19/84

No. 59 of 1982

IN THE JUDICIAL COMMITTEE OF 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

RECORD OF PROCEEDINGS

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INDEX OF REFERENCE

DOCUMENTS TRANSMITTED TO THE PRIVY COUNCIL BUT NOT REPRODUCED

No.	Description of Document	Date
1.	Notice of Motion for Leave to Appeal	30th September 1982
2.	Order granting Conditional Leave to Appeal to Her Majesty's Council	12th October 1982

No. 59 of 1982

IN THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL

O N A P P E A L

FROM THE COURT OF APPEAL OF HONG KONG

B E T W E E N :

THE COMMISSIONER OF INLAND REVENUE — Appellant

- and -

LO AND LO (a firm) — Respondent

RECORD OF PROCEEDINGS

In the High Court

No. 1
Stated Case
23rd
November
1981

No. 1

Stated Case - 23rd November 1981

BOARD OF REVIEW,
INLAND REVENUE ORDINANCE, Cap. 112.

Lo & Lo
vs.
Commissioner of Inland Revenue

CASE

Stated under Section 69 of the Inland Revenue Ordinance (Cap. 112) on the application of Lo & Lo.

At hearings of the Board of Review held on 10th and 11th June, 1981, Messrs. Lo & Lo, Solicitors and Notaries, hereinafter called "the Taxpayer", appealed against a Profits Tax Assessment raised against it for the year of assessment 1977-78 showing Assessable profits of $5,255,226 with Tax Payable thereon of $788,284.

2. The ground of appeal was that in computing the said assessment a claimed deduction of $770,000, being a provision made in the year of assessment by the Taxpayer for its future liability under a staff

retirement benefits scheme, was wrongly disallowed.

3. On the evidence adduced at the hearing of the appeal, the Board found the following facts admitted or proved:

(1) The Taxpayer has for many years practised in Hong Kong as solicitors.

(2) On 3rd January 1977 the Taxpayer issued to all its employees a circular letter setting out the general conditions of employment. Included in those conditions is one relating to retirement benefits 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."

(3) Prior to the issue of the above circular the Taxpayer had followed a similar practice. This practice was the unilateral decision of the Taxpayer.

(4) The Taxpayer's Profits Tax return for 1977-78 was based on accounts for the year ended 31st December 1977. During the year ended 31st December 1977 the Taxpayer actually paid out as retirement benefits to employees the sum of $93,102. In its accounts for 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 its taxation computation for the 1977-78 year of assessment the Taxpayer sought to claim in respect of retirement benefits a total deduction of $863,102, being the actual sums paid totalling $93,102 plus an amount of $770,000 standing to the credit of the provision at 31st December 1977;

(5) The reason for the discrepancy between the sum of $770,000 claimed as a deduction in respect of the provision and the sum of $320,456 debited in the accounts arises from the fact that in the previous year the Taxpayer had debited to its Profit and Loss Account the sum of $559,786 as "Transfer to Provision for Contingencies". No deduction was claimed or allowed in respect of this item in arriving at the assessable profit for the year ended 31st December 1976, year of assessment 1976-77. Of the $559,786 referred to above, the Taxpayer in its accounts for the year ended 31st December 1977 transferred from the "Provision for Contingencies" to the "Provision for Staff Retirement Benefits" the sum of $542,646. The balance of $770,000 standing to the credit of the "Provision for Staff Retirement Benefits" can therefore be analysed as follows -

Balance transferred from provision for contingencies	$542,646
Less: Payments to staff during year	93,102
	$449,544
Add: Transferred from Profit and Loss account during year	320,456
Balance at 31st December 1977	$770,000

(6) In raising the assessment for 1977-78 the Assessor allowed as a deduction in respect of retirement benefits only the amount of $93,102, being the sum actually paid by the Taxpayer during the year. The Assessor refused to allow any deduction in respect of the "Provision for Staff Retirement Benefit" - $770,000;

(7) The Taxpayer objected to the assessment on the grounds that the provision was an expense incurred in the year ended 31st December, 1977 in the production of assessable profits;

(8) During 1975 and 1976 the Taxpayer was losing employees to other firms of solicitors;

(9) On reason for dissatisfaction among employees was the lack of certainty with respect to annual bonuses and retirement benefits;

(10) Up to then the Taxpayer's practice was to pay annual bonuses of not less than 2 months salary, and retirement benefits to staff with over 10 years service of half the monthly salary multiplied by number of years of service;

(11) Neither the partners of the Taxpayer nor their employees considered there was any legal entitlement in the employees to such bonuses and retirement benefits;

(12) To eliminate some of this uncertainty the Taxpayer issued the circular of 3rd January 1977, clause 5 of which is set out in (2) above;

(13) The partners of the Taxpayer considered themselves legally bound by the said clause 5 as from 3rd January 1977;

(14) The Taxpayer considered that retirement benefits paid prior to 3rd January 1977 were gratuitous voluntary payments, not made under any legal obligation.

4. The Board raised the question whether the only consideration on the part of the employees in respect of their service prior to 3rd January 1977 was past consideration, so that the said clause 5 terms would not be enforceable by the employees against the Taxpayer. Clause 5 is part of a document under hand and not under seal. This question was contested by the parties, but as the Board considered that a decision on it was unnecessary for the determination of the substantive issue on the appeal, the Board, without deciding this contentious question, assumed for this appeal that there was valuable consideration moving from the staff members of the Taxpayer so that the terms contained in the said Clause 5 could be legally enforced against the Taxpayer.

5. The substantive issue in this appeal turns on whether the amounts claimed to be deducted in ascertainment of the chargeable profits for the year of assessment 1977-78 come within the deductions permitted under Section 16(1) of the Inland Revenue Ordinance, Cap. 112. The material words of the section are -

"In ascertaining the profits on 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....."

For the Taxpayer it was contended:-

(a) that it had incurred the liability to make retirement payments in the future by the document dated 3rd January 1977;

(b) 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 occurred in the basis period and to which the expense is therefore presently attributable although not yet finally ascertained nor paid;

(c) that there is a requirement that the provision is to be computed with reasonable accuracy.

7. For the Taxpayer the Australian cases of R.A.C.V. Insurance Pty. Ltd. v. F.C. of T. (74 ATC 4169) and F.C. of T. v. Nilsen Development Laboratories (10 ATR 255), and in particular the Scottish case of I.R.C. v. TITAGHUR Jute Factory Co. Ltd. (1978) STC 166 were relied upon.

8. The facts of the Titaghur case closely resemble the Taxpayer's. The company, which was resident in the U.K., carried on business in India. By an Indian statute the company became liable on 14th June 1971 to pay gratuities to about 17,000 of its employees on their leaving its employment. The amount payable to an employee depended on his salary at the end of employment and his length of service. Service prior to the statute coming into effect had to be taken into account. The company acted on actuarial advice and in the 1971 accounts debited £221,619 as "Provision for Retirement Gratuities". Of this sum £23,547 related to the service of employees in 1971 and the balance to pre-1971 service.

9. The Scottish Court of Session allowed the full deduction claimed on the ground that the Taxpayer

company, in the discharge of the obligation imposed on it by the Act, was making, on the basis of a reliable estimate, provision for the amount of the gratuities for which its employees had qualified as at the end of that year by reason of their having been in its employment on and after 14th June 1971, i.e. when the retrospective statutory obligation was introduced. In debiting that sum in its accounts it was showing the true amount by which its liabilities in respect of the employment of its workforce were increased in 1971. It could not have made provision any earlier for the payments required by the Act for the years preceding 1971, as it was under no liability to pay any gratuities until the Act came into force.

10. In particular the Taxpayer's representative relied on a passage in the judgment of the Lord President at p.177 :-

> "It must not be overlooked that the liability with which this case is concerned was imposed on the taxpayer company for the first time in 1971. The case would no doubt be a very different one had the liability existed in the years before 1971 for in this quite different state of fact it could hardly be suggested that provision made in the accounts for the year 1971 to reflect the measure of an accrued liability properly referable to earlier years would be a proper debit in computing the profits of the taxpayer company in 1971. The question with which Southern Railway of Peru Ltd. v. Owen was concerned was this. If a company is under an obligation which matures from year to year must it wait,in order to be able to claim a deduction in the computation of its profits until it has in fact matured; or may it charge a properly estimated provision to revenue account, representing the measure of the liability insofar as it has matured in the course of the year of the account? The House of Lords in Southern Railway of Peru Ltd. v. Owen did not have to consider, in the circumstances of that case, the measure of the allowable provision in the year in which the initial liability emerged but I see nothing in the speeches of their Lordships to cast doubt on the general proposition that where you can reliably estimate the extent to which a maturing obligation of the character with which this case is concerned has matured in the course of the accounting period, provision of the amount of the estimate will be a proper charge against trading receipts. As I see it the taxpayer company was not, in 1971, making

provision for any obligation which had matured in any earlier years. No liability existed at all before 14th June 1971. On the contrary the taxpayer company was making, in its 1971 accounts, a provision for the amount of the gratuities for which its employees had qualified as at the end of that year as a result of having been in the taxpayer company's employment on and after 14th June 1971. This is a provision wholly consistent with the principle underlying provisions on an accruals basis and in my judgment was a provision which fell tobe made by the taxpayer company, using the words of Lord Radcliffe in Southern Railway of Peru Ltd. v. Owen, 'by virtue of the fact that it has had the benefit of its employees' services' during 1971, i.e. on and after the date on which statutory liability to pay gratuities was imposed on it. It was, further, a provision which was required in 1971 ' to take account of the increased burden which.... the year's service' has thrown on the taxpayer company. In short insofar as it must be shown that the provision made is related to the service of the employees in and down to the end of the year 1971 the relationship is clear. The amount of the provision is no more than the measure of the liability which had emerged in 1971 and had accrued by the end of the year. That was the measure of the additional liability under which the taxpayer company had traded in 1971 and I am entirely in agreement with the Special Commissioners in holding that it was permissible for the taxpayer company to charge the whole provision against 1971 profits for corporation tax purposes."

11. For the Commissioner it was contended:-

(a) The effect of Section 16(1) of Cap. 112 is that in arriving at the amount of profit chargeable there shall be deducted from the receipts which would be subject to tax the deductions which are exclusively provided by the law;

(b) "There is no room for treating the (chargeable) profits ... as the balance of the total receipts over the total disbursements of the taxpayer arrived at upon ordinary business accounting considerations;" (Sir Garfield Barwick in the Privy Council cited in the Hong Kong case of C.I.R. v. Mutual Investments Co.Ltd. H.K. Tax Cases 188 at 225);

(c) The Australian case of Nilsen Development Laboratories Ltd. v. F.C.T. (1 ATR 305) is in point. This case was concerned with the deductibility of provisions for future long service pay and holiday pay under Section 51(1) of the Australian statute which is in these terms:-

> "All losses and outgoings to the extent to which they are 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 shall be allowable deductions except to the extent to which they are losses or outgoings of a capital private or domestic nature, or are incurred in relation to the gaining or production of exempt income".

