1987 December 19

[DEMETRIADES, J.]

IN THE MATTER OF ARTICLE 146 OF THE CONSTITUTION

VASSOS ELIADES LTD

Applicants,

v

THE REPUBLIC OF CYPRUS, THROUGH
1 THE MINISTER OF FINANCE,
2. THE COMMISSIONER OF INCOME TAX,

Respondents

(Case No 151/81).

Taxation — Income tax — Deductions — The Income Tax Laws, sections 11(1) and 13(c) — Gratuity by a company limited by shares to the widow of its Managing Director — In the circumstances, it was reasonably open to the Commissioner to disallow the deduction

Taxation — Income tax — Goods lost during Turkish invasion of Cyprus — Sellers waived their right to claim the price — Whether such a waiver constitutes a gift of a capital nature or a trading receipt — In the circumstances reasonably open to the Commissioner to treat it as a trading receipt — The British Mexican Petroleum Company Ltd v Jackson, 16 T C 570 distinguished

The applicants, who are a private company of limited liability, pray for a declaration to the effect that the decision of the Commissioner of Income Tax regarding the computation of their chargeable income for the years 1975 (74) to 1979 (78), and the notice of tax payable, issued on the year of assessment 1979(78), is null and void and of no effect whatsoever

Goods of the value of £15,996 00, which had been ordered by the applicants were unloaded at Famagusta harbour on the 29th June, 1974 A bill dated the 14th June, 1974, which would mature on the 1st October, 1974 was drawn and accepted by the applicants for the payment of the value of the goods plus bank charges The goods were lost by reason of the Turkish invasion

At the end of 1974, the value of these goods appeared in the books of the applicants as purchases though the goods were not included in their closing

stock in trade for that year. In the returns for the year 1975, the auditor of the applicants reported that the sellers of the goods Rosenthal had waived their claim for the value of the goods and because of this he credited their value to the trading and profit and loss account for the year that ended on the 31st December, 1975.

However, applicants' tax consultant was of a different view. His opinion was that the equivalent amount of the debt owed by the applicants and which had been waived by the sellers was not a receipt of the trade but a gift and, therefore, a receipt of a capital nature not liable to income tax.

In early 1975 Mr. Vassos Eliades, the Managing Director of the applicants, died and the company made to his wife a death gratuity of £15,000. - This amount was charged to the accounts of the company for the year 1975.

The questions that pose for decision in the present case are the following two:

(a) Whether the respondent's decision to disallow as a deduction the gratuity of £15,000.- paid to the widow of the deceased Managing Director of the company was reasonably open to him, and

(b) Whether the decision of the Commissioner to treat the debt waived by the sellers as a receipt of trade was also reasonably open to him.

Held, *dismissing the recourse:* (1) What deductions are allowed under the Law are specified in section 11(1) of the Income Tax Laws, which include, amongst others, outgoings and expenses wholly and exclusively incurred in the production of income. Section 13(e) of the Income Tax Laws further provides that no deduction shall be allowed in respect of any disbursements or expenses not being money wholly and exclusively laid out or expended for the purposes of acquiring the income.

(2) The fact that the payment of the gratuity was made in accordance with the provisions of the memorandum of the company does not render automatically such payment an allowable deduction for income tax purposes if it could not be treated as such under the provisions of the relevant Income Tax Laws.

(3) The payment of the gratuity could be allowed as a deduction only if it could be connected with the better carrying on of the trade or business of the company and with the earning of its income.

(4) In the circumstances of the case and as this is a family company, it could reasonably be inferred that the payment was made in order to fulfil the shareholders' desire for a financial assistance to the widow and not in order to enable the company to carry on its trade or business for the purposes of earning its income.

(5) There is no doubt that the sellers of the goods waived their right to claim the price because the applicant company was doing business with them.

(6) It is unreasonable to permit the applicant company to record in its books as a liability the sum of £15,996.- and not to include in its stock in trade the goods for which such liability was incurred. The entries made originally by the auditor of the company were rightly made by him and it was reasonably open to the respondent to treat the waiver of the debt as a trading receipt and decide on it accordingly.

Recourse dismissed. No order as to costs.

