Privy Council Appeal No. 59 of 1982

The Commissioner of Inland Revenue *Appellant*

v.

Lo and Lo (a firm) *Respondent*

FROM

THE COURT OF APPEAL OF HONG KONG

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 10TH MAY 1984

Present at the Hearing:

LORD SCARMAN
LORD ELWYN-JONES
LORD BRANDON OF OAKBROOK
LORD BRIGHTMAN
SIR DENYS BUCKLEY

*[Delivered by **Lord Brightman**]*

This is an appeal by the Commissioner of Inland Revenue from a decision of the Court of Appeal of Hong Kong. It relates to the deductibility for profits tax purposes of sums carried to reserve to answer future retirement payments to staff.

The taxpayers are a long established firm of solicitors and notaries practising in Hong Kong under the name of Messrs. Lo and Lo. Prior to 1977 the firm operated an *ex gratia* system of retirement benefits. In order to put matters on a legal footing, the firm, on 3rd January 1977, issued to all their employees a circular letter setting out for the future their general conditions of employment. Under paragraph 5 of the letter a retiring member of the staff, who had completed 10 years of service, was to become entitled to a lump sum payment roughly equivalent to 1/24 of his annual salary as at the date of retirement for each year of service. The paragraph was in the following terms:-

> "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

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> 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."

Their Lordships will refer to a member of the firm's staff who has completed 10 years of service as a long service employee.

Under the Inland Revenue Ordinance of Hong Kong, the year of assessment for the purposes of profits tax runs from 1st April to 31st March. The accounting year of the firm ran from 1st January to 31st December. The firm's return for the year of assessment 1977/78 was accordingly based on accounts for the calendar year 1977. In their return for that year the firm debited to profit and loss account the sum of $93,102 paid out to certain employees who had retired during that year, and in addition a sum of $770,000 transferred to reserve as "Provision for Staff Retirement Benefits". As explained by Vice-President Leonard in his judgment, tne latter sum:-

> "....was based on a calculation made by the [firm] 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 principal question in issue is whether such sum of $770,000, transferred to reserve as distinct from being paid out, is a proper deduction for the purpose of ascertaining the profits in respect of which the firm were chargeable to tax. In raising an assessment for the year 1977/78, the assessor allowed as a deduction the sum of $93,102 which had been paid out to employees who had retired during the year 1977, but he disallowed the sum of $770,000 carried to reserve. This assessment was upheld by the Board of Review. The firm appealed to the High Court by way of case stated. The Board stated four questions of law for the opinion of the High Court, of which only the first is relevant for present purposes, namely, whether on the facts found it was open to the Board to hold that the sum of $770,000 claimed to be deducted did not come within the deductions permitted by section 16(1) of the Inland Revenue Ordinance. This question involved a subsidiary point, whether the sum actually claimed to be deducted, if otherwise

allowable, should be disallowed because it was not an adequately measured appraisal of the liability.

Profits tax is imposed by Part IV of the Ordinance. Under section 14, which is the first section of Part IV, the tax is to be charged for each year of assessment on a 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.... as ascertained in accordance with this Part".

Section 2 contains a somewhat circular definition of assessable profits as "....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". The "basis period" for any year of assessment is defined as "the period on the income or the profits of which tax for that year ultimately falls to be computed"; in other words, it is the taxpayer's accounting period.

Section 16, which is the section upon which this appeal hinges, is in the following terms:-

> "(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..."

The statutory inclusions are, shortly stated, as follows:-

> "*(a)* sums payable.... by way of interest....
> *(b)* rent paid....
> *(c)* tax.... paid elsewhere....
> *(d)* bad debts incurred....
> *(e)* expenditure incurred in the repair of any premises....
> *(f)* expenditure incurred in the replacement of....
> *(g)* ....a sum expended for the registration of a trade mark...
> *(ga)* ....payments and expenditure on certain scientific research and technical education;
> *(h)* such other deductions as may be prescribed by any rule made under this Ordinance."

Sub-section (2) of section 16 has been repealed.

Section 17(1) provides that:-

> "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...."

and there follow a number of specific statutory exclusions, from *(a)* to *(h)*, of which the following are examples:-

"*(a)* domestic or private expenses, including the cost of travelling between residence and place of business;
(b) any disbursements or expenses not being money expended for the purpose of producing such profits."

