INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D2/99

Salaries Tax – appeal heard in the absence of Taxpayer – section 68(2D) of the Inland Revenue Ordinance – whether separation payment represents income from employment under sections 8(1)(a) and 9(1)(a) of the IRO – real nature of the payment.

Panel: Andrew Halkyard (chairman), Douglas C Oxley and Daniel Wan Yim Keung.

Date of hearing: 11 March 1999.
Date of decision: 12 April 1999.

The taxpayer was employed as chief operation officer under a written agreement for a term of two years commencing 1 November 1994. In the written agreement, there contained a term that the Employer had the right to terminate the agreement at any time without reason upon 90 days prior written notice to the taxpayer and the taxpayer was entitled to receive involuntary termination compensation. In an office memorandum dated 8 November 1995, the taxpayer's employment was terminated as of 28 December 1995 and the taxpayer was entitled to involuntary termination compensation under the written agreement.

In a document described as 'separation agreement' dated 30 November 1995, signed by both the Employer and the taxpayer, the officially termination date of the employment was confirmed on 5 February 1996. It further provided that the taxpayer would cease business for the Employer on 20 December 1995 and the taxpayer could pursue his own career opportunities after that date.

The dispute in the present appeal involves two components of the separation payment. The taxpayer claims that Sum A is a payment in lieu of notice and Sum B represents compensation for loss of employment. In any event, the taxpayer claims that Sum A and B are not paid for service and should not be taxable. The Commissioner refutes his claim and contends that Sum A and Sum B are income from employment and thus chargeable to salaries tax. The appeal was heard in the absence of the taxpayer. Prior to the hearing, the submissions of both parties were exchanged. The arguments of both parties were fully ventilated prior to and at the hearing.

Held:

(1) In considering whether a payment made on termination of employment is liable to salaries tax, the label attached to it is not determinative. What needs to be considered is the real nature of the payment and whether it is, in terms of sections 8(1) and 9(1) properly interpreted, 'income … from … any

employment of profit' (D13/89, IRBRD, vol 4, 242; D19/92, IRBRD, vol 7, 156; D90/96, IRBRD, vol 11, 727; D24/97, IRBRD, vol 12, 195; Dale v de Soissons [1950] 32 TC 118; Hamblett v Godfrey [1987] STC 60; Mairs v Haughey [1994] 1 AC 303 and EMI Group Electronics Ltd v Coldicott [1997] STC 1372 considered).

(2) The Board found that the whole tenor of the Employer's action, culminating in the separation agreement and its implementation, together with the taxpayer's express agreement thereto, is much more consistent with termination of the taxpayer's employment on 5 February 1996 than on December 1995. It follows that the Board disregard the label placed upon Sum A as a payment in lieu of notice and found that Sum A was the salary for the period up to the agreed dated of termination of employment. It is of no consequence whether or not the taxpayer was required to attend to his employment duties up to the date of termination.

(3) The Board did not find that the taxpayer surrendered any rights in consideration for accepting Sum B; rather, he was paid exactly what he was entitled to under his employment agreement. Accordingly Sum B falls within the taxable class (Dale v de Sossons [1950] 32 TC 118 applied; Mairs v Haughey [1994] 1 AC 303 distinguished; D13/89, IRBRD, vol 4, 242; D19/92, IRBRD, vol 7, 156; Hochstrasser v Mayes [1960] AC 376 and CIR v Humphrey [1970] 1 HKTC 451 considered).

Appeal dismissed.

Cases referred to:

D13/89, IRBRD, vol 4, 242
D19/92, IRBRD, vol 7, 156
D90/96, IRBRD, vol 11, 727
D24/97, IRBRD, vol 12, 195
Hochstrasser v Mayes [1960] AC 376
Mairs v Haughey [1994] 1 AC 303
Dale v de Soissons (1950) 32 TC 118
Hamblett v Godfrey [1987] STC 60
EMI Group Electronics Ltd v Coldicott [1997] STC 1372
CIR v Humphrey (1970) 1 HKTC 451

Tam Tai Pang for the Commissioner of Inland Revenue.
Taxpayer in absentia.

Decision:

1. This is an appeal against an assessment to salaries tax raised on the Taxpayer for the year of assessment 1995/96. The Taxpayer claims that he should not be assessed upon two sums paid to him upon the termination of his employment.

