INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D167/98

Salaries Tax – special payment on termination of employment contract – accessibility – whether income arising in or derived from Hong Kong from any office or employment of profit – compensation for loss of office – sections 8(1) and 9(1) of the Inland Revenue Ordinance, Chapter 112.

Panel: Ronny Wong Fook Hum SC (chairman), Philip Kan Liu Lun and Dennis Law Shiu Ming.

Date of hearing: 15 January 1999.
Date of decision: 26 February 1999.

The taxpayer was employed by Company A. Clause 8 of the Employment Contract provides that 'either party can terminate this employment contract by giving the other party 1 month's prior notice.' Company A sought to reduce its costs in the first quarter of 1996. On 19 March 1996. The taxpayer and Company A agreed to terminate the Employment Contract on 30 June 1996 and the taxpayer was given a special payment of $129,000. In the employer's return dated 28 June 1996, Company A included this sum as part of the taxpayer's emoluments. It was said to form part of 'other reward/allowances'. The issue is whether the taxpayer is liable for salaries tax in respect of the sum of $129,000.

Held:

1. The sum of $129,000 was the price Company A paid to ensure continued service by the taxpayer till 30 June 1996.

2. The sum was not a compensation for loss of office. Applying the wider approach in D24/97, IRBRD, vol 12, 195, there is no doubt that the payment was sourced from employment. Applying the narrow approach in the same case, the Board is satisfied that the payment was to the taxpayer to ensure continued service till 30 June 1996 (Henley v Murray 31 TC 351 considered).

Appeal dismissed.

Cases referred to:

Calvert v Wainwright 27 TC 475
Henley v Murray 31 TC 351
D24/97, IRBRD, vol 12, 195

Lee Kong Chun for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

Background

1. By a letter dated 2 June 1992 ['the Employment Contract'], the Taxpayer was employed as the training manager of the human resources department of Company A. Clause 8 of the Employment Contract provides that 'either party can terminate this employment contract by giving the other party 1 month's prior notice.' Clause 16 v further provides that 'Company A reserves the right to transfer you to other work sites, and to amend your working hours.'

2. Company A sought to reduce its costs in the first quarter of 1996. On about 16 February 1996, the Taxpayer as 'training and development manager' and Mr B as 'operations director' approved proposals to reduce the costs of Company A training programmes.

3. By a memo dated 19 March 1996, Mr B reported to a Mr C the following:

> 'Further to our discussion, I wish to confirm that [the Taxpayer] has indicated his decision to leave Company A. We have agreed on 30 June 1996 as his last date of employment and in return of this negotiated departure date, Company A will pay him two months salary in addition to his normal entitlements (that is regular pay, outstanding leave and pension repayment).

4. By letter dated 19 June 1996, Company A confirmed with the Taxpayer the terms of his departure. The letter referred to a 'special payment' in these terms:

> 'As per Mr B's memo dated 19 March 1996, you will receive a special payment equivalent to two months of your base salary.'

5. The special payment amounted to $129,000. In its employer's return dated 28 June 1996, Company A included this sum as part of the Taxpayer's emoluments. It was said to form part of 'other reward/allowances'.

6. Subsequent correspondence ensued between Company A and the Revenue on the nature of this payment of $129,000. Ms D, assistant human resources manager, dealt with the enquiries on behalf of Company A.

(a) In a letter dated 23 December 1997, Ms D stated that: 'Mr E (the Taxpayer) indicated his decision to leave the Company after several

discussions with his boss. They both agreed that the last date of employment of Mr E was 30 June 1996 and in return of this negotiated departure date, the Company paid him this terminal payment.'

(b) In a further letter dated 12 May 1998, Ms D further stated that: 'This payment was made to remunerate his past services rendered with the Company.'

7. The issue before us is whether the Taxpayer is liable for salaries tax in respect of the sum of $129,000.

Evidence of the Taxpayer

8. The Taxpayer gave sworn testimony before us. Ms Lee of the Revenue has very fairly indicated that the Revenue accepts the Taxpayer's testimony in full.

9. The Taxpayer informed us that:

(a) Prior to working with Company A, he was the employee training manager of Company F. Company F reduced its work force and he was asked to assume the position of technical support manager. It was not his field and he had difficulties coping with the demands from his new position.

(b) Company A was trimming down its activities in the first quarter of 1996. He had little work to do as its training & development manager. He anticipated that costs trimming will be followed by job reduction. In view of his unpleasant experience with Company F, he was not prepared to accept alternative employment in the operation side of Company A.

(c) He initiated the discussions leading to the payment of $129,000. He picked the departure date as that would give him 4 years of service with Company A. Had he remained passive, he would have received much more from Company A.

(d) Ms D took no part in his discussion with Mr B. It is inaccurate for Ms D to suggest that the sum in question 'was made to remunerate his past services rendered with the Company.'

10. The Taxpayer produced a letter from Mr B dated 7 January 1999. Mr B stated that:

'This special payment was made with a dual purpose in mind. It was to compensate you because your job was to become redundant and it was to also compensate you for agreeing to defer your departure to an agreed date. This

agreed date would allow you to complete an assignment, which you were working on at the time.'