Sub-section (2) of section 17 forbids a deduction, in the case of a partnership, for salaries or other remuneration of partners or for interest on partners' capital or loans.

The narrow issue is whether the sum carried to reserve in respect of the aggregate "accrued" rights of long service employees to retirement benefits was "an expense incurred" during the year 1977 by the firm in the production of profits in respect of which they were chargeable to tax. The Board of Review having answered the question in the negative, the High Court and the Court of Appeal answered it in the affirmative.

It is not in dispute that, as a matter of good accounting practice and for the purpose of showing a true picture of the profits of the year 1977, it was commercially correct to carry to reserve a sum equal to the "accrued" retirement benefits of long service employees. The argument of the appellant, as set out in paragraph 9 of his case, is that the point is solely one of the true construction of section 16; that the ordinary and natural meaning of "incur" is "render oneself liable to", or "bring upon oneself"; and that "a sum is an outgoing or expense incurred during a particular period only if that sum is paid, or there is a liability (legal or practical) to pay it, in that period". In the instant case there was no liability during the year 1977 to pay any sum by way of retirement benefit to a long service employee who did not in fact retire during that year, and such employee could not be said to have any right thereto. The sum was only payable to him at a future date when he left the firm's employment and was contingent on his not leaving as a result of dismissal for dishonesty, serious misconduct or gross inefficiency.

The appellant conceded that under the United Kingdom system of taxation the sum in question would have been allowable as a deduction for the purpose of computing the amount of profits or gains chargeable to tax. It was submitted, however, that the United Kingdom system was fundamentally different from the Hong Kong system. In the United Kingdom, profits or

gains fell to be accounted for on ordinary commercial principles subject to a prohibition against certain specified deductions. Under the Hong Kong system of taxation, the legislative scheme is to provide exhaustively for the items which may be deducted from receipts when ascertaining the taxable profit, regardless of good accountancy practice. In this respect the Hong Kong legislation was similar to that of Australia and New Zealand, where comparable sums had been held not to be deductible. The appellant referred in particular to *C.I.R. v. Mutual Investment Company Limited* [1967] 1 A.C. 587, where Sir Garfield Barwick, delivering the opinion of the Board, said (page 598):-

> "It is clear enough that sections 16 and 17 provide exhaustively for the deduction side of the account which is to yield the assessable profits."

This observation was made in the context of an earlier, but not significantly different, version of the Inland Revenue Ordinance.

It is perfectly correct to say that sections 16 and 17 provide exhaustively for the deductions which are permissible to be made, but not in the sense that permitted deductions are confined to the particular matters specified in paragraphs *(a)* to *(h)* of section 16(1). Sections 16 and 17 provide exhaustively for deductions in the sense that permitted deductions are confined to outgoings and expenses incurred in the production of profits in respect of which tax is chargeable; that such permitted deductions expressly include those specified in *(a)* to *(h)* of section 16(1), and expressly exclude those in section 17. In the opinion of their Lordships commercial considerations are not wholly to be disregarded in the course of this process. They are relevant for the purpose of deciding what can properly be treated as "outgoings and expenses....incurred during the basis period....in the production of profits in respect of which" the taxpayer is chargeable to tax.

In construing section 16, weight must be given to the fact that deductions are not confined to sums actually paid by the taxpayer. Such sums would be covered by the word "outgoings" standing alone. The contrast between "sums <u>payable</u>" in paragraph *(a)* and "rent <u>paid</u>" in paragraph *(b)* and the inclusion in paragraph *(d)* of "bad debts incurred" show clearly enough that the legislature was not thinking only of disbursements made during the basis period. The question is, therefore, how far beyond mere disbursements is section 16 intended to travel or, more specifically, does the section travel far enough to comprise the sum which the taxpayer seeks to deduct in the present case?