The claim for deduction was disallowed by the Full Court of the High Court of Australia -

> "HELD, dismissing the appeal; the expenditure was not incurred until such time as the actual leave was taken and, accordingly, a provision in respect of leave not taken during a relevant year was not an allowable deduction. Until the employee enters upon the appropriate leave there is no outgoing which is deductible under the provisions of S.51."

(Headnote at p. 506)

Barwick, J.J. found that employees of the company had become entitled to long service and holiday leave; their entitlement had become indefeasible, but that the company had not come under any obligation to pay any sum of money to the employees so entitled, and the company would be liable to make those payments when the employees entered upon the leave to which they were then indefeasibly entitled. (at p.506)

> ".... there can be no warrant for treating a liability which has not 'come home' in the year of income, in the sense of a pecuniary obligation which has become due, as having been incurred in that year."

> "That part of Sir Owen Dixon's statement in New Zealand Flat Investments Ltd. v. F.C. of T. which presently needs

emphasis is that the word 'incurred' in S.51(1) 'does not include a loss or expenditure which is no more than pending, threatened or expected': and I would for myself add 'no matter how certain it is in the year of income that that loss or expenditure will occur in the future'."

12. The Board was of the opinion that the Taxpayer's case would fail if heard under Australian law, on the authority of Nilsen's case, but that it could succeed under Ebglish law, on the authority of the Titaghur case, albeit this is a Scottish case.

13. The only reference in the Titaghur case to the law applicable to that case is Case 1 of Schedule D (paragraph 2 of the Case Stated on p.167 of the report). Neither representative of the parties appearing before the Board had cited the text of the relevant law applicable. Section 13C of the Income & Corporation Taxes Act 1970 appears to state the material provision -

"130. General rules as to deductions not allowable:

Subject to the provisions of the Tax Acts, in computing the amount of the profits or gains to be charged under Case 1 or Case II of Schedule D, no sum shall be deducted in respect of -

(a) any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation."

14. The Scottish court held that the company was confronted with a liability imposed by statute, made actuarially computed provisions for the liability and that the provisions were deductible. The court did not expressly hold that the company had incurred any obligation nor that it had made disbursements or expenditure.

15. In the circumstances the Board was of the opinion that the Australian deductibility provisions more closely resemble the Hong Kong provisions than those in the United Kingdom. The Board therefore applied the judgment of the High Court of Australia in Nilsen's case and held that the Taxpayer was not entitled to the deduction of $770,000 claimed in respect of the provision for retirement payments for pre-1977 services.

16. The Commissioner's representative also contended that the Taxpayer's appeal should fail on the ground that the sum claimed to be deducted was "in the nature of a rough reserve against the future rather than a measured provision" (Lord Radcliffe in Southern Railway of Peru v. Owen, 36 TC 602 at 644). In particular Lord Radcliffe criticised the company for omitting to allow for discounting.

17. The Taxpayer's representative's reply to this point was that the amount sought to be deducted is reasonably accurate. That although the sum was not discounted, the margin which would be obtained by the discounting would serve to offset the inevitable increase of future payments due to salary increases. Also with only about 23 employees involved, there was no case for the employment of an actuary as in the Titaghur case where about 17,000 employees were involved. The report of the Southern Railway of Peru case does not indicate the number of employees involved and it is probable that the number is well in excess of the Taxpayer's.

18. In the circumstances the Board accepted the contention of the Taxpayer's representative and held that it would not dismiss the appeal on this ground.

19. The appeal was dismissed and the assessment confirmed.

20. The Taxpayer has required the Board to state a case on questions of law for the opinion of the High Court under Section 69 of theInland Revenue Ordinance (Cap. 112) which Case the Board has stated and the members thereof do sign accordingly.

21. The questions of law for the opinion of the High Court are:-

(1) 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.

(2) 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.

(3) Whether the Board of Review erred in law in failing to follow the decision in IRC v. Titaghur Jute Factory Co. Ltd., (1978) S.T.C. 166.

(4) Whether the Board of Review erred in rejecting the summission "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 occurred in the basis period and to which the expenses is therefore presently attributable although not yet finally ascertained nor paid."

Dated this 23rd day of November 1981.

Sgd. S.V. Gittins

Dr. S.V. Gittins, Q.C., J.P.
Chairman

Sgd. R.K.C. Chow	Sgd. G.A. Hope	Sgd. S.V. Gittins
Mr. Roland K.C.Chow LL.M. Member	Mr. G.A. Hope, C.A., F.H.K.S.A. Member	Dr. Daniel B.H. Lam, LL.D., O.B.E, J.P. Member (Signed in his absence on his behalf and on his authorization)

Ref. B/R 45/80; D. 8/81; SC. 1/81

IRA/2/506; IRA/3/63

No. 2

Decision of Board of Review - 20th July 1981

BOARD OF REVIEW

APPEAL OF MESSRS. LO & LO

D E C I S I O N

The following facts are agreed:-

(1) Messrs. Lo & Lo /the Taxpayer/ has objected to a Profits Tax Assessment raised on it for the 1977-78 year of assessment. The Taxpayer claims that in arriving at the assessable profit the Assessor has wrongly failed to take into account provisions made by the Taxpayer for its future liability under a staff retirement benefits scheme.

(2) The Taxpayer has for many years practised in Hong Kong as solicitors.

(3) On 3rd January 1977 the Taxpayer issued to all its employees a circular letter setting out the general conditions of employment. Included in those conditions is one relating to retirement benefits 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 .."

(4) Prior to the issue of the above circular the Taxpayer had followed a similar practice as a result of informal arrangements made with the relevant staff.

(5) The Taxpayer's Profits Tax return for 1977-78 was based on accounts for the year ended 31st December 1977. During the year ended 31st December 1977 the Taxpayer actually paid out as retirement benefits to employees the sum of $93,102. In its accounts for 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 its taxation computation for the 1977-78 year of assessment the Taxpayer sought to claim in respect of retirement benefits a total deduction of $863,102, being the actual sums paid plus an amount of $770,000 standing to the credit of the provision at 31st December 1977.

(6) The reason for the discrepancy between the sum of $770,000 claimed as a deduction in respect of the provision and the sum of $320,456 debited in the accounts (Fact 5) arises from the fact that in the previous year the Taxpayer had debited to its Profit and Loss Account the sum of $559,786 as "Transfer to Provision for Contingencies". No deduction was claimed or allowed in respect of this item in arriving at the assessable profit for the year ended 31st December 1976, year of assessment 1976-77. Of the $559,786 referred to above the Taxpayer in its accounts for the year ended 31st December 1977 transferred from the "Provision for Contingencies" to the "Provision for Staff Retirement Benefits" the sum of $542,646. The balance of $770,000 standing to the credit of the "Provision for Staff Retirement Benefits" can therefore be analysed as follows -

Balance transferred from provision for contingencies	$542,646
Less: Payments to staff during year	93,102
	$449,544
Add : Transferred from Profit and Loss account during year	320,456
Balance at 31st December 1977	$770,000

(7) In raising the assessment for 1977-78 the Assessor allowed as a deduction in respect of retirement benefits only the amount of $93,102, being the sum actually paid by the Taxpayer during the year. The Assessor refused to allow any deduction in respect of the "Provision for Staff Retirement Benefit" - $770,000.

(8) The Taxpayer objected to the assessment on the grounds that the provision was an expense incurred in the year ended 31st December, 1977 in the production of assessable profits.

2. At the hearing before the Board, Tak-Shing Lo a partner of the Taxpayer gave evidence inter alia as follows:-

(a) During 1975 and 1976 the Taxpayer was losing employees to other firms of solicitors;

(b) On reason for dissatisfaction among employees was the lack of certainty with respect to annual bonuses and retirement benefits;

(c) Up to then the Taxpayer's practice was to pay annual bonuses of not less than 2 months salary, and retirement benefits to staff with over 10 years service of half the monthly salary multiplied by number of years of service;

(d) Neither the partners of the Taxpayer nor their employees considered there was any legal entitlement in the employees to such bonuses and retirement benefits;

(e) To eliminate some of this uncertainty the Taxpayer issued the circular of 3rd January 1977, clause 5 of which is set out in 1(3) above;

(f) The witness and his partners considered themselves legally bound by the said clause 5 as from 3rd January 1977;

(g) The Taxpayer considered that retirement benefits paid prior to 3rd January 1977 were gratuitous voluntary payments, not made under any legal obligation.

3. This evidence was unchallenged and we find this evidence constitutes additional facts.

4. However, this still leaves open for decision whether the only consideration on the part of the employees in respect of their service prior to 3rd January 1977 was past consideration, so that the said clause 5 terms could not be enforceable by the employees against the Taxpayer. Clause 5 is part of a document under hand and not under seal.

5. 9 Halsbury's Laws of England (4th edition) 320 states:

> "Past consideration. A so called ' past consideration', that is, something done by the promissee before the promise was made, may constitute a motive for the promises, but it is not valuable consideration. However, the courts do not take a strict chronological view, so that, provided the promises are part of one transaction, it

does not matter in what order they were given. The question whether consideration is past, or merely executed, is essentially one of fact.

An apparent exception to the rule is, that where services have been rendered by one person to another at his request, a subsequent promise to pay for those services can be enforced. This is, perhaps, not a real exception to the rule stated above, for in such a case there may be an implied promise to pay for the service, and the subsequent express promise may be treated either as an admission which evidences, or as a positive bargain which fixes, the amount of that reasonable remuneration on the faith of which the service was originally rendered."

6. On the evidence of Tak-Shing Lo, payments of retirement benefits prior 3rd January 1977 were not consequential to any promise to make such payments, so that the promise on 3rd January 1977 to pay for services prior to that date could be for a past consideration. For the Taxpayer it was contended:-

(a) That its notice of 3rd January 1977 constituted an offer by it to the staff members referred to therein to continue in its employment under the varied terms of service set out in the notice;

(b) By continuing in the employment of the Taxpayer a staff member accepted the offer and a contract of employment containing the varied terms of service came into effect;

(c) The consideration moving from the staff member was his agreement to continue in employment under the varied terms of service and was valuable and not past consideration.

7. The Commissioner's representative disputed these contentions and cited 23rd Chitty on Contracts paragraph 129, 9 Halsbury (4th edition) 328 and 16 Halsbury (4th edition) 553. We do not need to decide this appeal on this contentious point and we make no finding thereon.

8. For the purpose of considering the substantive issue in this appeal which we are coming to, we do not propose to decide this contentious point but would assume that there was valuable consideration moving from the staff members of the

Taxpayer so that the terms contained in the said Clause 5 could be legally enforced against the Taxpayer.

9. The substantive issue in this appeal turns on whether the amounts claimed to be deducted in ascertainment of the chargeable profits for the year of assessment 1977-78 come within the deductions permitted under Section 16(1) of the Inland Revenue Ordinance, Cap. 112. The material words of the section are -

> "In ascertaining the profits on 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 ....."

10. For the Taxpayer it was contended:-

(a) that it had incurred the liability to make retirement payments in the future by the document dated 3rd January 1977;

(b) 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 occurred in the basis period and to which the expense is therefore presently attributable although not yet finally ascertained nor paid;

(c) that there is a requirement that the provision is to be computed with reasonable accuracy.