The law

11. Section 8(1) of the Inland Revenue Ordinance ['the IRO'] provides that salaries tax shall be charged in respect of income arising in or derived from Hong Kong from any office or employment of profit. Section 9(1) of the IRO contains a non-exhaustive definition of income from office or employment. According to that definition, income from any office or employment includes gratuity, perquisite, or allowance, whether derived from the employer or others.

12. The word 'gratuity' connotes payment in respect of which the employee has no legal entitlement. The accessibility of voluntary payments has been explained by Atkinson *Calvert v Wainwright 27 T C 475* as follows:

> *'the principle which those cases establish … is this. Tips received by a man as a reward for services rendered, voluntary gifts made by people other than the employers, are assessable to tax as part of the profits arising out of the employment if given in the ordinary way as a reward for services; but, on the other had, personal gifts, which means gifts to a man on personal grounds, irrespective of and without regard to the question of whether services have been rendered or not, are not assessable.'*

13. As far as compensation for loss of office is concerned, the leading case in *Henley v Murray 31 T C 351*. The taxpayer in that case was the managing director of a property company. He was entitled to various benefits under his service contract with the forthcoming if the taxpayer were to sever his relationship with the company. The taxpayer agreed to resign on terms including payment of a sum calculated from the date of his resignation to the date of termination of his service agreement. The Court of Appeal held that the sum was not taxable.

(a) According to Lord Evershed, two classes of cases have to be distinguished:

  (i) The first class of cases is where the employers remain liable under the contract for the remuneration they had contracted to pay though they gave up their right to call upon the employee to perform the duties under the contract which he was bound to perform.

  (ii) The other class of where 'the contract goes altogether and some sum becomes payable for the total abandonment of all the contractual rights which the other party had under the contract.' In this latter class of cases, the receipt is not taxable.

(b) Jenkins L J put the matter succinctly thus:

> *'… the question in each case is whether, on the facts of the case, the lump sum paid is in the nature of remuneration or profits in respect of the office or is in the nature of a sum paid in consideration of the surrender by the recipient of his rights in respect of his office.'*

14. In D24/97, IRBRD, vol 12, 195 the Board reviewed the relevant English and local authorities and came to the view that two different approaches have been adopted in determining whether a payment falls within the tax net or not.

(a) The wider approach : It is not necessary to demonstrate that the income was received by the employee in the nature of a reward for services past, present or future. 'We do not need to know if the payment might have been for compensation for loss of the employment or a reward for services rendered in the past or as an inducement to continue with the service during the employment. Indeed it could be a combination of one or more of those reasons. All we need to know is that the payment was *sourced* from the employment.'

(b) The narrower approach : '… we have to examine the reason for the payment and be satisfied that the payment was to the employee for services and not as compensation for loss of employment.'

The Board considered the case before them on the basis of the narrower approach and held that the Taxpayer failed to discharge the onus of proof pursuant to section 68(4) of the IRO.

Our decision

15. We accept the evidence of the Taxpayer and reject the reason given by Ms D in Company A's letter of 12 May 1998. We find that the payment was not made to remunerate the Taxpayer for the 'past services' he rendered to Company A. This leaves only two reasons for the payment:

(a) Compensation for loss of office and

(b) Agreement to defer departure till 30 June 1996.

16. We find it difficult to see the basis of any claim by the Taxpayer for compensation. The Employment Contract was not a fixed term contract. It was terminable by either side 'giving the other party 1 month's prior notice'. There was no provision in the Employment Contract imposing an obligation on the part of Company A to maintain a training department. When agreement was struck between the Taxpayer and Mr B in mid-March 1996, that department was still on foot although its demise was on the card. In these circumstances, it is artificial to say that Company A was in breach in March 1996 and

that the payment was compensation for violation of the Taxpayer's contractual rights. This factor was not mentioned in the memo of 19 March 1996 or in the letter of 19 June 1996.

17. The second reason makes much more sense to us. The Employment Contract was terminable by 1 month's notice on either side. The Taxpayer did not wish to invoke that provision as he would like to complete 4 years of service with Company A. Company A would like to keep the Taxpayer till 30 June 1996 as that would allow the Taxpayer 'to complete an assignment, which [the Taxpayer] were working on at the time.' On the Taxpayer's own case, the sum of $129,000 was the price Company A paid to ensure continued service by the Taxpayer till 30 June 1996. This view accords with the correspondence exchanged between the parties in March 1996 and the return filed by Company A on 28 June 1996.

18. If we adopt the wider approach as described in D24/97, we have no doubt that the payment in question was sourced from the employment. If we follow the narrower approach, we are satisfied that the payment was to the Taxpayer to ensure continued services till 30 June 1996 and not as compensation for loss of employment.

19. The Taxpayer argued his case with passion. Like the Revenue, we entertain no doubt on the Taxpayer's honesty and integrity. We regret that on mature reflection we are not in a position to accept his contentions.

20. For these reasons, we dismiss the Taxpayer's appeal and confirm the assessment.