31st December 1977. In raising the assessment for the year of assessment 1977-78 the Assessor allowed as a deduction in respect of retirement benefits only the amount actually paid by the taxpayer during the year ended 31st December 1977, that is $93,102. The taxpayer objected to the assessment on the ground that the amount of $770,000 represented by the "Provision for staff retirement benefits" was an expense incurred in the year ended 31st December 1977 in the production of assessable profits.

7. In the High Court Mr. Justice Hunter considered the effect of Clause 5 of the conditions of employment and held that in every year every employee became entitled to receive by way of total remuneration a salary divisible into the elements, the first element being an immediate cash salary payable monthly, the second element being a future and contingent entitlement to receive an additional salary for the same year's service. In the Appellant's submission the facts agreed and found do not warrant that interpretation of clause 5. In the absence of other evidence the correct interpretation of clause 5 is that the entitlement to retirement benefits is not referable to any particular year or years of service: each year is no more than a qualifying period, and no quantifiable part of the benefits when received could be regarded as payments for the qualifying period ended 31st December 1977.

8. Mr. Justice Hunter in the High Court and Cons J.A. in the Court of Appeal regarded the (apparent) similarities between the United Kingdom legislation as of considerable importance in the construction of Section 16 of the Inland Revenue Ordinance. In the Appellant's respectful submission their Lordships fell into error in so doing. Mr. Justice Hunter prefaced his comparison with the warning that "All this authority is at most indirectly persuasive", but his decision rested primarily upon the argument that "the Hong Kong Ordinance was United Kingdom in origin

and concept, and..properly falls to be construed in the light of United Kingdom principles". In the Appellant's submission the conclusion does not follow from the premise. The judgment of Leonard V P on this issue is to be preferred. Cons J.A. regarded the decision of the Judicial Committee in De Lasala v. De Lasala (1980) A.C. 546 as applicable to this case. In the appellant's submission, the wording of Section 16 is fundamentally different from the legislation in England: see Paragraph 12 below of this Case. Furthermore, there is no decision of the House of Lords or any other English court as to the meaning of "incurred" in a taxing statute: The decision in Owen v. Southern Railway of Peru [1957] A.C. 334 is not in point: see Paragraph 12 below of this Case.

9. In the Appellant's submission the issue is one of construction, that is whether the $770,000 represented by the taxpayer's provision is an outgoing or expense incurred during the year ended 31st December 1977. The primary aid to the construction of Section 16(1) is not a consideration of the general principles of taxation in the United Kingdom but a consideration of the ordinary and natural meaning of the words and phrases used in Section 16(1): Commissioner of Inland Revenue v. Smyth (1914) 3 K.B. 406 at 420. In the Appellant's submission the ordinary and natural meaning of "incur" is "render oneself liable to"; "bring upon oneself". Applying that ordinary meaning to Section 16(1), a sum is an outgoing or expense "incurred during" a particular period only if that sum is paid, or there is a liability (legal or practical) to pay it, in that period. Proper accounting practice requires a taxpayer to make provision in his accounts for expenses notwithstanding that they will not be incurred until a later period. In the Appellant's submission such practice is irrelevant to the application of Section 16 which permits the deduction only of expenses incurred in the present period. In the Appellant's submission to give the word "incurred" its ordinary and natural meaning would not lead to any manifest or gross absurdity. Mr. Justice Hunter erred in suggesting that the construction of "incurred" for which the taxpayer contends must be manifestly more convenient and more conducive to fairness and justice. In any case, those are irrelevant considerations in the

construction of a taxing statute, in the Appellant's submission.

10. In the Appellant's submission, to describe the taxpayer as under a "contingent liability" during the year ended 31st December 1977 is to create a source of confusion. A "contingent liability" is not a species of existing liability. It is a liability which will arise or come into being if one or more of certain events occur or do not occur: Winter v. Commissioner of Inland Revenue [1963] A.C. 235 at 248, 249 per Lord Reid. If, as the Appellant contends, "incurred" in Section 16(1) has to do with liability (whether legal or practical), the taxpayer was under no liability during the year ended 31st December 1977. In the Appellant's submission the judgment of Leonard V P rests upon the above-mentioned confusion.

11. The construction of Section 16(1) for which the Appellant contends is supported by the examples given at letters (a) to (b) of Section 16(1) of permissible deductions. The words "paid" or "payable" are used therein. In the Appellant's submission the meaning given by Mr. Justice Hunter to "payable" is strained and artificial. In the Appellant's submission a sum is "payable" during a period if there is in that period a liability (whether legal or practical) to pay it. It is not enough, as Mr. Justice Hunter held, that one can say in that period that something must (that is, will) be payable.