Their Lordships turn to examine in more detail the precise nature of the retirement benefits in respect of which the deduction is claimed. It is correct to regard a retirement benefit as a sum payable in futuro, because there is no liability to pay until a future date arrives, namely the date when the employee leaves the firm's employment. Nevertheless the employee may leave when he pleases, so that the firm has no power to defer payment for any longer than the employee wishes. The right of the employee to receive his retirement benefit is absolute, in the sense that he need do nothing whatever except give a period of notice and pick up his money. True that he loses his entitlement if dismissed for dishonesty, serious misconduct or gross inefficiency before he gives notice or during the currency of the notice, but that does not make his right contingent. He has a vested right which is defeasible only in one possible but unlikely event. The corollary of the view that the long service employee has a vested right to his accrued lump sum payment is that the firm has an accrued liability for that sum.

Suppose that an employee enters the firm's employment on 1st January 1968 and is paid throughout at a constant rate of $10,000 a month. On 31st December 1977 he has an immediate right to receive $50,000 subject to his having given due notice to leave the company. Suppose that he continues with the company after 1977. His position on 31st December 1978 will be that he has a similar right to receive $55,000; in 1979 the figure will be $60,000 and so on, year by year; suppose that he retires at the end of the year 1987, $100,000 will then be paid to him. In ordinary commercial parlance the liability to pay $50,000 out of the $100,000 ultimately paid is referable to the year 1977; the liability to pay a further $5,000 is referable to the year 1978; and so on, year by year. The question now arises whether each of the respective sums which made up the ultimate $100,000 are to be regarded as "an expense incurred" during the year to which such sum is referable.

For reasons already given, "an expense incurred" is not confined to a disbursement, and must at least include a sum which there is an obligation to pay, that is to say an accrued liability which is undischarged. Their Lordships then ask themselves why the $50,000 in the example given is not to be considered a sufficiently accrued liability in the year 1977 to be admissible as an "expense incurred" in that year within the meaning of the section? The only argument could be that the employee has not seen fit to exercise his right to demand payment, and that he might forfeit such right through misconduct. Neither element in the opinion of their Lordships is sufficient to disqualify the $50,000 as an "expense incurred", given that such expression is not confined

to a disbursement. The employee had a choice whether to receive payment of $50,000 on 31st December 1977 or to defer receipt of such payment to a later date. The firm could not resist the obligation to make such payment on 31st December 1977 if the employee chose to take the appropriate steps to demand it. Their Lordships consider that in such circumstances it would be placing an unduly narrow construction on section 16 to deny such $50,000 the description of "an expense incurred during the year 1977".

Their Lordships are therefore of the opinion that, on a proper construction of section 16, the sum of $770,000, being the amount which long service employees could at the close of the year 1977 have demanded upon retirement, was an expense incurred during that year.

Their Lordships do not find it useful to refer to the Australian and New Zealand cases cited by the appellant, in which a different result was reached in somewhat comparable circumstances upon different statutes.

Their Lordships should not be taken as necessarily agreeing with the implication in the judgment of Mr. Justice Hunter that, if the firm are entitled to make a deduction in respect of the retirement sums earned by long service employees, they are equally entitled to make an appropriate deduction in respect of employees who are in process of qualifying as long service employees but have not yet done so. Such employees do not have any present right to demand payment, and different considerations may apply in their cases.

The appellant further contended that the $770,000 was not a measured appraisal of the expense incurred in the year 1977, but only a rough calculation. There was no attempt, it was said, to measure the present value of that future liability. In the opinion of their Lordships no question of discounting the $770,000 arose from the fact that the retirement benefit would not be payable until a future date. Such a submission would only be correct if the reserve fund to which such sum was carried was to be segregated from the firm's other assets and the income accumulated in augmentation of the fund. As this was not the position, the sum set aside to reserve, assuming no reduction in salary and no future misconduct of an employee, was the probable minimum amount which would ultimately be needed to cover the liability. It is true that the sum of $770,000 would not in all circumstances be the precise minimum. Apart from reduction due to possible misconduct of an employee it would also be reduced if the salary of an employee fell sufficiently in the last 12 months of his employment, by

comparison with his salary in the year 1977, to offset the effect of his further employment. Both the Board of Review, the High Court and the Court of Appeal accepted that the sum carried to reserve was sufficiently accurate, and their Lordships consider that that conclusion is not open to a successful challenge.

Their Lordships will humbly advise Her Majesty that the appeal should be dismissed. The appellant must pay the respondent's costs.