The proceedings before the Board

2. The Taxpayer now resides outside Hong Kong. At his request this appeal was heard in his absence under section 68(2D) of the Inland Revenue Ordinance ('IRO'). At the hearing the Commissioner was represented by Mr Tam Tai-pang. Prior to the hearing the submissions of both parties were exchanged. In particular, the Taxpayer was given ample opportunity to consider the Commissioner's written submissions that were handed to us. He responded in detail thereto. We commend this course of action. It ensured that the arguments of both parties were fully ventilated prior to and at the hearing.

3. When the hearing commenced we asked Mr Tam to read his submission to us. At the same time, we paused to read the Taxpayer's submission that, very usefully, followed the same pagination adopted by Mr Tam. After asking Mr Tam various questions to test his submission, and ensuring that we understood the thrust of the Taxpayer's submission, we reserved our decision. After considering all the documents and authorities placed before us, as well as the arguments of both parties, our decision is as follows.

The facts

4. The facts of this appeal, which we so find, are set out in the Commissioner's determination dated 31 August 1998.

5. By way of background, it is useful to reiterate certain basic facts.

1. The Taxpayer was employed by the Employer as chief operating officer under a written agreement which contained, among other things, the following terms:

3.1 The employment was for a term of two years commencing 1 November 1994, unless terminated prior to such date as provided under the agreement ('the Term').

The Taxpayer's remuneration included:

4.1 Base salary of US$700,000 per annum;

4.3 Performance bonus during the Term, to be awarded at the sole discretion of the board of directors of the Employer;

6.1 Reimbursement of moving expenses at the beginning and end of the Term;

6.3 Education benefit covering tuition and admission fees for the Taxpayer's children; and

6.4 Housing.

8.4 The Employer had the right to terminate the agreement at any time without reason upon 90 days prior written notice to the Taxpayer. If the agreement were terminated under this clause on or before the end of the two-year period commencing 1 November 1994, the Taxpayer was entitled to receive a sum described as 'involuntary termination compensation'. This sum was calculated by reference to his gross base salary for the remaining part of the two-year period (the amount being discounted for early payment).

2. In a document headed 'office memorandum' dated 8 November 1995 the Employer's president and chief executive officer wrote to the Taxpayer confirming that the Employer concurred to terminate, without reason, the Taxpayer's employment as of 28 December 1995 in accordance with clause 8.4 of the employment agreement. The office memorandum went on to state:

'I request that, if you wish, you remain in service to [the Employer] as executive vice president and advisor reporting directly to me until 31 January 1996. I hope that you will be able to stay in touch with [the Employer] in the capacity of ad hoc advisor to me after this date, where possible.

We confirm that you are entitled to involuntary termination compensation as defined in articles 6.1, 6.3 and 8.4 of the agreement, the coverage of moving and resettlement expenses and losses and the coverage of official tuition during, the original term, as defined respectively.'

3. In a document described as 'separation agreement' dated 30 November 1995, signed by both the Employer and the Taxpayer, the terms governing the termination of the Taxpayer's employment were confirmed. The terms included:

1. The employment would 'terminate officially' on 5 February 1996;

2. Notwithstanding 1. above, the Employer agreed that the Taxpayer would cease to execute business for the Employer on 20 December 1995 or any other date mutually agreed (the 'Separation Date') and that the Taxpayer could pursue his own career opportunities after the Separation Date; and

3. The Taxpayer would receive a 'separation payment' comprising various items 'in respect of all the entitlements under [his] employment agreement'.

4. The 'separation payment' included:

    1. A sum calculated by reference to the Taxpayer's base salary from 1 December 1995 to 5 February 1996; and

    2. 'Retirement Compensation' as defined in clause 8.4 of the employment agreement from 6 February 1996 to 31 October 1996.

5. The dispute in the present appeal involves two components of the separation payment. The two sums are (1) US$89,089 ('Sum A') and (2) US$504,735 ('Sum B').

    1. Sum A was calculated as follows: Base salary (US$700,000 per annum) for the period commencing 21 December 1995 (the day following the Separation Date) to 5 February 1996. The Taxpayer claims that this sum is a payment in lieu of notice and should not be taxable. In any event, the Taxpayer claims that this sum was not paid for services. The Commissioner refutes this claim and contends that it was simply part of his salary payable under the Taxpayer's employment agreement and is thus chargeable to salaries tax.

