Case No. D3/97

Salaries tax – lump sum paid on termination – whether gratuity or compensation for loss of office - apportionment.

Panel: Benjamin Yu SC (chairman), Richard J Mills-Owens SC and Anthony J H Wood.

Dates of hearing: 21 and 22 January 1997.
Date of decision: 9 April 1997.

The taxpayer served his employer for over 24 years. Upon termination of his service by the employer, he was paid a sum of $4,680,000 (equivalent to 24 months' basis salary) described as compensation for loss of office. The only written employment contract which the taxpayer had with his employer was dated 1971 and contained a provision that the employment may be terminated by the employer on 3 months' notice in writing or by 3 months pay in lieu of notice.

On the question of whether the sum of $4,680,000 was taxable as income arising in or derived from an office or employment of profit under section 8(1) of the Inland Revenue Ordinance.

Held:

1. A payment would be taxable if it is in the nature of a gift on account of past services. The word 'gratuity' connotes a gift or present usually given on account of past services.

2. A payment made on account of compensation for loss of employment. Similarly a payment in lieu of or an account of severance pay is not taxable.

3. It is not the label, but the real nature of the payment, that is important.

4. Where a payment is made partly for a taxable purpose, for example, as a gratuity in consideration of past services and partly for a non-taxable purpose, for example, to compensate the employee for loss of employment, the payment should be apportioned, and salaries tax can only be levied on the former.

5. On the facts, 75% of the sum of $4,680,000 was held to be attributable to compensation for loss of office and not taxable, and 25% of the sum of $4,680,000 was in the nature of gratuity, and is taxable.

Appeal partly allowed.

Cases referred to:

Henley v Murray 31 TC 351
D79/88, IRBRD, vol 4, 160
D12/92, IRBRD, vol 7, 122
D13/94, IRBRD, vol 9, 136
D16/95, IRBRD, vol 10, 144
Mairs v Haughley [1993] STC 569
Tilly v Wales [1943] AC 386
CIR v Hang Seng Bank [1991] 1 AC 306

K A Lancaster for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

The Appeal

1. This is an appeal by Mr A against a salaries tax assessment for the year of assessment 1995/96. The question in issue is whether the sum of $4,680,000 received by Mr A from his employer, Company B upon the termination of his employment falls within the charging provision of section 8(1) of the Inland Revenue Ordinance (the IRO). That section reads:

> '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 profits;…'
>
> Section 9(1) provides that:
>
> 'Income from any office or employment includes –
> (a) any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite or allowance,…'

2. In Henley v Murray 31 TC 351 at 367, Jenkins LJ said:

> *'As the many cases on this topic show, it is very difficult to determine the character of a payment made to the holder of an office when the tenure of the office is determined or the terms on which he holds it are altered, and the question in each case is whether, on the facts of the case, the lump sum paid is*

in the nature of the 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 the office.'

This is one of those cases.

The Facts

3. We have heard oral evidence from Mr A himself and from Mr C, the Managing Director of Company B. From their evidence and the documents made available to us, we find the following facts.

(1) In November 1971, Mr A was employed by Company B as a Shift Charge Engineer on the terms of a written agreement ('the 1971 agreement'). The 1971 agreement contained a provision (clause 13) that the employment may be determined by either Company B or Mr A giving to the other 3 months' notice in writing, or on the part of Company B, by 3 month's pay in lieu. Clause 15 provided that the normal retirement age was 55.

(2) Mr A served Company B for a period of just over 24 years, and his service was highly regarded by Company B. He received favourable reports of performance. He had built up a good relationship with the Company and its Chairman. Between November 1971 and December 1995, Mr A's position in Company B was elevated a number of times. Mr A was notified by Company B in writing notifications, that is, the one dated 25 September 1987, contained this statement: 'The other terms of employment as contained in your Service Agreement will remain unchanged.'