11. For the Taxpayer the Australian cases of R.A.C.V. Insurance Pty. Ltd. v. F.C. of T. (74 ATC 4169) and F.C. of T. v. Nilsen Development Laboratories (10 ATR 255), and in particular the English case of I.R.C. v. TITAGHUR Jute Factory Co. Ltd. (1978) STC 166 were relied upon.

12. The facts of the Titaghur case closely resemble the Taxpayer's. The Company, which was resident in the U.K., carried on business in India. By an Indian statute the company became liable on 14th June 1971 to pay gratuities to about 17,000 of its employees on their leaving its employment. The amount payable to an employee depended on his

salary at the end of employment and his length of service. Service prior to the statute coming into effect had to be taken into account. The company acted on actuarial advice and in the 1971 accounts debited £221,619 as "Provision for Retirement Gratuities". Of this sum £23,547 related to the service of employees in 1971 and the balance to pre-1971 service.

13. The Scottish Court of Session allowed the full deduction claimed on the ground that the Taxpayer company, in the discharge of the obligation imposed on it by the Act, was making, on the basis of a reliable estimate, provision for the amount of the gratuities for which its employees had qualified as at the end of that year by reason of their having been in its employment on and after 14th June 1971, i.e. when the retrospective statutory obligation was introduced. In debiting that sum in its accounts it was showing the true amount by which its liabilities in respect of the employment of its workforce were increased in 1971. It could not have made provision any earlier for the payments required by the Act for the years preceding 1971, as it was under no liability to pay any gratuities until the Act came into force.

14. In particular the Taxpayer's representative relied on a passage in the judgment of the Lord President at p.177:-

> "It must not be overlooked that the liability with which this case is concerned was imposed on the taxpayer company for the first time in 1971. The case would no doubt be a very different one had the liability existed in the years before 1971 for in this quite different state of fact it could hardly be suggested that provision made in the accounts for the year 1971 to reflect the measure of an accrued liability properly referable to earlier years would be a proper debit in computing the profits of the taxpayer company in 1971. The question with which Southern Railway of Peru Ltd. v. Owen was concerned was this. If a company is under an obligation which matures from year to year must it wait, in order to be able to claim a deduction in the computation of its profits until it has in fact matured; or may it charge a properly estimated provision to revenue account, representing the measure of the liability insofar as it has matured in the course of the year of the account? The House of Lords in Southern

Railway of Peru Ltd. v. Owen did not have to consider, in the circumstances of that case, the measure of the allowable provision in the year in which the initial liability emerged but I see nothing in the speeches of their Lordships to cast doubt on the general proposition that where you can reliably estimate the extent to which a maturing obligation of the character with which this case is concerned has matured in the course of the accounting period, provision of the amount of the estimate will be a proper charge against trading receipts. As I see it the taxpayer company was not, in 1971, making provision for any obligation which had matured in any earlier years. No liability existed at all before 14th June 1971. On the contrary the taxpayer company was making, in its 1971 accounts, a provision for the amount of the gratuities for which its employees had qualified as at the end of that year as a result of having been in the taxpayer company's employment on and after 14th June 1971. This is a provision wholly consistent with the principle underlying provisions on an accruals basis and in my judgment was a provision which fell to be made by the taxpayer company, using the words of Lord Radcliffe in Southern Railway of Peru Ltd. v. Owen, 'by virtue of the fact that it has had the benefit of its employees' services' during 1971, i.e. on and after the date on which statutory liability to pay gratuities was imposed on it. It was, further, a provision which was required in 1971 'to take account of the increased burden which .... the year's service' has thrown on the taxpayer company. In short insofar as it must be shown that the provision made is related to the service of the employees in and down to the end of the year 1971 the relationship is clear. The amount of the provision is no more than the measure of the liability which had emerged in 1971 and had accrued by the end of the year. That was the measure of the additional liability under which the taxpayer company had traded in 1971 and I am entirely in agreement with the Special Commissioners in holding that it was permissible for the taxpayer company to charge the whole provision against 1971 profits for corporation tax purposes."

15. For the Commissioner it was contended:-

(a) The effect of Section 16(1) of Cap.112 is that in arriving at the amount of profit chargeable there shall be deducted from the receipts which would be subject to tax the deductions which are exclusively provided by the law;

(b) "There is no room for treating the (chargeable) profits ..... as the balance of the total receipts over the total disbursements of the taxpayer arrived at upon ordinary business accounting considerations;" (Sir Garfield Barwick in the Privy Council cited in the Hong Kong case of C.I.R. v. Mutual Investments Co. Ltd. H.K. Tax Cases 188 at 225);

(c) The Australian case of Nilsen Development Laboratories Ltd. v. F.C.T. (11 ATR 505) is in point. This case was concerned with the deductibility of provisions for future long servicepay and holidaypay under Section 51(1) of the Australian statute which is in these terms:-

> "All losses and outgoings to the extent to which they are 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 shall be allowable deductions except to the extent to which they are losses or outgoings of a capital private or domestic nature, or are incurred in relation to the gaining or production of exempt income."

The claim for deduction was disallowed by the Full Court of the High Court of Australia -

> "HELD, dismissing the appeal; the expenditure was not incurred until such time as the actual leave was taken and, accordingly, a provision in respect of leave not taken during a relevant year was not an allowable deduction. Until the employee enters upon the appropriate leave there is no outgoing which is deductible under the provisions of s.51." (Headnote at p.506)

Barwick, C.J. found that employees of the company had become entitled to long service and holiday leave; their entitlement had become indefeasible, but that the company had not come under any obligation to pay any sum

of money to the employees so entitled, and the company would be liable to make those payments when the employees entered upon the leave to which they were then indefeasibly entitled. (at p.506)

> "..... there can be no warrant for treating a liability which has not 'come home' in the year of income, in the sense of a pecuniary obligation which has become due, as having been incurred in that year."

> "That part of Sir Owen Dixon's statement in New Zealand Flax Investments Ltd. v. F.C. of T. which presently needs emphasis is that the word 'incurred' in s.51(1) 'does not include a loss or expenditure which is no more than pending, threatened or expected': and I would for myself add 'no matter how certain it is in the year of income that that loss or expenditure will occur in the future'."

16. We are of the opinion that the Taxpayer's case would fail if heard under Australian law, on the authority of Nilsen's case, but that it could succeed under English law, on the authority of the Titaghur case.

17. The only reference in the Titaghur case to the law applicable to that case is Case 1 of Schedule D (paragraph 2 of the Case Stated on p.167 of the report). Neither representative of the parties appearing before us has cited the text of the relevant law applicable. Section 130 of the Income & Corporation Taxes Act 1970 appears to state the material provision -

> "130. <u>General rules as to deductions not allowable</u>:
>
> Subject to the provisions of the Tax Acts, in computing the amount of the profits or gains to be charged under Case I or Case II of Schedule D, no sum shall be deducted in respect of -
>
> (a) any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation."

18. The Scottish court held that the company was confronted with a liability imposed by statute,

made actuarially computed provisions for the liability and that the provisions were deductible. The court did not expressly hold that the company had incurred any obligation nor that it had made disbursements or expenditure.

19. In the circumstances we are of the opinion that the Australian deductibility provisions more closely resemble the Hong Kong provisions than those in the United Kingdom. We therefore apply the judgment of the High Court of Australia in Nilsen's case and hold that the Taxpayer is not entitled to the deduction of $770,000 claimed in respect of the provision for retirement payments for pre-1977 services.

20. The Commissioner's representative also contended that the Taxpayer's appeal should fail on the ground that the sum claimed to be deducted was "in the nature of a rough reserve against the future rather than a measured provision" (Lord Radcliffe in Southern Railway of Peru v. Owen, 36 TC 602 at 644). In particular Lord Radcliffe criticised the company for omitting to allow for discounting.

21. The Taxpayer's representative's reply to this point is that the amount sought to be deducted is reasonably accurate. Although the sum is not discounted, the margin which would be obtained by discounting would serve to offset the inevitable increase of future payments due to salary increases. Also with only about 23 employees involved, there is no case for the employment of an actuary as in the Titaghur case where about 17,000 employees were involved. The report of the Southern Railway of Peru case does not indicate the number of employees involved and it is probable that the number is well in excess of the Taxpayer's.

22. In the circumstances we accept the contention of the Taxpayer's representative and we would not dismiss the appeal on this ground.

23. The appeal is dismissed and the assessment is confirmed.

Dated this 20th day of July, 1981.

Sgd. S.V. Gittins
Dr. S.V. Gittins, Q.C., J.P.- Chairman

Sgd. R.K.C. Chow	Sgd. G.A. Hope	Sgd. Daniel S.H.Lam
Mr. Roland K.C. Chow, LL.M. Member	Mr. G.A. Hope, C.A., F.H.K.S.A. Member	Dr. Daniel S.H. Lam, LL.D., O.B.E., J.P. Member

Ref. B/R 45/80; D.8/81
IRA/2/506

In the High Court

No. 3
Judgment of Mr. Justice Hunter 18th March 1982

No. 3

Judgment of Mr. Justice Hunter - 18th March 1982

Inland Revenue Appeal No.2/81

BETWEEN

LO & LO — Appellant

v.

COMMISSIONER OF INLAND REVENUE — Respondent

Coram : Hon. Mr. Justice Hunter in Court
Date : 18th March 1982

J U D G M E N T

This is an appeal by case stated, under section 69 of the Inland Revenue Ordinance (Cap. 112) from a decision of the Board of Review dated 23rd November 1981, upholding the respondent Commissioner's disallowance, in a profits tax assessment, of an item entitled "Provision for staff retirement benefit $770,000" in the appellant solicitors' accounts.

In the case stated the Board has set out the facts it finds and the contentions advanced before it with commendable clarity. It is therefore sufficient for me to summarise. The relevant assessment was based upon the appellant's accounts for the year ended 31st December 1977. On 3rd January 1977 the appellants, to meet competition, introduced a new standard term into the conditions of employment of all its staff. This term was:-

> "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 twelve months of his employment. Naturally this will not apply where a number of the staff is dismissed for dishonesty, serious misconduct or gross inefficiency."

I do not share the Board's doubts about consideration in relation to this improvement. Any member of staff who continued to work on the basis (inter alia) of this new condition would give ample

consideration to enable him to sue upon this promise on his retirement. Indeed the Commissioner did not argue to the contrary before me. I therefore think that the partners in the firm were right thereafter to regard the firm as contractually bound by this promise.

Some staff members retired between January and December 1977, and by reason of this provision they received in all the total sum of $93,102. This sum was included in the accounts as a deduction and was allowed by the Commissioners. At the time of the preparation of the accounts the firm also made a calculation as to the total sum that they were now "on risk" to pay to other members of their staff by reason of this new provision. Save that the calculation related only to 23 employees, the case does not seem to me precisely to record how it was done. I have however been told in argument that the 23 employees were those who had already completed 10 years' service and had therefore, as it were, crossed the first hurdle raised by clause 5 of the letter. Those members who had served less than 10 years were ignored. The item "Provision for staff retirement benefit $770,000" was based upon this calculation.