    2. Sum B was calculated as follows: Base salary (US$700,000 per annum) for the period from 6 February 1996 to 31 October 1996, discounted by a factor for early payment as per clause 8.4 of the employment agreement. The Taxpayer claims that this sum represents compensation for loss of employment and should not be taxable. In any event, the Taxpayer claims that this sum was not paid for services. The Commissioner refutes this claim and contends that the payment was not compensation for any loss of rights, that it was made in accordance with the Taxpayer's contractual entitlements, that it was income from employment and is thus chargeable to salaries tax.

6. In a letter dated 14 December 1995 to the Taxpayer the Employer's president and chief executive officer stated:

    'I would like to express my appreciation for your accepting readily the terms of separation proposed by [the Employer].

    I can easily assume that the unexpected termination of employment and the loss of office would cause tremendous difficulties to you, your family

> and your career. I do hope, however, the severance compensation, that is, the separation payment … will help facilitate your and your family's accommodation to unexpected career changes and potentially disturbing personal and family life.'

The issues before us

6. The sole issues before us are whether Sum A and Sum B, the two components of the 'separation payment' described at fact 5 above, represent income from employment in accordance with sections 8(1)(a) and 9(1)(a) of the IRO.

The law considered in this appeal

7. Apart from the provisions of section 8(1)(a), 9(1)(a) and 68(4) of the IRO, Mr Tam cited the following cases to us, which we have considered:

The Hong Kong authorities

1. *D13/89, IRBRD, vol 4, 242 and*

2. *D19/92, IRBRD, vol 7, 156: these decisions stressed that in determining liability to salaries tax, it is crucial to interpret and apply the wording of the relevant provisions in the IRO, namely, sections 8(1) and 9(1). Accordingly, one should not read into these provisions any implied limitations adopted from United Kingdom precedents considering different statutory provisions that, to be taxable, income must be in the nature of a reward for services past, present or future. For income to be liable to salaries tax, it is enough that the source of the income was the employment.*

3. *D90/96, IRBRD, vol 11, 727: a termination payment made in accordance with a contractual provision was liable to salaries tax and was not compensation for the employer's breach of contract. There was a specific finding in this case that, in view of the taxpayer's employment history, the contractual provision was an inducement for the taxpayer to leave the former employment and take on new employment. The payment was therefore taxable, being from the employment as a reward for services to be rendered in the future.*

4. *D24/97, IRBRD, vol 12, 195: although somewhat similar to D90/96, the Board was faced with direct evidence of the taxpayer that he was not induced to enter into the employment because of the relevant clause for extra payment on termination. The Board decided that it should not delve into the subjective views of the parties to the employment contract (even though it did not dispute the truth of the taxpayer's evidence). Such subjective statements should not, in the Board's view, affect*

taxability. In the vent, the Board decided that, looked at objectively and practically, the extra payment clause formed part of the contractual package and, save in the case of clear objective circumstances to the contrary, must be deemed to have induced the employee to enter employment. The Board did not find it necessary to decide whether the 'wider approach' as set out in the Hong Kong cases (see 1. above) or the 'narrow approach' as set out in UK cases such as Hochstrasser v Mayes [1960] AC 376 and Mairs v Haughey [1994] 1 AC 303 (namely, that to be taxable the income must be referable to services: see also 1. above) was the correct test. Applying either approach would, in the Board's view, arrive at the same result – the income was from employment and liable to salaries tax.

The United Kingdom authorities

5. *Dale v de Soissons (1950) 32 TC 118: a Court of Appeal decision holding that a payment under a contractual provision for early termination of an employment was not compensation for loss of the employment. The payment was made strictly in accordance with the contract and was taxable because it arose from the due exercises of a payment option specified in the contract of employment itself.*

6. *Hamblett v Godfrey [1987] STC 60: a Court of Appeal decision holding that payments by an employer to employees for giving up their rights to belong to a trade union were taxable. In this case, the Court of Appeal apparently did not endorse the 'narrow approach' referred to at 1. above and reformulated the question of liability to tax in the following way: 'was the employment the source of the emolument?' (per Neill LJ at 71)*

7. *Mairs v Haughey [1994] 1 AC 303: a House of Lords decision holding that a payment to an employee as compensation for losing rights under a non-statutory redundancy scheme was not taxable. The decision was reached on the basis that the payment was not an emolument from employment; rather, it was made to compensate the employee for not being able to receive emoluments from the employment.*

8. *EMI Group Electronics Ltd v Coldicott [1997] STC 1372: Neuberger J held that a contractual payment in lieu of notice was taxable.*

8. More generally, and importantly in this appeal, it is well established that, in considering whether a payment made on termination of employment is liable to salaries tax, the label attached to it is not determinative. What needs to be considered is the real nature of the payment and whether it is, in terms of sections 8(1) and 9(1) properly interpreted, 'income … from … any employment of profit'.

