HCIA 1/2007

**IN THE HIGH COURT OF THE**
**HONG KONG SPECIAL ADMINISTRATIVE REGION**

**COURT OF FIRST INSTANCE**
INLAND REVENUE APPEAL NO. 1 OF 2007

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BETWEEN

COMMISSIONER OF INLAND REVENUE Appellant

and

TSAI GE WAH Respondent

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Before: Hon Reyes J in Court
Date of Hearing: 1 November 2007
Date of Judgment: 5 November 2007

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J U D G M E N T

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## *I. INTRODUCTION*

1. Mott MacDonald employed Mr. Tsai from 15 May 1997 to 1 March 2004 to work on the West Kowloon Reclamation Project. Over the last year of his employment, Mott MacDonald paid Mr. Tsai a salary, a housing allowance, and a gratuity of $251,280.

2. Mr. Tsai paid salaries tax on the housing allowance and salary received in 2003-4. But he claimed that his gratuity was not subject to tax. He said that this was because it represented severance and long service payments. There is no dispute that the Commissioner's established practice has been that severance and long service payments are not subject to tax.

3. The Commissioner disagreeing with Mr. Tsai's description of his gratuity, Mr. Tsai appealed to the Board of Review.

4. In January 2006 the Board upheld Mr. Tsai in part. The Board found that part of the gratuity (amounting to $103,196) was in the nature of a long service payment under the Employment Ordinance (Cap.57) (EO). The rest of the gratuity (the Board said) was subject to salaries tax.

5. Mr. Tsai does not appeal against the Board's decision. The Commissioner, on the other hand, asserts that the Board erred in concluding that $103,196 of the gratuity was a long service payment not subject to tax. The Commissioner has accordingly caused the Board to state a case regarding the proper characterisation of Mr. Tsai's gratuity.

6. The issue before me is whether $103,196 of the gratuity was rightly treated by the Board as a long service payment. More specifically, the questions stated by the Board for my determination are as follows:-

> "(1) On the facts found by the Board, did the Board err in law in holding that the Taxpayer [Mr. Tsai] was entitled to payment of a long service payment under the EO?
>
> (2) Did the Board err in law in holding that by operation of Clause 10 of the Renewal Agreement [between Mr. Tsai and Mott MacDonald], the Board did not need to seek assistance from the provisions of the EO for determination of the Taxpayer's entitlements to a severance payment or a long service payment?"
>
> (3) Did the Board err in law in holding that, if assistance would need to be sought from the provisions of the EO, Section 31IA (instead of Section 31I) would have applied in the case of the severance payment, and Section 31YAA (instead of Section 31Y) would have applied in the case of the long service payment to the Taxpayer?"
>
> (4) Did the Board err in law in holding that the Sum of $251,280.00 paid by MMHK [Mott MacDonald] consisted of a sum of $103,196.00, being the

> long service payment to which the Taxpayer was held by the Board to be entitled?"

## *II. DISCUSSION*

### *A. Question (1): Mr. Tsai's entitlement to a long service payment*

#### *A.1 Background*

7. Mott MacDonald originally employed Mr. Tsai for a period of 2 years under an appointment letter dated 22 May 1997. The employment was subsequently extended by agreement for further periods of 2 years under successive appointment letters.

8. Eventually, by a letter dated 22 February 2002, the employment was extended for 1 year from 1 April 2002 to 31 March 2003.

9. Finally, by a letter dated 3 March 2003, Mr. Tsai's employment under the terms of the February 2002 letter was extended with his agreement for a further year from 1 April 2003 to 31 March 2004.

10. The Case Stated refers to the February 2002 letter as the "Renewal Agreement". It was a term of the contract evidenced by the February 2002 letter that, on completion of service, Mr. Tsai would receive a gratuity.

11. Clause 10 of the February 2002 letter provided that:-

> "…. The gratuity payable will be the sum which, when added to the Company's contribution to the MPF Scheme, equals to 25% of the total basic salary drawn during your service period on the West Kowloon Reclamation project.
>
> Costs borne by the Company, such as severance pay and long service pay, will be deducted from the gratuity. You will not be entitled to a gratuity in the event of resignation or dismissal for unsatisfactory service."

12. Mr. Tsai's previous appointment letters contained similar, but not necessarily identical, provisions. Mr. Tsai had thus previously received gratuities at the end of his initial 2 year appointment and following each successive 2 year extension up through 31 March 2003.

13. Mott MacDonald paid the $251,280 gratuity which is the subject of this appeal following the cessation of Mr. Tsai's employment pursuant to Clause 10 of the February 2002 letter.

14. In determining the character of the $251,280 gratuity, the Board first looked at EO ss.31B and 31R.

15. EO s.31B requires an employer to pay severance to an employee who is dismissed for redundancy after having been employed under a continuous contract for a period of not less than 24 months.

16. EO s.31R requires an employer to make a long service payment to an employee who has been dismissed after having been employed under a continuous contract for not less than 5 years of service, but to whom the employer is not liable to pay severance by reason of such dismissal.

17. For the purposes of this case, the formula for calculating severance and long service payments under the EO are identical and would produce a like result.