Cases referred to:

The British Mexican Petroleum Company Ltd. v. Jackson, 16 T.C. 570;

Adamtsas Ltd. v. The Republic (1977) 3 C.L.R. 181.

Recourse.

Recourse against the income tax assessments raised on applicants for the years of assessment 1975-1979.

M. HadjiChristofis, for the applicants.

A.Evangelou, Senior Counsel of the Republic with M. Photiou, for the respondents.

Cur. adv. vult.

DEMETRIADES J. read the following judgment. By means of the present recourse the applicants, who are a private company of limited liability, pray for a declaration to the effect that the decision of the second respondent, that is the Commissioner of Income Tax (hereinafter referred to as the «Commissioner»), contained in his letters to the applicants dated the 11th February, 1981 and the 13th April, 1981, regarding the computation of their chargeable income for the years 1975 (74) to 1979 (78), and the notice of tax payable, issued in the year of assessment 1979 (78), is wrong and, therefore, null and void and of no effect whatsoever.

The company derives its income from manufactured goods which it imports. One of its suppliers are Messrs. Rosenthal Gals U. Porzellan A.G. (hereinafter referred to as «Rosenthal»), who, according to the facts submitted by the applicants, manufacture crystal and porcelain products.

The facts of the case are in brief, the following.

Goods of the value of £15.996 00, which were ordered by the applicants to Rosenthal arrived in Cyprus and were unloaded at Famagusta harbour on the 29th June, 1974 A bill dated the 14th June, 1974, which would mature on the 1st October, 1974, was drawn and accepted by the applicants for the payment of the value of the goods plus bank charges Before the goods, however, were cleared from customs, the second round of the Turkish invasion started, as a result of which Famagusta was occupied by the Turkish Forces and the goods were lost

At the end of 1974, the value of these goods appeared in the books of the applicants as purchases though the goods were not included in their closing stock in trade for that year. In the returns for the year 1975, the auditor of the applicants reported that Rosenthal had waived their claim for the value of the goods and because of this he credited their value to the trading and profit and loss account for the year that ended on the 31st December, 1975

However after the Commissioner examined the accounts of the applicants and raised certain queries with regard to the losses allegedly suffered by them during 1975, the applicants called in Mr Phanos Ionides, a Tax Consultant, to advise them in collaboration with their auditor. His opinion, which he also communicated to the Commissioner by his letter dated the 27th June, 1977 (see Appendix 1 to the Application) was that the equivalent amount of the debt owed by the applicants and which had been waived by Rosenthal was not a receipt of the trade but a gift and, therefore, a receipt of a capital nature not liable to income tax

By his letter dated the 11th February, 1981, which was addressed to Mr. Ionides and which is Appendix 3 to the Application, the Commissioner rejected the contention of Mr. Ionides regarding this matter On the same day the Commissioner, who apparently had completed by then the examination of the accounts of the applicants for the years 1975 to 1978, communicated to the auditor of the applicants his decision by letter of even date and he attached to it the amended computations of the losses of the applicants for the said years. Mr. Ionides then, on behalf of the applicants, by letter dated the 26th February, 1981, objected against the amended computation of

their losses and with regard to this matter he reiterated the claim of the applicants that Rosenthal, by waiving the debt, had made a gift to them not liable to income tax.

The stand taken by the Commissioner to the views expressed by Mr. Ionides in his objection appear at p. 2 of the third document (letter dated the 13th April, 1981) appended to the opposition, the relevant part of which reads:-

> «But even if we assume - just for the sake of discussion - that in 1974 there was an alleged liability to the Suppliers, then we see in 1975 that such liability does not exist; and since this liability had been recorded, it will have to be transferred to the credit side of the profit and loss account as it was correctly done by the company's auditor.
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> .....
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> In this case it was pointed out that *'The only possible method of determining the liability, seems to be by taking the amount which ultimately proved to be the actual liability'*. The actual liability in the case of Vassos Eliades Ltd is Nil and therefore the whole amount of £15,996 should be credited to the company's profit and loss account.»

In early 1975 Mr. Vassos Eliades, the Managing Director of the applicants, died and the company made to his wife a death gratuity of £15,000.-. This amount was charged to the accounts of the company for the year 1975.