Application of the law to the facts

Sum A

9. Notwithstanding the detailed argument of both parties we found this issue to be easily resolved. Essentially, the Taxpayer's arguments focused upon his contentions that the nature of this payment was one in lieu of notice, that it was not for services, and that it was therefore not taxable.

10. To support his contentions, the Taxpayer referred to various facts including:

1. He was not required (nor indeed allowed) to perform services from 21 December 1995 to 5 February 1996,

2. During this time he could pursue alternative work or other employment (see generally fact 3.2 above), and

3. The Employer has in its filings and correspondence with the Inland Revenue Department referred to the payment as one in lieu of notice.

11. In this regard, we also note that infelicitous language was used in the office memorandum, where the purported notice period was stated as ending on 28 December 1995, instead of 5 February 1996 (see fact 2). We also appreciate that the Taxpayer accepted that he would cease to execute business for the Employer on 20 December 1995 (the Separation Date) and therefore, from this perspective, his employment effectively came to an end on this date.

12. In the result, however, the Taxpayer's arguments are more than counter balanced by the facts that:

1. The parties expressly agreed that the Employment would 'terminate officially' on 5 February 1996 (see fact 3.1),

2. Both the Employer and the Taxpayer have always proceeded on the basis that termination of the employment took place under clause 8.4, which by its own terms dictates that 90 days notice must be given.

3. 90 days notice from 8 November 1995, the date of the office memorandum which first gave notice of termination of employment, ends precisely on 5 February 1996, and

4, The Employer up to 5 February 1996 honoured payment of all the Taxpayer's contractual remuneration and all his other entitlements as employee, including coverage in the Employer's group insurance scheme. For the period after 5 February 1996 the Taxpayer's only entitlement to remuneration from the Employer was Sum B.

13. Accordingly, it is our conclusion that the whole tenor of the Employer's actions, culminating in the separation agreement and its implementation, together with the Taxpayer's express agreement thereto, is much more consistent with termination of the Taxpayer's employment on 5 February 1996 than on 20 December 1995.

14. It follows that we disregard the label placed upon Sum A both by the Taxpayer and the Employer as a payment in lieu of notice. Quite simply it is, in accordance with the employment agreement, salary for the period up to the agreed date of termination of employment. It is thus properly liable to salaries tax under section 8(1) as expanded by section 9(1)(a), and it is of no consequence whether or not the Taxpayer was required to attend to his employment duties up to the date termination.

Sum B

15. This sum has been termed both by the Employer and the Taxpayer as 'involuntary termination compensation'. It is agreed that it was paid under clause 8.4 of the employment agreement.

16. The Taxpayer argued that the nature of this payment was genuine compensation for loss of employment (see also fact 6), that it was not for services, and that it was therefore not taxable. The Taxpayer also contends that the existence of the separation agreement shows that he lost rights arising from the termination of his employment agreement and that this latter agreement, of itself, could not offer clear protection of his entitlements vis-à-vis the Employer.

17. The Taxpayer admits that he has never claimed that the Employer committed any breach of his employment contract. However, he nonetheless claims that the Employer wanted to avoid any litigation he would be willing to bring against the Employer for punitive or compensatory damages. We reject this latter statement. Not only is there no evidence before us to support the existence of any right by the Taxpayer to bring any action against the Employer, but the so-called 'involuntary termination compensation' agreed to by the Taxpayer was totally in accordance with his rights under his employment agreement.

