

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D10/04

Salaries tax – whether a sum received by the appellant upon termination of his service was chargeable to salaries tax – approach to be adopted in determining whether payment was in fact a gratuity – whether sum was part of the contractual payment package or paid under the Employment Ordinance.

Panel: Ronny Wong Fook Hum SC (chairman), William Cheng Chuk Man and Herbert Tsoi Hak Kong.

Date of hearing: 18 March 2004.

Date of decision: 18 May 2004.

By an agreement dated 20 February 1995, the appellant was engaged by Company A as a senior inspector of works on the terms specified in a Memorandum on Terms of Employment ('the Memorandum').

Under the Memorandum, the term of appellant's engagement was for three years and was subject to early termination by Company A upon providing three month's written notice. In addition, the Memorandum provided that upon early termination the appellant would be entitled to a gratuity in the sum of 25% of the basic salary the appellant received during his substantive office with Company A.

By letter dated 28 February 1997, the appellant's employment was duly terminated with effect from 31 May 1997. Subsequently, in accordance with the Memorandum, the appellant was duly paid a sum of HK\$320,209.00 for the period between 20 February 1995 and 31 May 1997. This sum was labelled a 'Gratuity' in the returns of Company A.

The appellant submitted that this sum was not assessable to salaries tax as it constituted a severance payment within the meaning of sections 31B and 31G of the Employment Ordinance (Chapter 57) ('the EO'). The issue before the Board was whether the sum of HK\$320,209.00 constituted income from the appellant's employment with Company A within the meaning of section 8 of the Inland Revenue Ordinance (Chapter 112) ('the IRO').

Held:

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1. The label attached to a payment such as 'gratuity' or 'severance payment' is not a conclusive indicia as to the nature of the payment in question. The proper approach is to look at the terms of the contract and the character of a payment made under it in order to determine the true nature of such payment.
2. A distinction must be drawn between severance payments made pursuant to the statutory obligation under the EO and those made pursuant to the provisions of a contract of employment.
3. The sum in question was part of the payment package between the appellant and Company A at the commencement of the relevant period of employment. It was payable to the appellant without any breach on the part of Company A.
4. Accordingly, following the approach in D51/01, since the payment was sourced from the appellant's employment and was a payment in respect of his services, the payment was 'income' for the purposes of section 8 of the IRO and taxable as such.

Appeal dismissed.

Cases referred to:

D51/01, IRBRD, vol 16, 451

D81/01, IRBRD, vol 16, 671

Chow Cheong Po for the Commissioner of Inland Revenue.

Taxpayer in person.

Decision:

1. By an agreement dated 20 February 1995, the Appellant was engaged by Company A as the senior inspector of works on the Project B on terms set forth in a 'Memorandum on Terms of Employment' ['the Memorandum']. According to the Memorandum:

- (a) The term of engagement was for a period of three years.
- (b) 'On satisfactory completion of the full period of agreement required by this Memorandum or if the service of the person engaged is terminated under paragraph 11.1 or 13.1 of this Memorandum and for reasons other than

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misconduct, the person engaged will receive a gratuity for the period of service, including periods of annual leave earned and taken within the agreement. Such gratuity will be payable at the rate of 25% of total basic salary of substantive office drawn during the agreement period' (paragraph 4).

- (c) '[Company A] may as necessitated by work on site at any time determine the engagement of the person engaged by giving him three calendar month's notice in writing or by paying him one month's salary in lieu of notice ...' (paragraph 13.1).

2. By letter dated 28 February 1997, Company A gave three months' notice to the Appellant terminating his employment on 31 May 1997.

3. According to the return of Company A, the Appellant was paid a "Gratuity" in the sum of \$320,209 in respect of the period between 20 February 1995 and 31 May 1997. The issue before us relates to the assessability of the whole or part of this sum of \$320,209.

4. The Appellant maintains that the sum of \$320,209 is not assessable to salaries tax as the same constitutes severance payment which he is entitled under sections 31B and 31G of the Employment Ordinance (Chapter 57) ('EO').