The claim of the applicants for the deduction of this amount was discussed between the Commissioner and the auditor of the applicants and the former at first decided to allow, as a deduction, the sum of £5,000.-. Later on, and after the examination of the returns of the applicants was completed and the amended computation of losses, to which I have earlier referred, were communicated by the Commissioner to the auditors of the applicants, it appeared that the Commissioner disallowed wholly as a deduction the gratuity to the widow of the late Managing Director of the applicants. Mr. Ionides, by his letter dated the 26th February, 1981, also submitted objection with regard to this matter.

The sub judice decision was communicated to the company by means of a letter dated the 13th April, 1981, against which the present recourse was filed.

The applicants abandoned their claim which was originally raised in these proceedings that the funeral expenses for the burial of their Managing Director was deductible. The Commissioner also stated that the preliminary point which he raised in his opposition, namely that the recourse was filed prematurely, could not stand and he abandoned it.

Having said this, I find that the questions that pose for decision in the present case are the following two:

(a) whether the respondent's decision to disallow as a deduction the gratuity of £15,000.- paid to the widow of the deceased Managing Director of the company was reasonably open to him, and

(b) whether the decision of the Commissioner to treat the debt waived by Rosenthal as a receipt of trade was also reasonably open to him.

I now come to the first question that poses for determination.

The applicant company is a family company, the shareholders of which were the deceased Managing Director, his widow and their two sons. After the death of the Managing Director the Board of Directors passed a resolution for the payment of the gratuity to the widow. This resolution was taken by virtue of the provisions of paragraph (p) of clause 3 of the Memorandum of Association of the company, which reads as follows:

> «To make donations and give subscriptions to any object likely to promote the interests of the Company, and to grant bonuses, gratuities and pensions to officers or ex-officers and employees or ex-employees of the Company, or their dependents or connections and to endow, support and subscribe to any educational, social or charitable institution or society calculated to be beneficial to such person.»

As it appears from the letter of the respondent, dated the 13th April, 1981, the amount of £15,000.- was not treated as an allowable deduction because it was not payable to the heirs of the late Managing Director but to a particular person, his wife, and, therefore, it represented a personal gift to her by the company.

Counsel for the respondent submitted that this was only one of the factors taken into consideration by the respondent when deciding that the payment was a voluntary one and not an

expense wholly and exclusively incurred for the production of the company's income.

What deductions are allowed under the Law are specified in section 11(1) of the Income Tax Laws, which include, amongst others, outgoings and expenses wholly and exclusively incurred in the production of income. Section 13(e) of the Income Tax Laws further provides that no deduction shall be allowed in respect of any disbursements or expenses not being money wholly and exclusively laid out or expended for the purposes of acquiring the income.

On this point counsel for the applicant company submitted that the payment of the death gratuity was made for the sake of preserving for the company its good name as an ideal employer, a fact which would enable the company to look forward to securing the services of well qualified men in its employment, particularly in executive posts, who no doubt would regard such payment as an additional advantage of their employment. He further submitted that the payment was made pursuant to the powers given to the company by its memorandum and in order to preserve the goodwill and reputation of the company, as a good employer and, therefore, it was made for the purposes of the company's trade and as such it is an allowable deduction from profits.

The fact that the payment of the gratuity was made in accordance with the provisions of the memorandum of the company does not render automatically such payment an allowable deduction for income tax purposes if it could not be treated as such under the provisions of the relevant Income Tax Laws.

Having given the matter due consideration I have reached the conclusion that the payment of the gratuity could be allowed as a deduction only if it could be connected with the better carrying on of the trade or business of the company and with the earning of its income.

In the circumstances of the case and as this is a family company, it could reasonably be inferred that the payment was made in order to fulfil the shareholders' desire for a financial assistance to the widow and not in order to enable the company to carry on its trade or business for the purposes of earning its income.

Therefore, I am of the view that it was reasonably open to the respondent to treat the payment of the gratuity as not deductible and there is no justification to interfere with such a finding.

The fact that when reaching his original decision the respondent decided to make an allowasnce of £5,000.- from the sum of the gratuity, against which the applicant had objected, does not preclude him, during the re-examination of the case and in the correct application of the provisions of the Law, to disallow the whole amount of the gratuity as a deduction. The reference by counsel for the applicant to other cases where the respondent had made concessional allowances of certain amounts of death gratuities for income tax purposes is not evidence by itself leading to the inevitable conclusion that the respondent was bound, in the circumstances of this particular case, to accept finally part of the gratuity in question as deductible if it otherwise was not deductible.