12. If a comparison of other legal systems is of assistance, then in the Appellant's submission it is the Australian system which most closely resembles the Inland Revenue Ordinance so far as deductibility is concerned. In both systems, the legislative scheme is to provide exhaustively for the items which may be deducted from receipts when ascertaining the taxable profit. The Hong Kong Scheme is so described in Mutual Investment Co. Ltd v. Commissioner of Inland Revenue (1967) A.C. 587 at page 599C-D. The Australian scheme is so described in F.C.T. v. James Flood Pty. Ltd (1953) 88 C.L.R. 492 at page 505. Both systems differ fundamentally from the legislative scheme in the United Kingdom which is prohibitive rather than exhaustively permissive. It has been left to the United Kingdom courts to lay down, first, that where prohibitions are in limitative form, the legislation impliedly

authorises deductions within those limits; and, secondly, that the ascertainment of profits or gains is, in the absence of express provision to the contrary to be arrived at in accordance with ordinary commercial principles. The decision of the House of Lords in Owen v. Southern Railway of Peru Ltd (1957) A.C. 334 is not based upon a construction of United Kingdom legislation but upon the application of ordinary commercial principles in the absence of legislative guidance. The Australian courts have held that that decision is inapplicable in Australia, where authority for a deduction must be found not in general principles but under some provision of their statute. The statutory test for deduction in Australia is in all material respects the same as the test in Section 16 of the Inland Revenue Ordinance. The Australian courts have decided that there is no warrant for treating a liability which had not "come home" in the relevant year, in the sense of a pecuniary obligation which has become due, as having been incurred in that year: New Zealand Flax Investment Ltd v. F.C.T. (1938) 61 C.L.R. 179; Emu Bay Railway Co. v. F.C.T. (1944) 71 C.L.R. 596; F.C.T. v. James Flood Pty Ltd (1953) 88 C.L.R. 492; and Nilson Development Laboratories v. F.C.T. (1981) 55 A.L.J.R.

13. Alternatively if an expense or outgoing is "incurred" notwithstanding that no payment is made and there is no present liability to make payment, then in the Appellant's submission a sum represented by a provision in a taxpayer's accounts of a period for such a liability is an expense or outgoing "incurred during" that period if but only if the sum is exclusively referable to that period. It must be possible to say that that sum was an expense of that and no other period. In the Appellant's submission the taxpayer cannot satisfy this test. The amount represented by the provision of $770,000 was not an expense of the year ended 31st December 1977 because the employees' entitlement to retirement benefit is not attributable to their services in any particular year: see Paragraph 7 above of this Case. If it is attributable, part thereof is attributable to previous years.

14. If that is not the correct test, or if the taxpayer satisfies it, then in the Appellant's submission an amount represented by provision in a taxpayer's accounts is "incurred during" a period if and only if the provision is a

measured appraisal of the expense of that period, rather than a rough reserve against the future. In the Appellant's submission the taxpayer does not satisfy this test. No attempt has been made to measure the present value of the future liability. The sum of $770,000 represented the sums which the taxpayer's staff would have been entitled to receive if they had all retired on 31st December 1977. The taxpayer has omitted to allow for discounting. It is not enough to assert that the margin which would be obtained by discounting would serve to offset the inevitable increase of future payments due to salary increases: That is a rough and ready correlation and the taxpayer adduced no expert accountancy or actuarial evidence to justify it. It is not enough to say that there is no case for the employment of an actuary with only 23 employees involved: the expense of making a measured appraisal is irrelevant.

15. The Appellant therefore submits that the judgments of the High Court and of the Court of Appeal should be reversed and that this appeal should be allowed for the following among other

R E A S O N S

(1) BECAUSE on the true construction of the Inland Revenue Ordinance there is no outgoing or expense incurred during the year ended 31st December 1977 by the taxpayer in respect of retirement benefits paid or due and payable in that year;

(2) BECAUSE in the alternative on the true construction of the said Section 16(1) there is no outgoing or expense incurred during the said year by the taxpayer in respect of the provision for liability for retirement benefits which is not exclusively referable to services performed during the said year;

(3) BECAUSE in the alternative on the true construction of the said Section 16(1) the amount of the said provision does not represent the true amount of outgoing or expense incurred by the taxpayer during the said year in respect of the said benefits being a rough estimate and not a measured appraisal thereof.

(4) BECAUSE the reasoning in the judgments of the Court of Appeal and of the High Court is wrong.

STEWART BATES.

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O N A P P E A L

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B E T W E E N :

THE COMMISSIONER OF INLAND REVENUE — Appellant

- and -

LO AND LO (A FIRM) — Respondent

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