# Case No. D151/00

**Salaries tax** – exemption – whether severance payment/long service payment – whether entitled to 10% tax refund under the Tax Exemption (1997 Tax Year) Order – sections 8(1), 9(1), 68(4) and 87 of the Inland Revenue Ordinance (' IRO' ).

Panel: Patrick Fung Pak Tung SC (chairman), Robin M Bridge and Colin Cohen.

Date of hearing: 5 February 2001.
Date of decision: 27 March 2001.

The taxpayer was employed as a resident site staff under a contract of employment dated 5 January 1996 signed between Company A and himself. The agreement was intituled ' Hong Kong Government project local resident staff Agreement' and expressed to be made between Company A ' acting as agents for the Government of Hong Kong' and the taxpayer.

Under the terms of the Agreement, the employment of the taxpayer was to end on 4 July 1998. By a letter dated 8 June 1998, Company A wrote to the taxpayer and said that approval had been given by Department C to extend the taxpayer' s contract until 21 November 1998 and that gratuity covering 30 months from 5 January 1996 to 4 July 1998 would be paid to the taxpayer at the end of his current contract.

The Commissioner has a declared policy and an established practice that no salaries tax will be assessed and demanded on severance payments and long service payments made in accordance with the Employment Ordinance (' EO' ).

The taxpayer also submitted that he was entitled to a 10% tax refund based on the Tax Exemption (1997 Tax Year) Order made by the Chief Executive in Council pursuant to section 87 of the IRO.

**Held:**

1. In light of the express terms of the Agreement and the Memorandum, the Board is in no doubt that, during the period between 5 January 1996 and 27 November 1998, the taxpayer was an employee of the Government and not Company A which was acting only as an agent of the Government, its disclosed principal.

2. The EO does not provide for its application to the Government. In view of the provision of section 66(1) of the Interpretation and General Clauses Ordinance, the Board is of the view that the EO does not bind the Government.

3. The gratuity was part of the remuneration paid to the taxpayer by the Government. It was and is not severance payment or long service payment made to the taxpayer under the EO. Hence, the same was not exempt from salaries tax under the declared policy and established practice of the Commissioner.

4. Even if the Board is wrong in its conclusion above and the EO does apply for the benefit of the taxpayer, it is of the opinion that these still do not assist the taxpayer. It is settled law that labels such as 'gratuity' or 'severance payment' are not conclusive. One must 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. The gratuity was part of the remuneration and reward paid to the taxpayer for his service for the full period of the contract of employment as subsequently extended. It was not a severance payment or long service payment made to him under the EO.

5. Furthermore, by virtue of section 31I of the EO, any entitlement of the taxpayer to severance payment under the EO would have been reduced to zero because of the gratuity he was receiving under the terms of the Agreement. Similarly, by virtue of section 31V of the EO, even if the taxpayer was entitled to claim long service payment, it was still a sum smaller than his gratuity.

6. Although the gratuity was calculated with reference to the basic salary for the period of the Agreement, it did not accrue to him until completion thereof. The whole gratuity should be chargeable in the year of assessment 1998/99. The Tax Exemption (1997 Tax Year) Order is applicable to the year of assessment 1997/98.

**Appeal dismissed.**

Cases referred to:

D90/96, IRBRD, vol 11, 72
D24/97, IRBRD, vol 12, 195

Chow Chee Leung for the Commissioner of Inland Revenue.

Taxpayer in person.

**Decision:**

1. This is an appeal by the Taxpayer against a notice of assessment and demand for salaries tax for the year of assessment 1998/99 (' the Assessment' ) issued by the Respondent (' the Commissioner' ) on 13 October 1999. An objection was lodged by the Taxpayer on 19 October 1999. By his letter dated 26 September 2000, the Commissioner made a determination and rejected the Taxpayer' s objection. The Taxpayer has brought this appeal against such determination.

2. The original amount of the salaries tax assessed was $159,936. By a letter dated 31 January 2001 addressed to the Taxpayer and copied to this Board, the Commissioner gave notice that as a result of an incorrect computation relating to certain rental value in the Assessment, the Assessment was less than what it should have been and that it was the Commissioner' s intention to ask the Board to confirm the re-assessment resulting in the amount of tax payable being $165,740 instead of $159,936.