(3) By June 1993, Mr A was appointed the Chief Operating Officer with extensive responsibilities. He was then the 2nd most senior employee of Company B, just under the Managing Director.

(4) In September 1993, Company B offered to Mr A the option of extending his retirement age to 60. By then, Mr A was 49. Mr A accepted the offer and agreed to extend the date of retirement to his 60th birthday.

(5) Over the year 1995, Mr A's relationship with the Managing Director, Mr C, deteriorated. Mr A was due to go on leave on 8 December 1995. Before the, he was aware that Mr C intended to reorganise the company, but he had not been told what if any his position would be in the new structure. On 7 December, he challenged the Managing Director on his future and was told that there was no suitable position for him within the new structure. Mr A was obviously upset and asked Mr C what he intended to do. Later on that day, Mr C produced a letter dated 7 December 1995 which was in the following terms:

'As you are aware from our earlier discussions, we are making changes in several of our executive positions to facilitate the implementation of our agreed upon Strategic Plan. In the course of our restructuring and in line with these changes, there is no obvious senior position available which appropriately utilizes your talents and abilities. Accordingly, we propose to offer you an early retirement package which recognizes your long service and valuable contribution to the Company over the last 24 years.

We propose the following terms for the early retirement package:

. Retirement effective 31 March 1996.
. Gratuity payment equivalent to twenty four (24) months basic salary.
. A fully paid consultancy agreement of twelve (12) months where you will be on call on an as needed basis and this agreement can be extended by mutual agreement.
. A confidentiality agreement and a commitment to mutual goodwill to be signed by both parties.

The financial result of the above arrangement will be the equivalent of three (3) years current basic salary, which will amount to approximately $7,000,000.

You will of course in addition to the above payment receive your full entitlement of the proceeds from the Senior Executive Retirement Plan and the Provident & Retirement Fund based on your accumulated service of approximately 24½ years as at the 31 March 1996.

Please signify your acceptance of this arrangement by signing in the space provided below.'

(6) Mr A at first refused to accept the terms in this letter. He took objection to the word 'gratuity' as he said he was on permanent and pensionable terms. Later that day, Mr A told Mr C that he believed he was entitled to an additional $1,000,000 over the offer. On the following day, 8 December 1995, the Managing Director brought another letter to Mr A. It was to be a letter from Mr A addressed to the Managing Director and was in these terms:

'I have signed the early retirement letter dated 8 December 1995 confirming the terms and conditions of my early retirement from the Company effective 31 March 1996. I understand your need to announce the organization changes within the next couple of weeks and I therefore agree to the release of the announcement of my retirement during the week of 11 December 1995.

Although I have signed my acceptance of the terms and conditions, I am still of the view that I am entitled to a further payment of approximately $1,000,000.

Therefore, we agree that this is a matter that I will discuss with the Chairman upon my return to Hong Kong in early January 1996. After I have reviewed my case with the Chairman, I will accept his decision regarding my claim. In the event that he supports my claim, you accept that the Company will pay the amount agreed by the Chairman. In the event that he does not support my claim, I will then accept the terms of your letter dated 8 December 1996.

Please be assured that the outcome of this matter will not in any way change my preparedness to act as a Consultant for the Company nor will it affect the professional manner in which I will carry out the assignment agreed to.'

(7) Mr A was agreeable that the matter be decided by the Chairman of Company B, and he signed both the 7 December and the 8 December letters. This was just before he left Hong Kong.

(8) Later, when Mr A talked to the Chairman, he withdrew his request for the extra $1,000,000 as he realised that it was misconceived. At the same time, he got his consultancy contract extended from 12 months to 18 months. We should note that the parties in the consultancy agreement were slightly different. It was between Company B (Development) Limited, an associated company of Company B, with Mr A's company, Company D.

(9) By a letter dated 7 February 1996, Company B confirmed the terms of the termination. We quote below the relevant part of the letter:

' **Termination of Employment**

As a result of the Company's reorganisation, your employment with the Company will cease on 1 April 1996. In this regard, I would like to confirm the following terms and conditions which will apply to you in association with your termination of service:

1. Service & Salary

   Your last day of service will be 31 March 1996 and you will receive salary calculated up to this date.