The issue dividing the parties can thus simply be stated. Does Part IV of the Inland Revenue Ordinance allow a taxpayer in a profits tax computation to make a deduction against a future contingent liability to its staff of the type created by clause 5 as the appellants contend or as the Commissioner contends, can a taxpayer deduct against receipts only sums actually paid under such a scheme in the year in which such payments are actually made?

It is at the outset convenient to consider the effect of clause 5 and why the firm wished to make this provision at all. To my mind the effect of this clause can be summarised as follows:-

(i) In every year every member of staff becomes entitled to receive by way of total remuneration a salary divisible into two elements.

(ii) The first element is immediate, and is cash payable at whatever intervals are otherwise specified e.g. at the rate of $2X a month.

(iii) The second element which is future and contingent in two different ways, is the

> entitlement to receive an additional half month's salary, an additional $X for the same years' service. The right to claim the money is contingent upon completion of 10 years' service and of not being dismissed. The right to receive it is contingent upon retirement.

I have deliberately used the phrase "every member" in sub-paragraph (i) above because I can see no difference in principle between the position of the members of staff who have served less than 10 years and those who have served more than 10 years. Each group is potentially "earning" his retirement benefit. A risk of future payment arises in respect of both groups. The risk is more remote in respect of the former group, but this seems to me to be a matter to be taken into consideration only in the calculation of the provision. It follows in my view that if the appellants are entitled to make this provision at all, they have erred on the side of caution in excluding some unknown number of staff who have served less than 10 years.

In these circumstances the firm says that the true cost of a member of staff (at least those who have completed 10 years' service) is the total cost of both elements. If both do not appear in the accounts then such accounts do not give a true and fair view of that year's staff costs. This retirement lump sum is the product of years of service and should be charged to profits over those years. To charge it only in the final year when it is paid will distort the accounts for that year in any event, and possibly gravely distort them if a number of long-serving employees should happen to retire together. The commercial correctness of this contention is not in issue. It is not disputed that if the appellants' accounts are prepared upon the basis that provision should be made which is in fact necessary, judged by ordinary accountancy and commercial standards, then the appellants' provision should appear, and the profit would be reduced accordingly. I shall call this "the true profit". But what is contended is that on the true construction of the Hong Kong Ordinance the taxpayer is taxed, not on the true profit in the above sense, but upon a different statutory computation of profit which excludes this provision, and which I shall call "statutory profit". In an assessment of statutory profit what is permissible by way of deduction is not governed by accountancy or commercial standards but by what the law permits, and the law permits only such sums to be deducted as are paid or payable in the year of assessment.

Before me Counsel on both sides agreed that

(i) the relevant sections of the Hong Kong Ordinance for present purposes were sections 14 (with the definition of "assessable profits" in section 2), 16 and 17.

(ii) The general rule is to be found in section 16(1) which reads 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".

(iii) The remaining sub-clauses in section 16(1) give permitted examples of deductible outgoings and expenses introduced by the word "including".

(iv) Section 17 lists prohibited deductions.

(v) In relation to any deduction which was neither expressly permitted nor prohibited, the question was governed by the general rule which the court had now to construe.

(vi) There was no Hong Kong authority directly in point.

(vii) The only Hong Kong case of any assistance was the decision of the Privy Council in Commissioner of Inland Revenue v. Mutual Investment Co. Ltd. (1) Both parties relied upon that part of the speech of Sir Garfield Barwick giving the opinion of the Privy Council at p.598 D - G, where he emphasised that the then equivalent of sections 16 and 17 required the striking of a balance between receipts and deductions, and the taxation of the net profits produced by such balance. For reasons which will appear here-after I regard this approach as of decisive importance. The Ordinance expressly excluded dividends from receipts, it did

(1) (1967) A.C.587

not expressly exclude the expense of receiving dividends. But the Privy Council held that the application of the same principles to expenditure and income necessarily excluded both, p 599 B.

(viii) Part IV of the Ordinance dates back to 1947. When first introduced section 16 was substantially in the terms recorded in the Mutual Investment (1) case at p 587, and included the words :

> "There shall be deducted all outgoings and expenses wholly and exclusively incurred".

In the absence of direct Hong Kong authority, both parties resorted to other jurisdictions. The appellants relied upon the United Kingdom practice, and particularly upon the decision of the House of Lords in Owen v. Southern Railway of Peru (2) and Inland Revenue Commissioner V. Titaghur Jute Factory Co. Ltd. (3) as showing that theirs was a permissible provision in the United Kingdom. The Commissioner, on the other hand, relied upon the Australian practice and upon the construction put upon the word "incurred" in the Australian Court and particularly upon three decisions of the High Court of Australia, namely New Zealand Flax Investments v. Federal Commissioner of Taxation (4); Federal Commissioner of Taxation v. James Flood Pty. Ltd. (5); and Nilsen Development Laboratories v. Federal Commissioner of Taxation (6). In short the contest virtually became United Kingdom v. Australia.

In these unusual circumstances which understandably embarrassed the Board (case paragraph 12) I think it essential to keep clearly in mind the purposes and limitations of such an investigation. The position seems to me to be that:-

(i) it cannot be over-emphasised that its sole purpose is to aid the construction of a Hong Kong Ordinance.

(1) (1967) A.C. 587
(2) (1956) 36 TC 602 (Owen)
(3) (1978) STC 166 (Titaghur)
(4) (1938) 61 CLR 179 (New Zealand Flax)
(5) (1953) 88 CLR 492 (Flood)
(6) (1981) 11 ATR 505 (Nilsen)

(ii) Neither the relevant United Kingdom nor the Australian legislation is identical in terms to our Ordinance. All this authority is at most indirectly persuasive.

(iii) It seems to me to follow that I am in an unusual position for a judge of first instance, of having to examine critically decisions of the courts of last resort in the United Kingdom and Australia, in order to assess their persuasive effect in Hong Kong.

(iv) Of necessity Counsel on both sides have been compelled to address the court upon systems of tax law with which they are not directly familiar and with limited access to resources. I therefore recognise a high possibility of error in my assessment of these systems.

With these reservations and almost E & O E, I shall now attempt to set out and explain the differences between the two systems which seem to me to be relevant in the present Hong Kong context and the apparent reasons for them.

United Kingdom Practice

The principal relevant statute is the Income and Corporation Taxes Act 1970, and the nearest parallel is the taxing of "annual profits" under Schedule D s. 108 e.g. under cases 1 & 2 s. 109. Much of this Act is a modern re-enactment of provisions which go back to the 19th century. the legislative pattern is similar to that of the Hong Kong Ordinance, whose draftsman almost certainly had the UK precedent before him. The prohibitions equivalent to section 17 are to be found in section 130(b) - (o). The permissible deductions approximately equivalent to section 16(a) - (h) are to be found in various sections including sections 131 - 135. The opening words of section 130 and subsection (a) which operates both positively and negatively, bridge the gap and provide what I have called above the "general rule" in the following terms:-

> "Subject to the provisions of the Tax Acts in computing the amount of the profits or gains to be charged under case 1 or case 2 of Schedule D, no sum shall be deducted in respect of:-
>
> (a) any disbursements or expenses not being wholly and exclusively laid out or

expended for the purposes of the trade, profession or vacation".

When these words are compared with the original form of section 16 quoted above, it is apparent that the draftsman must have had before him the then United Kingdom equivalent of section 130, and that he chose to substitute the word "incurred" for the phrase "laid out or expended". I have to consider his legislative intent. Was he intending no change of meaning and simply using one more contemporary word instead of a phrase which had 19th century origins and perhaps connotations? Or was he intending a deliberate change of meaning and in particular adopting the meaning which had already been ascribed to the word "incurred" by the High Court of Australia? It seems to me impossible to suggest an answer to this question by a consideration of this word alone. In its context in this Hong Kong Ordinance it seems to me capable of bearing either of the meanings advanced before me, and capable of having had either construction put upon it in the other two jurisdictions in their different contexts. I am comforted here to note that in the Court of Appeal in Owen Romer LJ records a submission for the Crown at p 630 in these words:

> "Deductions which may be made from the gross profits for that year are those which can fairly be regarded as expenditure which has been incurred for the purpose of earning that year's profits".

It is obvious that Counsel for the Crown was not advancing any Australian argument, but that he was simply paraphrasing what he was contending was the effect of the UK statute. Before I can answer the question whether the Hong Kong legislator was likewise paraphrasing or intending a deliberate change of meaning I have to look beyond the single word to the broader context.

Owen (2) is the leading case. It concerned a company trading in Peru. By Peruvian statute it was obliged to pay certain sums to its employees on their retirement, basically calculated by taking a proportion of their last year's salary and by multiplying the number of years of service, unless some particular disabling event had occurred e.g. the servant had been dismissed for misconduct. The company made provision in its accounts for this future liability, and the issue was whether such

(2) (1956) 36 TC 602

provision was deductible in an assessment of profits. The House of Lords held that in principle the deduction was permissible, but that the actual provision made was not sufficiently precisely calculated to be allowed.

Lord Radcliffe, with whom Earl Jowitt and Lord Tucker agreed, spoke for the majority. His reasoning can I think be summarised thus:-

(i) In the absence of statutory direction to the contrary, the assessment of profit or gain was primarily a question of fact "to be ascertained" by the tests applied in ordinary business citing Lord Haldane in Sun Insurance Office v. Clark, 6 TC 59, at page 78, p 641.

(ii) "Provision for retirement payments is more likely to give an actual reflection of the true cost of earning the year's receipts than merely charging against them the year's payments to employees who retire in the year" p 641.

(iii) The courts have found no difficulty in adopting commercial standards and avoiding the constraints of strict legal liability in adjusting receipts to particular years in order to arrive at a truer statement of profit and the same approach should apply to outgoings. "There is nothing improper in admitting valuations or estimates if by so doing a truer balance is arrived at between the receipts of a year and the cost of earning them, or the expenses of a year and the fruits of incurring them. ... What is true of receipts is true of liabilities" p.642.

(iv) There was no substance in the contention that a rule of law existed which precluded the bringing in of items which were "in legal terms contingent at the closing of the relevant year" p 642/3. This was the precise contention before me.

(v) "The answer to the question what can or cannot be admitted into the annual account is not provided by any exact analysis of the legal form of the relevant obligation ... Whatever the legal analysis I think that, for liabilities as for debts, their proper treatment in annual statements of profit depends not upon the legal form but upon the trader's answers to two separate questions. The first is, have I adequately stated my

profits for the year if I do not include some figure in respect of these obligations? The second is: do the circumstances of the case, which include the techniques of established accounting pratice, make it possible to supply a figure reliable enough for the purpose? pp 643-4.

(vi) Consistently with this approach he criticised at p 641 the attempts to treat the various annual sums "as accruing in respect of" a particular year's service.

Lord MacDermott expressed what I regard as the same conclusion in slightly different words as follows:

> "As a general proposition it is, I think, right to say that in computing his taxable profits for a particular year, a trader who is under a definite obligation to pay his employees for their services in that year (my Lord's emphasis) an immediate payment and also a future payment in some subsequent year, may properly deduct not only the immediate payment but the present value of the future payment provided such present value can be satisfactorily determined or fairly estimated" pps 635, 636.