3. Prior to and at the hearing of the appeal, the Taxpayer was asked whether he needed more time to deal with and whether he wished to object to the re-assessment as indicated by the Commissioner. The Taxpayer answered both questions in the negative. We therefore proceeded to deal with the appeal on that basis.

**The facts**

4. No evidence was called by the Taxpayer or the Commissioner. Save for the question as to whether the Taxpayer was employed by Government, there was no dispute about the facts.

5. The Taxpayer was employed as a resident site staff under a contract of employment dated 5 January 1996 (' the Agreement' ) signed between Company A and himself.

6. The Agreement was intituled ' Hong Kong Government project local resident staff Agreement' and expressed to be made between Company A ' acting as agents for the Government of Hong Kong' and the Taxpayer (therein defined as ' the person engaged' ).

7. Clause 1 of the Agreement read as follows :

> ‘ 1. The Government AGREES to employ the person engaged through the Consulting Engineers [Company A] upon the Conditions contained in this agreement and the appendix hereto annexed.’

8. Under clause 2 of the Agreement, the Taxpayer undertook to perform his duties as senior inspector of works in an Area B scheme ‘ or other Hong Kong Government scheme’ and to act according to instructions or directions given ‘ by the Government through the Consulting Engineers or other duly authorised officers’ .

9. Clause 3 of the Agreement provided that his initial salary would be at the rate of $39,300 per month ‘ (MPS 34) in Salary Scale Points 34 – 37 of the approved salary scales of the Government’ .

10. Clause 4 of the Agreement provided that the Agreement was subject to the conditions set forth in the appendix thereto annexed and that the same should be read and construed as part of the Agreement.

11. Clause 5 of the Agreement provided that Company A would not be in anyway personally liable for anything arising out of the Agreement.

12. The appendix annexed to the Agreement was a document intituled ‘ Memorandum on terms of employment for local resident site staff other than those who were eligible for and were occupying non-departmental quarters as at 1 May 1991 Hong Kong Government schemes’ (‘ the Memorandum’ ).

13. Under paragraph 1.1 of the Memorandum, the term of engagement of the person engaged (that is, the Taxpayer) was specified to be two and a half years.

14. Paragraph 2 of the Memorandum provided, inter alia, that the person engaged should carry out his duties which the Government (through the consulting engineers or otherwise) might call upon him to perform, that he should reside in such place and occupy himself as the Government might likewise direct, that he should not be engaged in business except with the prior approval of the Government and that he should conform to the Colonial regulations, regulations of the Hong Kong Government, circulars and departmental instructions insofar as the same were applicable.

15. Paragraph 4 of the Memorandum read as follows :

> ‘ Gratuity
>
> 4. On satisfactory completion of the full period of agreement required by this Memorandum or if the service of the person engaged is terminated under paragraphs

9.1 or 11.1 of this Memorandum and for reasons other than misconduct, the person engaged will receive a gratuity for the period of service, including vacation leave (carried forward from previous agreement(s) and/or earned during the current agreement) taken within the agreement. Such gratuity will be payable at the rate of *25%/18.75% of total basic salary of substantive office drawn during the agreement period. In the event of the person engaged' s death during the agreement period, the amount of gratuity earned will be paid to his estate.'

16. Paragraph 15 of the Memorandum read as follows :

' Changes in Terms of Engagement

15. Notwithstanding anything contained in this Memorandum or in the covering letter of offer of appointment, the Government reserves the right to alter any of the person engaged' s terms of appointment, and/or conditions of service set out in this Memorandum or the said covering letter should Government at any time consider this to be necessary.'

17. Under the terms of the Agreement and the Memorandum, the employment of the Taxpayer was to end on 4 July 1998.

18. By a letter dated 8 June 1998, Company A wrote and said the following to the Taxpayer :

' Please be informed that approval has been given by Department C to extend your contract until 27 November 1998. All terms and conditions of your employment will be [sic] remain unchanged. As far as the gratuity covering 30 months from 5 January 1996 to 4 July 1998 is concerned, the payment will be paid to you at the end of your current contract.'

This offer of extension of employment was accepted by the Taxpayer.