I now come to the second issue raised in the present proceedings. Counsel for the applicant company argued that the relevant entries in the accounts of the company by its auditor in respect of the amount concerned were wrongly made in that the waiver of the debt was entered into the relevant accounts as a trade receipt, whereas it ought to have been entered as a capital receipt, because such waiver was made by Rosenthal as a gift to the applicant company for reasons independent and irrelevant from the transaction out of which the debt arose.

The said contention of counsel was based mainly on the authority of *The British Mexican Petroleum Company Limited v. Jackson*, 16 T.C. 570, on which Mr. Ionides based his argument in trying to persuade the Commissioner that he was wrong in his approach to the matter in issue. The reasons for disagreeing with the said approach are to be found in the Commissioner's letter of the 13th April, 1981, which reads:-

> «Permit me to disagree with you that the facts of this case are identical in all respects with the U.K. case *British Mexican Petroleum Co Ltd v. Jackson*.
>
> In the case mentioned by you the company could not continue to perform its obligation under the contracts and the realisable value of its assets were not sufficient to meet the claim. Undoubtedly - as it was held - a very bad bargain had been made and that too much had been charged.

The two suppliers of the British Mexican Petroleum (The Andrew Weir and Co Ltd and the Husteca Co Ltd) by releasing the debt *had a distinct purpose*, a purpose namely to give the Company relief by in effect *giving them new capital;* and this, obviously because, the whole voting power of the British Mexican Petroleum was in the hands of these two Suppliers. These two Suppliers could have wound up the Company and certainly no profit would have been made in the winding up and the debt would then disappear.

All the above facts do not exist in the case of Vassos Eliades Ltd and therefore, there can be no correlation between these two cases.

It is also important to mention that in the case British Mexican Petroleum the goods were purchased and the unsold goods were included in the company's closing stock and that there was a legal obligation on the part of the company to meet its liability. In our case, however, the goods never reached the company's warehouse and there was neither a purchase nor a liability; and the goods were never included in the company's closing stock.

But even if we assume - just for the sake of discussion - that in 1974 there was an alleged liability to the Suppliers, then we see in 1975 that such liability does not exist; and since this liability had been recorded, it will have to be transferred to the credit side of the profit and loss account as it was correctly done by the company's auditor.»

On the other hand, counsel for the respondent referred by way of useful guidance to the case of *Adamtsas Ltd. v. The Republic,* (1977) 3 C.L.R. 181, where (at p. 195) the following are stated:

«Directing myself with these judicial pronouncements, and having in mind the long correspondence exchanged between the liquidator and the insurance company, I have reached the conclusion that the insurance company, in spite of what has been said that it was an ex gratia payment, it was a payment or a part payment for part of the goods which were looted by the Turks during the inter-communal troubles.

There is no doubt that the payment was effected because the company in question was doing business with the said insurance company and, therefore, in my view it is a trading

receipt, that is to say, a payment by the insurance as a matter of business. For these reasons, I think that the Commissioner rightly treated it as a trading receipt and liable to tax. I, would, therefore, dismiss this contention of counsel for the applicant, because the said sum of £4,000.- was the receipt from the trade which had been carried on by the company.»

I have considered very carefully the authorities cited and the contentions put forward by counsel and I have no doubt that the waiver of the debt was made by Rosenthal because the applicant company was doing business with them. It is unreasonable to permit the applicant company to record in its books as a liability the sum of £15,996.- and not to include in its stock in trade the goods for which such liability was incurred. The entries made originally by the auditor of the company were rightly made by him and it was reasonably open to the respondent to treat the waiver of the debt as a trading receipt and decide on it accordingly.

I treat the present case, on its own particular circumstances, as distinguishable from the facts and circumstances of *The British Mexican Petroleum Company Limited,* case, supra.

For all the foregoing reasons, the present recourse fails and it is dismissed accordingly.

Costs of these proceedings to be paid by the applicants.

Recourse dismissed with costs against applicants.