Although Lord MacDermott may appear to be taking a slightly more legalistic view than Lord Radcliffe, I very much doubt if this is correct and certainly can see no difference for present purposes. It is plain from the context that by "definite obligation" he meant not something that had accrued or become enforceable in the year in question, but an obligation which taking the work-force as a whole would come home in the future as "a matter of commercial certainty" p.637. In other words in Lord MacDermott's language clause 5 before me would constitute an obligation which the prudent trader could not ignore; and in Lord Radcliffe's words it was an obligation to which regard ought properly to be had in answer to his first question. Both their Lordships would I think have gratefully adopted, as I do, the Lord President's apposite phrase in Titaghur (3) "maturing obligation".

In Titaghur (3) the Court of Session in Scotland simply followed and applied Owen (2) in

(2) (1956) 36 TC 602
(3) (1978) STC 166

a case where, with the substitution of statutory liability for contractual liability under clause 5, the facts are nearly indistinguishable from those before me. Indeed the only real argument in that case was whether the company was entitled to charge in the year in question a provision for its whole workforce which provision was as retrospective as the legislation which had provoked it. The Court's answer was "yes", because that was the year in which the obligation had first arisen. If therefore the UK practice is a relevant guide then reasoning in this decision is directly applicable.

Australian Practice

Here the relevant statute is the Income Tax Assessment Act 1936-1974. The only section of this Act which I have had put directly before me is section 51(1) upon which the Commissioner particularly relies. This section reads as follows -

> "All losses and outgoings to the extent to which they are 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 shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income".

I have had to take the Australian legislative pattern and the relationship of this section to the rest of the Act from the authorities cited to me. The Commissioner's argument here is that the word "incurred" should be given the same meaning in Hong Kong as in Australia, and that I should adopt and apply the construction put upon this word by the High Court of Australia.

In argument the two cases which were dissected at length were Flood (5) and Nilsen, (6) particularly Nilsen. In both cases the Court relied upon some dicta from the judgment of Sir Owen Dixon, then Dixon J. in New Zealand Flax. (4) But having since read the whole of Sir Owen's judgment, I must take it as my starting point because it seems to me to

(4) (1938) 61 CLR 179
(5) (1953) 88 CLR 492
(6) (1981) 11 ATR 505

give the clearest possible explanation of the Australian practice and of its limitations.

The taxpayers in that case, the New Zealand Flax Co., has sold bonds to members of the public and had thereby entered into contracts with such members, the central features of which were "the furnishing by the company of a piece of land for growing New Zealand flax and of a mill for the treatment of the flax, its cultivation, cutting, treatment and sale by the company, and of the yearly distribution of net proceeds among the bond holders" p 200. The assessments in question related to the first two years of the company's operation, during the first of which it had incurred no expenditure and during the second very modest expenditure only. In drawing up its accounts it had brought in on the receipts side all moneys both received and receivable under its bonds; and on the outgoings side it made substantial provision for the future performance of its obligations outlined above. The Commissioner left the credits standing and disallowed the whole provision for future outlay. At p 201 Sir Owen said:

> "It is evident that upon the assumption that the bond moneys form part of the company's revenue a full and complete provision must be made thereout to enable the company to fulfil its obligations to provide the land, plant it with flax, make a mill available and so on, before it is possible to make any fair and just computation of the net profit of the company for the year in which such bond moneys are receivable" (my emphasis).

He clearly would have given effect to this and applied the dictum of Lush J. which he quotes at p 206 to the effect that "expenses they will incur" ought to be set off against receipts, "if the statute allowed it". But he was bound by earlier "interpretations" of the Australian statute that "the assessment must begin by taking, under the name of assessable income, the full receipts on revenue account, and only such deductions must be made as the statute in terms allows" p 199. At p 206 he detected in the statute "instances of special businesses and transactions may be found when nothing but the net profit could be regarded as a revenue item" (again my emphasis): but he went on to point out that outside these areas the general principle of interpretation must apply and in that context the use of the word "incurred" was too narrow to bring in expenditure that was certain but future. He concluded at p 207 as follows:

"But the reserves on account of the mill and for the purpose of cleaning, burning, draining, ploughing, cultivating, planting and for 'maintenance and general" cannot be brought within the authority of section 23(1)(a) (the predecessor of section 51(1)). The business propriety of making such an allowance may be made clear by stating the dilemma which affects the use of the funds represented by the suggested reserves. For either they should be expended in the work described by the headings mentioned, or else they should be repaid to the bond holders as damages or otherwise. Clearly the company should not retain the money or divide it between the Crown and their shareholders under the respective descriptions of income tax and dividends, whether dividends in a liquidation or in a going concern. But the Income Tax Assessment Act is not framed to give effect to such considerations".

When the most distinguished Australian judge within living memory feels impelled to describe the consequences of the taxing statute before him in words such as those last quoted, it seems to me that I should think very hard before acceding to the Commissioner's argument before me and concluding that the same legislative strait-jacket exists also in Hong Kong. Further it seems to me plain that Sir Owen reached his decision with reluctance and under the compulsion of authority. Had his taxing Act permitted the drawing of a balance, the treatment of "net profit" as the "revenue item", and not required this two-stage approach of ascertaining first "full receipts" and then secondly and separately permissible deductions, I feel convinced that his conclusion would not have been the same.

In Flood, (5) the High Court of Australia disallowed an attempt by a taxpayer to bring into account in year 1 that part of his employee's entitlement to holiday pay which in a commercial sense had "accrued" in that year, and held that nothing was deductible until the holiday was in fact taken in year 2. In so doing the Court applied dicta in New Zealand Flax (4) and again drew attention to the two-stage requirement of the assessment under the Australian Act above described. Deductibility of expenses it said was "not a matter depending upon 'proper commercial and accountancy

(4) (1938) 61 CLR 179
(5) (1953) 88 CLR 492

practice rather than jurisprudence'" p 506. It is noteworthy that three years later the practice disallowed in this decision was regarded by Lord Radcliffe in Owen (2) as established practice in the United Kingdom, sc p 641.

Finally in Nilsen (6) the High Court followed and possibly narrowed Flood (5). The burden of this decision is that no liability has been "incurred" within the Australian Act unless it has become due and payable in the year in question. This seems to me to be the effect of the judgment of Harwick CJ, "a pecuniary obligation which has become due" p 509; of Gibbs J., "a presently existing liability" p 511, i.e. a "present liability to make a payment" p 512, and of Mason J., "the employer is bound to make the payment" p 514. Before me the Commissioner specifically adopted the judgment of Gibbs J. as correct, and I was invited to apply to Hong Kong the test of "presently existing liability".

Two further points emerge from this decision:-

(i) The Court accepted that properly drawn commercial accounts would make provision for the items which the Court disallowed for tax, see Barwick CJ p 510 and Gibbs J. p 511. It follows that in Australia there is a fundamental distinction between what I have called true profit and what I have called statutory profit.

(ii) Gibbs J. with the approval of Stephen J. dealt specifically with an argument based on the United Kingdom decision in Owen, (2) and contrasted the United Kingdom practice with that in Australia. In three sentences he described the United Kingdom system in implicit contrast to that ruling in Australia. He said (and the numbering of his sentences is mine):-

"(i) Under the English legislation it is necessary to compute the profits or gains of the taxpayer in the year in question.

(ii) To enable the true profit to be determined it is necessary to deduct

(2) (1956) 36 TC 602
(5) (1953) 88 CLR 492
(6) (1981) 11 ATR 505

from receipts any sum which is an essential charge against those receipts.

(iii) In deciding how the profits are to be ascertained the Courts have regard to ordinary commercial principles." p 512

He went on to contrast the Australian practice re-emphasising that it was a two-stage income then deductions computation. Whereas at stage 1 it was permissible for income to be "ascertained by means of a commercial profit and loss account" p 512. This was not permissible at stage 2, the deductions stage, "as such an approach would leave little scope for the operation of" the material section p 513.

The Differences

This review of authority I think enables me to compare and contrast the two systems as follows:-

(i) On the ascertainment of receipts there may be little material difference. Both systems admit the propriety of commercial principles e.g. to the apportionment or appropriation of income, see Owen (2) p 641-2, Nilsen (6) p512.

(ii) The real differences arise in relation to the computation of deductions. In the United Kingdom this is basically a question of fact to be decided on commercial principles and it "depends not upon legal form". In Australia it is a matter of law and jurisprudence, the question being whether in law the sum became due and payable during the material year.

The reasons for these differences are I think equally apparent. In Australia the assessment process consists of two separate and distinct stages. It is therefore proper and permissible to treat each separately, and to apply different principles to each. In the United Kingdom the search is for the balance - the net profits. It seems to me to follow that "what is true of receipts is true of liabilities" per Lord Radcliffe p 642; that the same principles have necessarily to be applied to both sides of the account; and that if accounting

(2) (1956) 36 TC 602
(6) (1981) 11 ATR 505

principles are applied to revenue they must equally be applied to deduction. In the UK the process is not two-stage; rather it represents two sides of the same coin.

To which of these two systems is the Hong Kong Ordinance most analogous, not in form but in substance? The answer seems to me to be plain. It is the United Kingdom system. It is quite clear from sections 14, 16 and 17 that what the Ordinance raises is a tax on profits and that the steps enumerated in section 16 are steps towards the ascertainment of profit. This is what the Privy Council emphasised in the Mutual Investment's (1) case. This is precisely what Sir Owen Dixon said in New Zealand Flax (4) that the Australian statute did not permit. If the Ordinance requires the striking of a balance because it is looking to net profit, then the reasoning in Owen (2) precisely applies. The same principles must apply to the assessment on both sides of the account. Further I think that this has already been held to be the case by the Privy Council in the Mutual Investment (1) decision for the reasons above-suggested. Another way of testing the matter is to ask whether the three sentences above-quoted from the judgment of Gibbs J. in Nilsen (6) apply equally to the Hong Kong Ordinance. In my judgment the answer is "yes" to each sentence..

In the light of this survey I return to the construction of a Hong Kong Ordinance. I am unable to regard the word "incurred" as having some fixed and settled meaning in all contexts, or to accept that in section 16 it necessarily has the meaning ascribed to it by the High Court of Australia in section 51(1) of the Australian Act. In view of the judgment of Dixon J. in New Zealand Flax (4) it seems to me singularly unlikely that the legislator positively intended to adopt the Australian meaning, and much more probable that he was not intending to change the meaning of the UK precedent and was simply paraphrasing. But these semantic considerations fall into insignificance in comparison with the fundamental differences between the two systems outlined above. These seemed to me to demonstrate that the Hong Kong Ordinance was United Kingdom in origin and concept, and that it properly falls to be construed in the light of United Kingdom principles.