- (a) Section 31B(1) of the EO provides:

'Where an employee who has been employed under a continuous contract for a period of not less than 24 months ending with the relevant date –

- (a) is dismissed by his employer by reason of redundancy; or*
- (b) is laid off within the meaning of section 31E*

the employer shall ... be liable to pay to the employee a severance payment calculated in accordance with section 31G'.

- (b) Section 31(G) of the EO provides that

'Subject to this Part, the amount of a severance payment to which an employee is entitled in any case shall be calculated by allowing-

- (a) in the case of a monthly rated employee, two-thirds of his last full month's wages, or two-thirds of \$22,500, whichever is less;*

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- (b) *in any other case, 18 days' wages based on any 18 days chosen by the employee and occurring during his last 30 normal working days, or two-thirds of \$22,500, whichever is less,*

for every year ... of employment under a continuous contract by his employer subject in all cases to a maximum payment not exceeding, where the relevant dated occurs in a period specified in column 1 of table A in the Seventh Schedule, the amount specified in column 2 of that table opposite to the period'

- (c) Section 31I of the EO further provides that:

'If an employee becomes entitled to payment of the severance payment under this Part and-

- (a) *because of the operation of the employee's contract of employment, one or more gratuities based on length of service or one or more relevant occupational retirement scheme benefits have been paid to the employee; or*

- (b) *a relevant mandatory provident fund scheme benefit is being held in a mandatory provident fund scheme in respect of the employee,*

the severance payment is to be reduced by the total amount of all of the gratuities and benefits to the extent that they relate to the employee's years of service for which the severance payment is payable'.

5. The difficulties with this branch of the law stems from the Revenue's concession in not taxing severance payments paid pursuant to the statutory obligation as imposed by the EO. Taxpayers had frequently transposed such concession to a situation where the payment in question was made pursuant to the provisions of a contract of employment.

6. What we are concerned with is the proper constructions of sections 8 and 9 of the Inland Revenue Ordinance ('IRO'):

- (a) Section 8 of the IRO provides that *'salaries tax shall ... be charged for each of assessment on every person in respect of his income arising in or derived from Hong Kong from ... any office or employment of profit...'*
- (b) Section 9(1)(a) of the IRO provides that *'Income from any office or employment includes .. any wages, salary, ...gratuity, perquisite, or allowance, whether derived from the employer or others ...'*

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7. In the context of these two sections of the IRO, the question to be asked is whether the sum in question constitutes income from the Appellant's employment with Company A. The authorities suggest two approaches in answering this question. The wider approach seeks to investigate whether the payment in question was *sourced* from the employment. The narrower approach asks whether the payment in question was a payment for services rendered by the taxpayer. All the authorities are in one voice in rejecting labels such as 'gratuity' or 'severance payment' as conclusive indicia as to the nature of the payment in question for salaries tax purposes. The proper approach is to look at the terms of the contract and the character of a payment made under it in order to determine the true nature of such payment.

8. The Revenue drew our attention to the decisions of this Board in Case No D51/01, IRBRD, vol 16, 451 and Case No D81/01, IRBRD, vol 16, 671 as illustrative of the principles which we summarised in paragraph 7 above. The Appellant sought to distinguish Case No D51/01 on the basis that the taxpayer in that case had not been employed for a continuous period of 24 months with the result that the payment in question could not be regarded as severance payment within the EO. He urged us to place no weight on Case No D81/01 on the basis that it was a case on long service as opposed to severance payment. We reject these submissions of the Appellant and we find both authorities of assistance in our deliberation. In Case No D51/01, the Board clearly pointed out in paragraph 30 of its decision that:

'At the end of the day one still has to look into the true nature of the payment. There is no doubt that, in the present case, the payment in question was part of the pay package agreed between Company A and the Taxpayer at the commencement of the employment (as an inducement to the Taxpayer to take up the employment) which became payable without any breach on the part of Company A'.

9. We are of the view that the present case is indistinguishable from Case No D51/01. The sum in question was part of the pay package agreed between the Appellant and Company A at the commencement of the relevant period of employment. It was payable to the Appellant without any breach on the part of Company A. The payment was sourced from the Appellant's employment and was a payment in respect of his services. The payment is income for the purposes of section 8 of the IRO and is therefore taxable as such.

10. For these reasons, we dismiss the Appellant's appeal and confirm the assessment.