18. In this regard, we note that the Taxpayer contended that he had to compromise the promises made to him by the Employer's president and chief executive officer at fact 2. Specifically, the Taxpayer reminded us that as part of his "involuntary termination compensation" he was promised entitlement to those items defined in clauses 6.1, 6.3 and 8.4 of his employment agreement 'during the original term [of the employment agreement], as defined respectively'. (emphasis added) Notwithstanding this promise, under the separation agreement the Taxpayer accepted payment of the education benefit (see clause 6.3) by the Employer only up to 5 February 1996. In analysing this issue, we remind ourselves that we must look at the substance of the sum (Sum B) in dispute. We note the imprecise terms of the office memorandum (quoted more fully at fact 2) and the lack of any concrete evidence as to the terms of negotiation between the parties prior to signing the separation agreement. Most importantly, Sum B was, as noted above, paid totally in

accordance with the entitlement set out in the Taxpayer's employment agreement. In the event, we are not convinced by the Taxpayer's arguments that he surrendered any rights in consideration for accepting Sum B.

19. On the basis of the above conclusion, we find that the facts of this appeal are most similar to the case of Dale v de Soissons (1950) 32 TC 118. In that case, under the terms of his service agreement Colonel de Soissons was appointed as assistant to the managing director for three years from 1 January 1945. However, under an express contractual provision the employer was entitled to terminate the agreement on 31 December 1945 or 31 December 1946 upon payment of £10,000 or £6,000 respectively as 'compensation for loss of office'. The employer terminated the agreement on 31 December 1945, upon payment of £10,000. In the word of Roxburgh J, which were approved by the Court of Appeal, 'the Colonel surrendered no rights. He got exactly what he was entitled to get under his contract of employment. Accordingly the payment … falls within the taxable class' (per Evershed MR at 128). In our view, the same reasoning and result applies to the present case.

20. We appreciate that Dale v de Soissons is an English case, dealing with legislative provisions phrased somewhat differently to section 8(1) and 9(1) of Hong Kong's IRO. Accordingly it must be applied very cautiously. Certain decisions of the Board of Review, including D13/89, IRBRD, vol 4, 242 and D19/92, IRBRD, vol 7, 156, have noted this issue. But even heeding this need for caution does not ultimately advance the Taxpayer's case. The reason for this is that these Hong Kong decisions arguably point to an even wider ambit of liability to salaries tax than that which would prevail under the earlier United Kingdom cases. In other words, if we adopted the so-called 'wider approach' referred to above, to decide that Sum B was taxable we would only need to be satisfied that the source of the payment was the employment, regardless of whether or not he payment was made in consideration of the Taxpayer's services. If it became necessary to reach our decision on this approach, we would conclude that we are so satisfied.

21. However, we prefer not to base our decision on this 'wider approach'. We query whether the Hong Kong decisions, when properly analysed, are significantly different from the leading United Kingdom cases such as those of the House of Lords in Hochstrasser v Mayes [1960] AC 376 and Mairs v Haughey [1994] 1 AC 303. We are not convinced that the wording in the United Kingdom legislation considered in cases such as Dale v de Soissons is as significant as has been suggested. In this regard, we note the one Hong Kong court decision which, among other things, examined sections 8(1) and 9(1), CIR v Humphrey (1970) 1 HKTC 451. In Humphrey's case, the Supreme Court (Appellate Jurisdiction) cited the leading United Kingdom cases, including Hochstrasser v Mayes, and was prepared to apply them (per Mills-Owen J at 486). In Humphrey's case, nothing turned upon the different wording of the Hong Kong legislation and we would suggest that the leading United Kingdom decisions remain of strong persuasive authority in interpreting the charging provisions to salaries tax.

22. For the sake of completeness, we note that the strongest authority cited to us in support of the Taxpayer's case is Mairs v Haughey. However, that case can be

distinguished from the facts of this appeal. In Mairs v Haughey, as in this case, the sum in dispute was paid under an express contractual provision. However, unlike this case, the sum in dispute was paid for extinguishing contractual rights. In the present appeal, we have found that Sum B was not paid for any loss of contractual rights.

23. As has been said previously, cases of this kind are never entirely easy. In the last resort, to paraphrase the final paragraph of the decision of the Court of Appeal in Dale v de Soissons, it appears to us to turn upon the short question that we have attempted to answer, namely, whether following the language of sections 8(1) and 9(1) the sum in dispute can be said to arise from the contract of employment. We reiterate our conclusion that Sum B was not paid in consideration of the Taxpayer surrendering contractual rights; rather, he was paid exactly what he was entitled to under his employment agreement. Accordingly the sum, in our judgement, as in Dale v de Soissons, falls within the taxable class.

24. For all the above reasons we think the Commissioner was right and the appeal should be dismissed.