(1) (1967) A.C. 587
(2) (1956) 36 TC 602
(4) (1938) 61 CLR 179
(6) (1981) 11 ATR 505

There are, I think, two subsidiary considerations which point to the same conclusion. First in relation to the permitted deductions in section 16(a) the word used is "payable" not "paid". Does this word required that the item be payable in the material year as the Commissioner argues on the definition in Nilsen, (6) or in that year or the future as the appellants urge on the reasoning in Owen.(2) The matter was tested in argument against the exception "legal fees". Take this example. A trading taxpayer instructs a solicitor in relation to litigation directly relevant to his trading receipts. This litigation extends over three accounting periods. No bill is rendered and/or taxed until after the litigation is concluded. Until that event, says the Commissioner, all contingencies have not been removed and no quantified sum is clearly due and payable. This premise may well be correct. From this the Commissioner concludes that the whole sum is a permissible deduction only in the third year. I cannot agree that this distortion of the true position is made necessary by the word "payable". It seems to me simpler, more straightforward, and consistent with the use of this word, to say in year 1 that something must be payable to the solicitors, and to deduct an estimated sum or provision in that year. The Owen (2) reasoning is equally applicable and convincing.

Secondly, it must, I think, be manifestly more convenient, more conducive to "fairness and justice" and less productive of results like those in New Zealand Flax (4) for a "true profit" calculation to govern not simply commercial results but taxation as well. I can see no merit in this distinction between true profit and statutory profit. I must emphasise here that I am speaking of proper provision against receipts and profits, not a provision or transfer to reserves generally which is quite a different matter. In these circumstances I think I can adopt and apply the principles of construction set out by Sir Garfield Barwick in Mutual Investment (1) at p 596B. In relation to this decision I should for completeness say that I cannot accept the Commissioner's argument as to the effect of the paragraph in that speech starting at p 598G. To my mind Sir Garfield was not there ruling out ordinary business

(1) (1967) A.C. 587
(2) (1956) 36 TC 602
(4) (1938) 61 CLR 179
(6) (1981) 11 ATR 505

considerations for all purposes; but simply excluding the taxpayer's computation there because of the inclusion amongst its receipts of dividends which were specifically excluded by statute from the category of receipts.

In my judgment therefore:-

(i) The reasoning in Owen (2) and Titaghur (3) apply to the construction of the Hong Kong Ordinance.

(ii) For the purposes of the ascertainment of their profits under section 16, the appellants were entitled to include in their accounts a provision in respect of their maturing liability under clause 5 computed as in Titaghur (3).

(iii) Such provision could properly reflect the firm's prospective future liability to its whole staff and not simply to those who had already served 10 years or more.

Finally I was asked by the Commissioner to note and record his position on two further points. The first was that he still wished to challenge the Board's finding in paragraph 18 of the award. I do not see how this is open to him. Whether the firm's estimate was sufficiently precise within the principles of Owen (2) was a question of fact for the Board. They considered it and answered it in the appellants' favour. If in so doing they left out of consideration the members of staff who had served less than 10 years, this operated against the firm not in its favour. It cannot be said, and indeed is not said, that there was no evidence before the Board upon which it could have reached this result. In these circumstances I do not myself see why this finding is not conclusive. Certainly I cannot possibly review or even criticise it on the material before me.

Secondly it was said that the matter had to go back to the Board if I find as I have, because the taxpayer could not deduct both the actual payments and the provision in this year. In the first year I fail to see why not. The actual deduction relates to the benefit payable in that year; the provision to benefit payable in the future. Different considerations will apply to future years when the firm will be confined to an adjusted provision, see Lord Radcliffe in Owen (2) at p.641.

(2) (1956) 36 TC 602
(3) (1978) STC 166

For these reasons I think that in very understandable circumstances the Board came to a wrong conclusion, and that this appeal must be allowed. For my part I would answer the Board's specific questions as follows:-

(i) No - the provision came within section 16.

(ii) No - clause 5 created the liability.

(iii) The error was in failing to follow and apply the reasoning in Owen and Titaghur.

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

(D.S. Hunter)

Judge of the High Court

Robert Kotewall, instructed by Lo & Lo for appellant
Barrie Barlow, Crown Counsel for the respondent

In the High Court

Order of Mr. Justice Hunter 18th March 1982

No. 4

Order of Mr. Justice Hunter - 18th March 1982

INLAND REVENUE APPEAL NO. 2 OF 1981

BETWEEN

LO and LO — Appellant

and

COMMISSIONER OF INLAND REVENUE — Respondent

DATE STAMPED 27 APR 1982

BEFORE THE HONOURABLE MR. JUSTICE HUNTER IN COURT

O R D E R

UPON appeal by way of case stated dated the 23rd day of November, 1981 from a decision of the Board of Review by the Commissioner of Inland Revenue against the decision of the Board and UPON HEARING Counsel for the Respondent and Counsel for the Appellant.

IT IS ORDERED that the answer to the first question put by the Board of Review in paragraph 21(1) of the case stated be 'No'.

AND IT IS ORDERED that the answer to the second question put by the Board of Review in paragraph 21(2) of the case stated be 'No'.

AND IT IS ORDERED that the answer to the third question put by the Board of Review in paragraph 21(3) of the case stated be "The error was in failing to follow and apply the reasoning in "Owen" and "Titaghur"'.

AND IT IS ORDERED that the answer to the fourth question put by the Board of Review in paragraph 21(4) of the case stated be 'I would prefer to express the error as in (iii) above with particular reference to the views of Lords Radcliffe and MacDermott, than to endorse this precise proposition'.

AND IT IS FURTHER ORDERED that the appeal brought by the Appellant firm be allowed with costs to be paid by the Respondent to the Appellant.

Dated the 18th day of March, 1982.

(N.J. Barnett)
Registrar.

No. 5

Notice of Appeal - 23rd April 1982

IN THE COURT OF APPEAL

CIVIL APPEAL No. 48 of 1982

(On Appeal from Inland Revenue Appeal No. 2/81)

BETWEEN

The Commissioner of Inland Revenue — Appellant (Respondent)

and

Lo and Lo a firm — Respondent (Appellant)

Notice of Appeal

Take Notice that the Court of Appeal will be moved as soon as Counsel can be heard on behalf of the abovenamed Appellant (Respondent) on the appeal from the Judgment herein of the Honourable Mr. Justice Hunter given on the 18th day of March 1982 whereby he allowed the taxpayer firm's appeal with costs.

And Further Take Notice that the grounds of this appeal are that:-

1. The provision in the accounts of the taxpayer for the payment of retirement benefits was not an outgoing or expense incurred during the year of assessment for the purposes of Section 16(1) of the Inland Revenue Ordinance, Cap. 112 because : (a) the provision was a future liability and not an outoing or expense which had been incurred, and (b) the provision reflected a contingent future liability.

2. The Learned Judge erred in distinguishing the decision of the High Court of Australia in Nilsen Development Laboratories v. F.C.T. (1981) 11 ATR 505 and the Learned Judge failed to properly apply the House of Lords decision in Owen v. Southern Railway of Peru (1956) 36 T.C. 602.

3. The Learned Judge erred when he asked himself the question of which tax system in most analogous to the Hong Kong Inland Revenue

Ordinance "not in form but in substance" and should have confined himself to applying the words of Section 16(1) of Cap. 112 without presumption.

4. Alternatively, if the Learned Judge was correct and the provision had been incurred in the year of assessment the provision in the accounts was no more than a rough estimate of liability and was therefore not deductible as the taxpayer had failed to properly quantify its liability.

Dated the 23rd day of April, 1982.

Sgd. B.G.J. Barlow
(B.G.J. Barlow)
Counsel for the Appellant(Respondent)
Attorney General's Chambers

To: The Respondent (Appellant)
Lo and Lo,
Solicitors,
Swire House, 11th Floor,
Hong Kong.

No. 6

Respondent's Notice under O.59 r.6(2)
16th June 1982

IN THE COURT OF APPEAL

CIVIL APPEAL NO. 48 OF 1982

(On Appeal from Inland Revenue Appeal No. 2/81)

BETWEEN : THE COMMISSIONER OF INLAND REVENUE — Appellant (Respondent)

and

LO AND LO, a firm — Respondent (Appellant)

RESPONDENT'S NOTICE UNDER ORDER 59 RULE 6(2)

TAKE NOTICE that the Respondent, while seeking to uphold the judgment and order entered for the Respondent against the Appellant upon the hearing of the Respondent's appeal before the Honourable Mr. Justice Hunter on the grounds on which such judgment and order were in fact given and entered, desires to contend on the appeal that the said judgment and order should be affirmed on the following grounds :

1. Irrespective of which system of taxation is more analogous to the Kong Kong Inland Revenue Ordinance, Cap.112, and irrespective of the precise wording of the different pieces of legislation, it is the principles and practice of taxation enunciated by the House of Lords in Southern Railway of Peru v. Owen (1956), 36 T.C. 602 which should be followed in Hong Kong.

2. Alternatively, even if Australian authorities are relevant, Nilsen Development Laboratories, v. F.C.T. (1981), 11 ATR 505 is not a satisfactory authority for Hong Kong as

(1) its ratio decidendi is unclear,

(2) it is inconsistent with earlier Australian decisions, notably F.C.T. (1974) v. James Flood Pty. Ltd. (1953), 88 C.L.R. 492 and RACV Insurance Pty. v. F.C.T. (1974), 74 ATC 4169,

(3) it was decided against the background of a structure of taxation which is

different from that obtaining in Hong Kong.

AND FURTHER TAKE NOTICE that the Respondent will apply to the Court of Appeal for an order that the Appellant pay to the Respondent the costs occasioned by this notice to be taxed.

Dated the 16 day of June, 1982

Sgd. Lo and Lo

LO AND LO

To : The Appellant (Respondent)
The Commissioner of Inland Revenue

IN THE COURT OF APPEAL Civil Appeal 48/82

BETWEEN

THE COMMISSIONER OF INLAND REVENUE Appellant

and

LO AND LO, A FIRM Respondent

Coram: Leonard V-P, Cons & Zimmern JJ.A.
Date : 28th September, 1982

JUDGMENT

Leonard V-P:

Zimmern J.A. has authorised me to say that he has read this judgment in draft and that he agrees with it.

The notice of appeal as argued raises two closely allied issues. Before attempting to define these I should indicate the nature of the sum which the respondent claims to deduct under section 16(1) and the purposes of the remaining relevant sections in Part IV of the Ordinance. On the 3rd January, 1977, the respondents introduced a new term into the conditions of employment of all its staff, which read:

"Clause 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 for a member of the staff who is dismissed for dishonesty, serious misconduct or gross inefficiency."

Two sums appeared in the respondent's accounts for the period between January and December 1977. Some staff members, all of whom had served for more than 10 years retired during that period and they received in all the total sum of $93,102. This sum was allowed as a deduction by the Commissioner. The

sum which was disallowed by the Commissioner ($770,000) was based on a calculation made by the respondent as to the total of the lump sum payments that they might be obliged to pay 23 other members of the staff who had already completed 10 years' service but whose service continued. Each such staff member might by retiring secure his entitlement to his lump sum payment and could forfeit it only by dismissal for cause. The total of $770,000 then represented the total of minimum lump sums - what the 23 would have been entitled to had they retired then and there. Each would become entitled to an increasing lump sum for each complete year he served after December 1977. The first issue to be decided, then is whether the total of the lump sum payments should properly be deducted in ascertaining the profits in respect of which the respondents were chargeable to tax; and the second whether the total of those lump sums could be dismissed as "no more than a rough estimate of liability".