19. By a letter dated 9 November 1998 from the Department C to Company A, the former indicated that approval was given under Civil Service Regulations 551 and 559 for the Taxpayer to undertake paid employment (with Company A) as resident site staff under the direct employment scheme for the specified project during his final leave period between 28 November 1998 and 31 January 1999.

20. Between 30 July 1998 and 29 January 1999, the Taxpayer received a 25% gratuity from Company A amounting to $432,212.26 calculated as follows :

| **Period** | **Total salary** | **Gratuity** |
|---|---|---|

| | $ | $ |
|---|---|---|
| 05-01-1996 to 04-07-1998 | 1,365,506 | 341,376 |
| 05-07-1998 to 27-11-1998 | 250,571 | 62,643 |
| 28-11-1998 to 31-01-1999 (final leave period) | 112,772 | 28,193 |
| | | 432,212 |

21. The Commissioner has a declared policy and an established practice that no salaries tax will be assessed and demanded on severance payments and long service payments made in accordance with the EO.

**The case of the Taxpayer**

22. The main case of the Taxpayer can be summarised as follows :

(i) During the period between 5 January 1996 and 31 January 1999, he was employed by Company A and not the Government.

(ii) The EO applied to his employment.

(iii) The 25% gratuity in the sum of $432,212 referred to in paragraph 20 above was in effect severance payment/long service payment which he was entitled to claim from Company A under the EO.

(iv) The said gratuity in the sum of $432,212 should therefore be exempt from salaries tax.

23. In addition, there are two subsidiary points which we shall deal with.

**The case of the Commissioner**

24. The main case of the Commissioner can be summarised as follows :

(i) During the period between 5 January 1996 and 27 November 1998, the Taxpayer was employed by the Government and not Company A.

(ii) Section 66 (1) of the Interpretation and General Clauses Ordinance (Chapter 1) provides as follows :

‘ *66. Saving of rights of State*

*(1) No Ordinance (whether enacted before, on or after 1 July 1997) shall in any manner whatsoever affect the right of or be binding on the State unless it is therein expressly provided or unless it appears by necessary implication that the State is bound thereby.'*

(iii) By definition, the word 'State' in the said section 66(1) includes the Government of the Hong Kong Special Administrative Region.

(iv) The EO does not bind the Government and does not apply to any employee of the Government.

(v) Even if, contrary to the argument of the Commissioner, the EO were binding on the Government or applicable to the employment of the Taxpayer (whether by the Government or Company A), the said gratuity was not severance payment or long service payment under the EO but a contractual gratuity paid under his contract of employment.

(vi) The said gratuity is therefore not exempt from salaries tax.

**Our conclusion**

25. In light of the express terms of the Agreement and the Memorandum set out in paragraphs 5 to 19 above, we are in no doubt that, during the period between 5 January 1996 and 27 November 1998, the Taxpayer was an employee of the Government and not Company A which was acting only as an agent of the Government, its disclosed principal.

26. This fact was indeed acknowledged and confirmed by the Taxpayer himself when in a letter addressed to the Inland Revenue Department and dated 8 May 2000, he said :

> ' My employer was not the Company A; he was only as agents for the Government of Hong Kong (See appendix no 1 of my contract). I was a Contract Staff of HK Government as "Resident Site Staff" under Branch D' s Department since 1 June 1991 without breaking in several contracts. My status was the Hong Kong Government Contract Staff on that period (from 1 June 1991 to 27 November 1998).'

27. Section 4 of the EO deals with the application of the Ordinance itself. It does not provide for its application to the Government. In view of the provision of section 66 (1) of the Interpretation and General Clauses Ordinance, we are of the view that the EO does not bind the Government. It is also quite clear that persons employed by the Government are governed by the Civil Service Regulations.

28. The Government was therefore never obliged to pay any severance payment or long service payment to the Taxpayer under the EO.

29. The said gratuity in the sum of $432,212 was part of the remuneration paid to the Taxpayer by the Government. It was and is not severance payment or long service payment made to the Taxpayer under the EO. Hence, the same is not exempt from salaries tax under the declared policy and established practice of the Commissioner referred to in paragraph 21 above.

30. Our conclusion on this point alone is sufficient to dispose of the Taxpayer' s appeal.

31. Even if we are wrong in our conclusion above and the EO does apply for the benefit of the Taxpayer, we are of the opinion that it still does not assist the Taxpayer for the reasons set out below.