2. Compensation for Loss of Office

   In compensation for the premature termination of your employment and for your loss of office and in consideration of your waiving any and all possible claims against the Company in connection with your employment and its termination, a payment of $4,680,000 will be made to you.

3. Bonus

You will receive a pro-rata bonus calculated on the basis of completed months of service from 1 January 1996 to 31 March 1996.

6. Provident & Retirement Fund

Your monthly contribution and vested benefit under the Provident & Retirement Fund will be calculated up to 31 March 1996 in accordance with the Rules and Trust Deeds of the Fund.'

The Law

4. Before we deal with the evidence on the nature of the payment, we should first set out what we consider to be the applicable principles of law.

5. The question in each case is whether the payment in question is 'income arising in or derived from Hong Kong' from 'any office or employment of profit' within the meaning of section 8 of the IRO. Section 9 expressly includes 'gratuity' as income from any office or employment.

6. We are grateful to Mr Lancaster for drawing our attention to the relevant authorities, both for and against the Revenue. We derive the following principles from the authorities:

(a) A payment would be taxable if it is in the nature of a gift on account of past services. The word 'gratuity' connotes a gift or present usually given on account of past services: D79/88 and D12/92

(b) A payment made on account of compensation for loss of employment, for example, on an employee's dismissal, is not taxable: D79/88, and D13/94. Similarly a payment in lieu of or on account of severance pay is not taxable: D16/95.

(c) It is not the label, but the real nature of the payment, that is important: D79/88.

We have already made reference to Jenkins LJ's judgment in Henley v Murray where he identified the question as being whether the lump sum was paid 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.

7. Where a payment is made partly for a taxable purpose, for example, as a gratuity in consideration of past services and partly for a non-taxable purpose, for example, to compensate the employee for loss of employment, it seems to us that the payment should be apportioned, and salaries tax can only be levied on the former: see Mairs v Haughley [1993] STC 569, Tilly v Wales [1943] AC 386. The fact that the IRO does not contain an

express provision for apportionment does not obviate the need to do so: CIR v Hang Seng Bank [1991] 1 AC 306 at 323B.

The nature of the payment in this case

8. We turn to consider the nature of the payment of $4,680,000 in this case. Was it to compensate Mr A for loss of his employment? Was it a gratuity for his past services? Or was there a combination of reasons?

9. The sum of $4,680,000 is equivalent to 24 months of Mr A's basic salary. In his Determination, the Commissioner of Inland Revenue took the view that Mr A was bound by the terms of the 1971 agreement and that his employment was terminable on 3 months' notice. It is said that since Mr A did get 3 months' notice, he had no legal right to any compensation for loss of employment. The Commissioner further had regard to the fact that the lump sum represented 24 months' basic salary and was not calculated by reference to the actual loss suffered by Mr A, and was more akin to a gratuity payment. Indeed, it was referred to as a 'gratuity' in the letter dated 7 December 1995. In arriving at his determination, the Commissioner did not have the benefit of hearing evidence from Mr A and Mr C.

10. Before the Board, Mr A gave evidence that although his original agreement had a provision permitting termination by 3 months' notice, he would undoubtedly have taken legal action against Company B if he was only given 3 months' notice or pay in lieu of notice. He contended that with the passage of time and his promotion to the highest levels of the company, the 3-month notice was not valid on moral grounds or with the precedents. By 'precedents' he was referring to the fact some 300 more junior staff were offered 1 month's pay for each year of service subject to a maximum of 20 months. He reckoned that as he served Company B for 24 years, he should be entitled to 24 months' pay and that the limit applicable to junior staff should not apply to him because of his seniority.