Section 16(1) of the Inland Revenue Ordinance, Cap. 112 provides:

> "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".

That subsection was agreed by counsel in the Court below to contain "the general Rule" relating to the permissibility of making deductions for the purpose of ascertaining profits in respect of which a person is chargeable to tax. The remaining subclauses in section 16(1) give examples of permitted deductions and contain a list of outgoings and expenses introduced by the word "including". The use of this word suggests that unlisted outgoings and expenses are permitted 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. The examples given are not exhaustive and the question as to any deduction which is neither expressly permitted nor prohibited, is governed by the general rule set out at the beginning of section 16(1).

The matrix in which section 16(1) finds itself is Part IV of the Ordinance. This part is entitled "Profits Tax" but there is no definition to be found in the Ordinance of the word "profits". There is a definition in section 2 of the words "assessable profits" which "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". This definition does not appear to me to be any assistance, it brings us back to Part IV and therefore does not help in its interpretation. Part IV consists of 39 sections, only 5 of which namely sections 14, 15, 16, 17 and 18, were referred to in argument before us. In the Court below it was agreed that the relevant sections were sections 14 (with the definition of "assessable profits" in section 2) 16 and 17 but that is not to say that other sections may not be looked to for their interpretation. One must look to the entirety of Part IV.

Section 14 is the charging section and provides that profits tax shall be charged for each year of assessment at the rates there mentioned 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.

Section 15 deems sums described in paragraphs (a) to (k) to be receipts arising in or derived from the Colony from a trade, profession or business carried on in the Colony. I need not concern myself with this section, save to note its position and that the sums described are deemed to be receipts. I can find no assistance in section 15B, 15C or 15D.

Although it was not cited to us in argument, section 16A is of interest, it reads:

> "16A Where a person carrying on a trade, profession or business in the Colony makes a payment which is either:
>
> (a) a contribution, other than an ordinary annual contribution to a fund duly established under an approved retirement scheme, or

(b) a premium, other than an ordinary annual premium, in respect of a contract of insurance under an approved retirement scheme,

such payment shall, to the extent that it is made in respect of individuals employed by such person for the purposes of producing profits in respect of which he is chargeable to tax under this Part and that it is not excessive in view of all the relevant circumstances, be deemed to be an expense wholly and exclusively incurred in the production of such profits and shall be allowed as a deduction therefrom in accordance with subsection (2).

(2) For the purpose of making the deduction provided for in subsection (1), one fifth part of the payment shall be deemed to have been expended during the basis period in which the payment was actually made and the remaining four parts shall be deemed to have been expended at the rate of one part in the basis period for each of the succeeding four years of assessment;

Provided that in no case shall the total amount of the deductions exceed the amount of the payment.

(3) For the avoidance of doubt it is hereby declared that this section is applicable only to payments made in or after the basis period for the year of assessment commencing on 1st April 1955".

Subsection (3) appears to suggest that in the opinion of the draftsman payments made prior to the coming into force of section 16A to a retirement scheme (even although approved) would not be an expense wholly and exhaustively incurred in the production of profits; the same conclusion may be reached from the use of the word "deemed" in section 16A(1). Section 16B, section 16C and section 16D are not of assistance.

Section 17 deals with deductions that are not permitted, it reads:

"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"

various matters set out in 8 sub-paragraphs.

Section 18 deals with the basis for computing profits and provides in general that assessable profits for any year of assessment from any trade, profession or business carried on in the Colony shall be computed on the full amount of the profits therefrom arising in or derived from the Colony during the year preceding the year of assessment.

I have no doubt that the liability towards the staff, if incurred at all was incurred in the production of taxable profits so that the words calling for interpretation are "all outgoings and expenses to the extent to which they are incurred".

I consider that in any approach to the interpretation of our Ordinance it is necessary to bear in mind the warning in I.R.C. Appuhamy (1) at 72 that it is not useful to refer to decisions in other jurisdictions where the forms of the respective statutory provisions are not the same. The statutory provisions in the United Kingdom, those taxing "annual profits", are as the trial judge pointed out similar but not the same as ours. The words used there are:

> "No sum shall be deducted in respect of:
>
> (a) any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation".

Section 15(1) of the Australian Income Tax Assessment Act 1936 to 1974 which reads:

> "All losses and outgoings to the extent to which they are 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, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private, or domestic nature or are incurred in relation to the gaining or production of exempt income".

again is similar but again there are important differences, to which I will refer, and what is being dealt with again is (judging by the title to the Act) income tax. What we are dealing with is an Ordinance which imposes taxes on property,

(1) (1963) 1 All E.R. 69

earnings, profits and interest and which in Part IV imposes a tax on profits. As the trial judge recognised all the authorities cited to him (and to us) are, at most, indirectly persuasive. In the English cases the words falling for interpretation appear to have been "any disbursements or expenses not being money wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation". The relevant words in section 51(1) of the Income Tax Assessment Act 1936 in Australia appear to have been "all losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income or are necessarily incurred in carrying on business for the purpose of gaining or producing such income", but section 51(1) not only bears a resemblance to our section 16(1), it also, by its reference to losses or outgoings of capital or of a capital, private or domestic nature introduces matters dealt with by our section 17 and by its reference to outgoings "incurred in relation to the gaining or production of "exempt income". I assume it pre-empts the argument unsuccessfully advanced in C.I.R. v. Mutual Investment Co. Ltd. (2) Its structure then is quite different from ours as are the words "losses and outgoings" used in place of our words "outgoings and expenses". The differences in wording and the warning in Appuhamy's case have resulted for me in a complete stoppage of play in the England and Australia test due to bad light.

By its use of the words "outgoings and expenses to the extent they are incurred" our legislation would appear to recognise a distinction between "outgoings" and "expenses". We have seen that the word "profits" is not defined and although the phrase "assessable profits" is, it is defined in a somewhat circuitous way. Again the phrase "profits arising in or derived from the Colony" is defined for the purposes of Part IV "without in any way limiting the meaning of the term" as including "all profits from business transacted in the Colony whether directly or through an agent". The use of the phrase "without in any way limiting the meaning of the term" gives some slight indication that the term "profits" is intended to be a wide one to be interpreted in its every day commercial meaning. It is these profits that Part IV seeks to tax. Does our Ordinance by the words it used compel its reader to hold that the legislature intends to impose and imposes a tax not on profits but on a

(2) A.C. 587 (1967)

figure arrived at by a statutory computation which prevents the respondents claiming a deduction which is normal commercially in ascertaining profits? To determine this we must look to the words "one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to tax. Nothing is to be read in, nothing is to be implied (Cape Brandy Syndicate v. I.R.C. (3)

Because of the differences between our legislation and the English legislation on the one hand and the Australian legislation on the other the only case which I have found of assistance is C.I.R. v. Mutual Investment Co.Ltd.(2) The following table shows the relevant sections as they were then and as they are now:

Relevant provisions in Ordinance as it was when C.I.R. v. Mutual Investment Co. Ltd. i.e. Inland Revenue Ordinance as amended by Inland Revenue (Amendment) Ordinance 1956. Section 2.	As now.
"Assessable profits" means the net profits for the basis period arising in or derived from the Colony calculated in avoidance with the provisions of Part IV but does not include profits arising from the sale of capital assets.	"Assessable profits" means the profits in respect of which a person is chargeable to tax for the basis period of any year of assessment calculated in accordance with the provisions of Part IV.
Section 14 "(1) Corporations profits tax shall, subject to the provisions of this Ordinance, be charged for each year of assessment on every corporation carrying on trade or business in the Colony in respect of the profits of the corporation arising in or derived from the Colony from such trade or business".	Section 14 "(1) Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment 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".

(2) A.C. 587 (1967)
(3) (1921) 1 K.B. 64 at 71

Section 16 "(1) For the purpose of ascertaining the assessable profits if any person there shall be deducted all outgoings and expenses wholly and exclusively incurred during the basis period for the year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part".	Section 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..."
Section 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 ... (b) any disbursement or expenses not being money expended for the purpose of producing such profits".	No change.

The Judicial Committee there regarded it as:

"Clear enough that sections 16 and 17 provide exhaustively for the deduction side of the account which is to yield the assessable profits. They relate deductibility to the production of profits in respect of which the corporation is chargeable to tax which by section 18A are the assessable profits calculated in accordance with Part IV. Section 16(1) does not provide for the deduction of expenses from the assessable profits but for the deduction of expenses 'for the purpose of' the ascertainment of assessable profits. Its terms presuppose receipts from which deductions can be made to determine a balance which will be the assessable profits. On the other side of the account are the total receipts derived from the Colony not being from the sale of capital assets, see section 2 and section 14(2) and not being dividends, which in their Lordship's

opinion, are excluded from the account by section 26(a). It is the balance of this account which, in their Lordship's opinion, is spoken of as the 'net profits' in the definition of assessable profits in section 2.

Having regard to these provisions there is no room in their Lordship's opinion for treating the profits to which section 14(1) refers as the balance of the total receipts over the total disbursements of the taxpayer arrived at upon ordinary business accounting considerations or for commencing the process of calculating assessable profits with an opening figure of the total of the business receipts and thereafter deducting the permitted deductions making the deductibility referable to the business receipts and not to the receipts forming part of the assessable profits. Indeed the use of the word 'profits' as distinct from receipts in section 14(1) is inconsistent with any such conclusion or process".

While appreciating that the legislative purpose in enacting the new section 16 was to avoid the interpretation of section 16 adopted by the Full Court (but ultimately not accepted by the Privy Council) in C.I.R. v. Mutual Investment Co. Ltd. (2) (see (1964) H.K.L.R. 173 and (1967) A.C. 587). I am puzzled as to why the introductory words to section 16(1) were changed to "In ascertaining ....." while the words "For the purposes of ascertaining" in section 17 were left unchanged. As to this and having regard to the ultimate result of the Mutual Investment case I am compelled to the view that the only legislative change effected by the new section 16(1) was that brought about by the substitution of the words "to the extent to which they are incurred during the basis period" for the words "wholly and exclusively incurred during the basis period". Section 16 may then be paraphrased to read:

> "In order to ascertain the taxable profits you shall deduct from the total of receipts and sums deemed to be receipts all outgoings and expenses to the extent to which they are incurred in the production of such profits".

I think this paraphrase also accords with the passage I have quoted from C.I.R. v. Mutual Investment Co. Ltd. (2) If I am correct in this paraphrase the

first issue can be decided by deciding whether the total of the lump sums can be said to be an "expense" "incurred". I think it must be in the ordinary meaning of those words for it is an allowance for the cost of administering a retirement scheme started to avoid losing experienced staff and as such is an expense. This is particularly so if there is to be a difference between "expense" and "outgoing". It is "incurred" in that liability for it was assumed. I do not, however, think that it is entirely proper to split up the words used in this manner and merely do so as a check on my interpretation of the words "expenses to the extent to which they are incurred in the production of profits" which to my mind embrace such an allowance as this. I cannot see that the liability was contingent affects the expense resulting from the contingent liability from being "incurred".