32. Section 8 (1) of the IRO provides as follows :

> ' *(1) Salaries tax shall, subject to the provisions of this Ordinance, be charged for each year of assessment on every person in respect of his income arising in or derived from Hong Kong from the following sources –*
>
> *(a) any office or employment of profit and*
>
> *(b) any pension.'*

33. The relevant part of section 9 (1) of the IRO provides as follows :

> ' *(1) Income from any office or employment includes –*
>
> *(a) any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others.....'.*

34. It is settled law that labels such as ' gratuity' or ' severance payment' are not conclusive. One must 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. See decisions of the Board in D90/96, IRBRD, vol 11, 727 and D24/97, IRBRD, vol 12, 195.

35. Looking at the terms of the Agreement including the Memorandum, we have no doubt that the 25% gratuity was part of the remuneration and reward paid to the Taxpayer for his service for the full period of the contract of employment as subsequently extended. The said sum of

$432,212 was in law and in fact the Taxpayer' s income (that is ' gratuity' or ' perquisite' ) arising in or derived from Hong Kong from his office or employment of profit. It was not a severance payment or long service payment made to him under the EO.

36. Furthermore, section 31I of the EO reads as follows :

> ' *31I. Severance payment to be reduced by amount of gratuities and benefits in certain cases*
>
> *If an employee becomes entitled to payment of a 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.'*

37. The effect of the said section 31I is that if, as in this case, the employee receives a gratuity under the terms of his contract of employment which is based on the length of service and the amount of such gratuity exceeds the amount of any severance payment he would have been entitled to under the formula set out in section 31G of the EO, then such severance payment is reduced to nil.

38. There is no dispute that any severance payment calculated in accordance with the said section 31G would be less than the gratuity of $432,212.

39. Hence, despite his length of service, any entitlement of the Taxpayer to severance payment under the EO would have been reduced to zero because of the gratuity he was receiving under the terms of the Agreement.

40. The Taxpayer presented a similar argument based on his alleged entitlement to long service payment. This could only have been an alternative to severance payment.

41. The Taxpayer claimed that he was entitled to long service payment in the sum of $268,435 whilst the Commissioner calculated it to have been $112,350.

42. The equivalent of section 31I of the EO in relation to long service payment is section 31V thereof.

43. Even if the Taxpayer was entitled to claim long service payment in the amount of $268,435, it was still a sum smaller than $432,212.

44. We mentioned in paragraph 23 above that there were two subsidiary points which we would deal with.

45. First, there is the re-assessment upwards of the tax payable from $159,936 to $165,740 based on the erroneous calculation of the rental value referred to in paragraphs 2 and 3 above.

46. The Taxpayer has not addressed any argument to us on this point. The revised calculation of the rental value and the additional tax payable set out in paragraphs 24 to 27 of the written submission of Ms Chow for the Commissioner appears to us to be in order.

47. Secondly, the Taxpayer in his letter to the Clerk to the Board dated 23 October 2000 made the point that he should be entitled to a 10% tax refund based on the Tax Exemption (1997 Tax Year) Order made by the Chief Executive in Council pursuant to section 87 of the IRO.

48. The answer by the Commissioner to this point is as follows : The Taxpayer was entitled to a gratuity on completion of the Agreement. He completed the period of the Agreement in the year of assessment 1998/99. Although the gratuity was calculated by reference to the basic salary for the period of the Agreement, it did not accrue to him until completion thereof. The whole gratuity should be chargeable in the year of assessment 1998/99. The Tax Exemption (1997 Tax Year) Order is applicable to the year of assessment 1997/98. Although it is permissible to relate back the gratuity of $341,376 to the years of assessment 1995/96, 1996/97 and 1997/98, it is not to the Taxpayer' s advantage to do so. Hence, the exemption under the Order is not applicable to his case.

49. Again the Taxpayer has not addressed us to the contrary on this point.

50. Section 68 (4) of the IRO provides that at an appeal to the Board :

> *' The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.'*

We are not satisfied that the Taxpayer has discharged his onus.

51. In the result, we dismiss the Taxpayer' s appeal.

52. We further confirm the re-assessment of the tax payable by the Taxpayer from $159,936 to $165,740.