11. Mr C made an affidavit stating that the payment was to compensate Mr A for the premature termination of his employment, and in consideration of Mr A waiving all possible claims against Company B in connection with his employment. Before us, Mr C said this:

> 'I believe the term in the employment, given Mr A's seniority in the company, was totally inappropriate as a basis for concluding a separation agreement for an employee of his seniority in the company, 24 years of service and who had earlier been given good grounds to believe that his employment would terminate through to the age of 60.'

When asked about the position of other staff members, Mr C said the company would only apply the 3 months' notice provision in cases of dismissal for cause; and that the company chose, in other cases, not to invoke the 3 months' notice provision as to do so would be totally inappropriate and contrary to the company's best commercial interests.

12. Mr C's evidence is to the effect that the figure of $4,680,000 was arrived at by him with the Chairman having regard to the following matters:

(a) Mr A's seniority,
(b) the length of Mr A's service,
(c) the quality of his service, and
(d) Mr A was 51 at the time but had, by reason of the letter of September 1993, good grounds to believe that his employment would continue until the age of 60.

Mr A further said that the settlement was arrived at on the basis of what would be fair and to reflect Company B's obligation to Mr A by reference to the experience of the Chairman of Company B in Hong Kong and that of Mr C in Australia and New Zealand.

13. Mr C also explained that the word 'gratuity' in the letter of 7 December 1995 did not reflect the reality. It was a letter compiled by himself and the General Manager at Corporate Human Resources and they were using American terminology.

Our Conclusion and Reasons

14. In our view, we should not attach much weight to the fact that the payment was labelled as a 'gratuity' in the letter dated 7 December 1995. We are not surprised that an employer in the position of Company B would, in protecting its own interest, refrain from making any admission in that letter of any legal liability to its employee arising out of the termination of the employment. As we stated above, it is the real nature of the payment, and not the label, which is important.

15. If Mr A was in fact only entitled to a 3-month notice, he would have no legal right to compensation. However, we do not think that the position is that simple. It is doubtful whether a provision for termination in an agreement made in 1971 when Mr A was at a relatively junior position would govern his contractual relationship with Company B some 24 years later when he was the 2nd most senior employee. Even if it were, Company B would appear not to have sought to invoke it and, on Mr C's evidence, may well have been prepared to waive any right to rely on such a provision. If Mr A was not bound by the provision for termination by 3 months' notice, he would be entitled at common law to reasonable notice. For a person in Mr A's position, reasonable notice could be not less than 12 months, during which Mr A's loss would not be limited to his basic salary, but would include his housing and medical benefits and any loss incurred by him in his provident and retirement entitlement. Moreover, Mr A may be able to claim severance pay under the Employment Ordinance.

16. The true position, however, is that neither Mr A nor Company B took legal advice at the time. They did not seek to analyze Mr A's legal rights or Company B's liability or to quantify Mr A's potential claim. Mr A had not yet threatened legal proceedings. It turned out that Company B's offer was considered by Mr A, within the very short time that he had, to be acceptable. Whilst it may well be that Mr A's reasons for

accepting the figure of $4,680,000 were not identical to those of Company B in offering it, we find that on both sides the major reason for the payment was the compromise of whatever claim that Mr A may have against Company B for the termination of his employment. We also find that one not insubstantial element of the payment was the fact that Mr A had rendered valuable service to Company B over a long period of time. In other words, the $4,680,000 was in part a gratuity.

17. In the circumstances, we are of the view that the sum of $4,680,000 should be apportioned so that only that part of the payment attributable to the 'gratuity' element should be taxed. No doubt, it is difficult to apportion a lump sum when the parties themselves have not consciously addressed their mind to the question. However, we believe that it is our duty to do the best we can on the evidence; and in so doing we find that 75% of the sum of $4,680,000 was attributable to compensation for loss of employment and is not taxable, and the remaining 25% of that sum was in the nature of a gratuity, and is taxable. We accordingly remit the assessment to the Commissioner for further determination in accordance with our opinion as expressed in this decision.