I have said that I believe that my paraphrase accords with the passage quoted from C.I.R. v. Mutual Investment Co. Ltd. (2) although Mr. Barlow laid considerable stress on that part of the passage reading:

> "There is no room in their Lordship's opinion for treating the profits to which section 14(1) refers as the balance of the total receipts over the total disbursements of the taxpayer arrived at upon ordinary business accounting considerations".

That however must be read in its context and what their Lordships were dealing with was an expense incurred in earning that part of Mutual Investment's profits which was not to bear tax. One must if one is to give any significance to section 16(1) ascertain the expenses to be deducted (from receipts) - in the case in which the liability for those expenses has been assumed for the production of profits subject to taxation as distinct from the case in which the liability has been assumed for the production of profits not subject to taxation - upon ordinary business accounting considerations.

Does the presence of section 16A alter the position? It was not suggested before us that it did and I think this is the correct approach. On my interpretation it is unnecessary and in thinking that it was necessary the legislature made a mistake of law. This mistake cannot change the law. (see Smith Kline and French v. A.G.) (4)

(4) (1966) H.K.L.R. 498

As to the second issue it arises from paragraphs 16, 17 and 18 of the Board's case. Mr. Barlow complains that there is no true finding of fact in these paragraphs. They read:

> "16. The Commissioner's representative also contended that the taxpayer's appeal should fail on the ground that the sum claimed to be deducted was 'in the nature of a rough reserve against the future rather than a measured provision' (Lord Radcliffe in Southern Railway of Peru v. Owen (5)). In particular Lord Radcliffe criticised the company for omitting to allow for discounting.
>
> 17. The taxpayer's representative's reply to this point was that the amount sought to be deducted is reasonable accurate. That although the sum was not discounted, the margin which would be obtained by the discounting would serve to offset the inevitable increase of future payments due to salary increases. Also with only about 23 companies involved, there was no case for the employment of an actuary as in the Titaghur case where about 17,000 employees were involved. The report of the Southern Railway of Peru case does not indicate the number of employees involved and it is probable that the number is well in excess of the taxpayer's.
>
> 18. In the circumstances theBoard accepted the contention of the taxpayer's representative and held that it would not dismiss the appeal on this ground".

I consider that there is implicit in the Board's acceptance of the contentions of the taxpayer a finding that the sum sought to be deducted is accurate. Furthermore the trial judge found himself unable "to review or even criticise it" on the material before him. I find myself in the same position.

From these reasons I would dismiss the appeal.

(P.F.X. Leonard)
Vice President

(5) 36 T.C. 602 at 644

Cons J.A.:

My Lord the Vice-President has sufficiently set out the facts and legislation which provide the background to this appeal.

Taken literally neither an "outgoing" nor an "expense" can be incurred until it is actually paid. "Outgoing" speaks for itself and "expense" is derived from the Latin, to pay away. However, neither of the two jurisdictions to which we have been referred takes that strict view. Australia may allow the deduction of monies that are "due", although they are not actually paid until some later years: Nilsen Development Laboratories Proprietary Ltd. v. Federal Commissioner of Taxation. (1) England allows the present value of payments that will, as matter of commercial certainty, become payable in the future, provided the present value of the future payment can be satisfactorily determined or fairly estimated.

The leading authority in England is that of the House of Lords Owen v. Southern Railway of Peru.(2) The facts of that case differ from the present, apart from the nature of the business practiced by the taxpayer, in only two respects. Firstly the liability to pay on retirement was imposed by statute rather than by contract and secondly that there was no additional claim to deduct monies which might be thought referable to previous years. The first distinction is to my mind immaterial. The second is covered by I.R.C. v. Titaghur Jute Factory Co. Ltd. (3) A decision of the Scottish Court of Session which applied Owen (2) and allowed both amounts to be deducted.

I appreciate that the circumstances of the present case do not fall strictly within the terms of the second principle laid down by Their Lordships of the Privy Council in De La Salle v. De La Salle, (4) namely that this Court is in effect bound by the decisions of the House of Lords where our legislature has adopted the same legislation as is in force in England. But the general tenor of Their Lordships' remarks inclined me to think that we should do so, unless there is an effective difference in the language used or the two sets of legislation operate upon different patterns.

(2) (1956) 36 T.C. 602
(3) (1978) S.T.C. 166
(4) (1979) H.K.L.R. 214 at 220

It is suggested by the Commissioner that both exceptions apply. Firstly, the word used in section 16(1) is "incurred", whereas in England it is "laid out or expended", together with the difference between "in the production of profits in respect of which he is chargeable to tax" and "for the purposes of the trade, profession or vocation". Secondly, it is said that in Australia the taxable profits are calculated on a two stage system whereby the whole financial receipts of the taxpayer are added up and from the total thus achieved the statutory deductions are made, leaving a balance subject to taxation. The English system is said to be a one stage system of drawing a balance according to normal commercial or accounting practice.

"In the production of profits etc." is from the taxpayer's point of view, a more narrow exception than "for the purposes of the trade etc.", and I do not think much assistance could be drawn from any English case that dealt with the latter phrase. However, we are not concerned with that aspect. For us the crucial word is "incurred", and to my mind that has, if anything, a wider meaning than "laid out or expended", for it includes the acceptance of a liability as well as the meeting of that liability as and when it matures. Thus if there be any difference in meaning at all, it is a difference that can only be in favour of the taxpayer and would not detract from the authority of Owen. (2)

As to the second objection I must confess to some difficulty in appreciating the distinction suggested, for it seems to me that whether one applies statutory or commercial rules a profit can only be established by deducting the appropriate losses from the appropriate receipts. The vital difference between the jurisdictions, as I see it, is merely that in Australia what is appropriate by way of deduction is decided in the last resort by the judges applying statutory standards, whereas in England it is judged by the standards set by the accountancy profession, subject of course to any particular overriding legislation. In my opinion Hong Kong falls within the latter pattern for although there are some particular instances set out in subsection 16(1) those instances are introduced by the word "including". That implies that there must be other deductable items which have not been specifically mentioned, and how are these to be found except by reference to normal accountancy practice, provided of course that they do not contravene the general words of the subsection.

(2) (195C) 36 T.C. 602

I do not think this conclusion is inconsistent with the words of Sir Jarfield Borwick (sic) in C.I.R. v.Mutual Investment Co. Ltd.(5) The question in that case was not whether outgoings or expenses had or had not been incurred. There was not doubt that they had. The question was whether in the ascertainment of taxable profits they could be set off against particular receipts. The passage on which the Commissioner relies must be taken in that general context and in the particular context of the highly technical argument that their Lordships were at that stage refuting.

The views I have just expressed follow more or less closely the line taken by Hunter J. in the Court below. But I would not go so far as he does to suggest that it produces a result which is necessarily "manifestly more convenient and more conducive to 'fairness and justice'" than that adopted by the Australian courts. It seems to me that there is much to be said for the simplicity and certainty of the Australian approach. The unforunate situation that was highlighted in New Zealand Flax Investment Ltd. v. Federal Commissioner OF Taxation (6) which, together with the criticism voiced therein by Dickson J., so heavily influenced the judge below, and which, incidentally, at least to some extent appears to have been of the taxpayer's own making, could easily be provided for by legislation.

I agree with the comments made by my Lord the Vice-President, upon section 16A and upon the further argument that the taxpayer had failed sufficiently to quantify his claim.

I also would dismiss the appeal.

(D. Cons)
Justice of Appeal

Mr. Barrie Barlow, Crown Counsel for appellant
Mr. Robert Kotewell (Lo & Lo) for respondent

(5) (1967) A.C. 587
(6) (1938) 61 C.L.R. at 179

No. 8

Order - 28th September 1982

IN THE COURT OF APPEAL

(on appeal from Inland Revenue Appeal No. 2 of 1981)

BETWEEN

The Commissioner of Inland Revenue — Appellant (Respondent)

and

Lo and Lo, a firm — Respondent (Appellant)

BEFORE THE HONOURABLE MR. JUSTICE LEONARD, VICE PRESIDENT, THE HONOURABLE MR. JUSTICE CONS JUSTICE OF APPEAL AND THE HONOURABLE MR. JUSTICE ZIMMERN JUSTICE OF APPEAL IN COURT

O R D E R

UPON READING the Notice of Appeal dated the 23rd day of April, 1982 filed on behalf of the Appellant (Respondent) by way of appeal from the judgment of the Honourable Mr. Justice Hunter given on the 18th day of March, 1982 whereby it was ordered that the taxpayer firm's appeal be allowed with costs.

AND UPON READING the said judgment dated the 18th day of March, 1982

AND UPON HEARING Crown Counsel for the Appellant and Counsel for the Respondent.

IT IS ORDERED that the said judgment of the Honourable Mr. Justice Hunter dated the 18th day of March 1982 be affirmed, and that this appeal be dismissed with costs to be paid by the Appellant (Respondent) to the Respondent (Appellant).

Dated the 28th day of September, 1982

(N.J. Barnett)
Registrar

In the Court of Appeal

Order granting Final Leave to Appeal to Her Majesty in Council - 18th November 1982

No. 9

Order granting Final Leave to Appeal to Her Majesty in Council - 18th November 1982

Civil Appeal No. 45 of 1982

IN THE COURT OF APPEAL

(On Appeal from Inland Revenue Appeal No.2 of 1981)

BETWEEN

THE COMMISSIONER OF INLAND REVENUE — Appellant (Respondent)

and

LO AND LO (a firm) — Respondent (Appellant)

BEFORE THE HONOURABLE MR. JUSTICE LEONARD, VICE-PRESIDENT, THE HONOURABLE MR. JUSTICE CONS, JUSTICE OF APPEAL, AND THE HONOURABLE MR. JUSTICE FUAD, JUSTICE OF APPEAL

O R D E R

UPON READING the Notice of Motion herein dated the 10th day of November, 1982 on behalf of the above-named Appellant (Respondent) for final leave to appeal to Her Majesty the Queen in Her Privy Council from the judgment of the Court of Appeal pronounced on the 28th day of September 1982.

AND UPON READING the affirmation of Harry Macleod filed herein on the 11th day of November, 1982 and all his exhibits therein referred to.

AND UPON HEARING Counsel for the Appellant (Respondent) and UPON PERUSING the letter of consent dated the 17th November 1982 from the Respondent (Appellant).

IT IS ORDERED that the Appellant (Respondent) do have final leave to appeal to Her Majesty the Queen in Her Privy Council from the judgment of the Court of Appeal pronounced on the 28th day of September 1982.

AND IT IS FURTHER ORDERED that the costs of this application be costs in the appeal.

Dated the 18th day of November, 1982.

(N.J. Barnett)
Registrar

No. 59 of 1982

IN THE JUDICIAL COMMITTEE OF 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

RECORD OF PROCEEDINGS

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Solicitors for the Respondent