18. The Board reasoned that the combined effect of EO ss.31B and 31R was that an employer should not be required to make both severance and long service payments in respect of the same period of employment.

19. There can be no doubt (and no one disputed) that Mr. Tsai had been continuously employed by Mott MacDonald for more than 5 years. He was employed under a "continuous contract" as defined in EO s.3 and Schedule 1.

20. It followed (the Board thought) that Mr. Tsai was entitled to receive severance pay if he had been dismissed for redundancy or long service pay if he had been dismissed for some other reason beyond his control.

21. Before the Board Mr. Tsai claimed to have been dismissed for redundancy.

22. But the Board did not believe that it was necessary to decide precisely whether Mr. Tsai was entitled to severance or long service pay. This was because (at Case Stated §23):-

> "[f]or practical purposes, the Board considered that it mattered not whether the Taxpayer was dismissed or not because even if he was entitled to both a long service payment and a severance payment, he would only be paid one and the same amount under the EO. The Board decided that since it had no evidence as to whether or not the Taxpayer was in fact redundant, it treated the Taxpayer' s entitlement under the circumstances as a long service payment."

23. The Board consequently held that Mr. Tsai was at least entitled to receive long service pay from Mott MacDonald under the EO.

*A.2 The Commissioner's submission*

24. Mr. Herbert Li (appearing for the Commissioner) argues that, in coming to its conclusion on Mr. Tsai's entitlement to long service payment, the Board misapplied the burden of proof.

25. Mr. Li refers to Inland Revenue Ordinance (Cap.112) s.68(4). That states that "[t]he onus of proving that the assessment appealed against is excessive or incorrect shall be on the [Taxpayer]".

26. Mr. Li accepts that Mr.Tsai was dismissed from his employment from Mott MacDonald. But (Mr. Li argues) Mr. Tsai neglected to adduce evidence to show that he did not fall within the terms of EO s.31S.

27. The latter provision sets out circumstances in which an employee will not be entitled to receive long service payment.

28. For example, s.31S(1) provides that an employee will not be entitled to long service pay where his employer terminates a contract by reason of the employee's conduct. Section 31S(2) provides that an employee shall not be entitled to long service pay where he leaves before his employer's notice of termination of employment has expired. Sections 31S(3) and (4) provide that an employee shall not be entitled to long service pay where, within a certain period before his dismissal is to take effect, his employer offers to renew his contract on certain terms.

29. Mr. Li submits that Mr. Tsai's failure to demonstrate the inapplicability of the situations enumerated in s.31S means that he has not discharged his burden under IRO s.68(4).

30. Mr. Li relies in support of his argument on a letter from Mott MacDonald to the Inland Revenue dated 1 April 2005.

31. That letter was in response to an inquiry dated 10 March 2005 from the Inland Revenue. Mott MacDonald was asked to provide the following information:-

> "(a) confirm if [Mr. Tsai] was entitled to any severance pay and/or long service pay under his service with your company.
>
> (b) confirm if your company has paid any severance pay and/or long service pay to [Mr. Tsai] and advise the amount of each item.
>
> (c) confirm if any payment mentioned in point (b) had been deducted from the gratuity of HK$251,280 as stated in clause 8 of the employment contract dated 22 May 1997."

32. On 1 April 2005 Mott MacDonald replied as follows:-

> "(a) Mr. Tsai was entitled to severance pay and/or long service pay in accordance with Employment Ordinance, cost of which will be deducted from gratuity under clause 8 of his employment contract dated 22nd May 1997, copy of which is attached.
>
> (b) The company has not paid any severance pay and/or long service pay to Mr. Tsai, being circumstances giving rise to severance pay and/or long service pay did not occur.
>
> (c) No payment mentioned in point (b) above had been deducted from the gratuity of HK$251,280 as stated in clause 8 of the employment contract dated 22nd May 1997."

33. Mr. Li relies on paragraph b of Mott MacDonald's response to the Inland Revenue as evidence that, contrary to the Board's conclusion, no long service payment was actually made to Mr. Tsai.

*A.3 Analysis of the Commissioner's submission*

34. I am not persuaded by Mr. Li's arguments.

35. I do not think that IRO s.68(4) means that it was incumbent on Mr. Tsai to establish a negative and show that none of the circumstances in EO s.31S applied.

36. There was nothing before the Board to show that any of the limbs of s.31S were relevant. In those circumstances, it would be oppressive to expect Mr. Tsai to demonstrate that circumstances of which there was no whiff of a suggestion had in fact not happened. That can hardly be the function of IRO s.68(4).

37. The evidence before the Board (as noted in Case Stated §30) was that Mr. Tsai had indisputably worked for Mott MacDonald for a continuous period of 5 years. In the absence of any realistic suggestion that one or other of the situations in EO s.31S had occurred, I do not think that the Board could have legitimately speculated that one of such situations may nevertheless possibly have happened. On the contrary, the Board rightly refrained from the temptation to engage in such speculation.

38. The most that Mr. Li can point to in support of his case is paragraph b of Mott MacDonald's letter of 1 April 2005. But what does the letter, read in context, mean?

39. The Board read paragraphs a and b of Mott MacDonald's letter as contradictory. So do I. In paragraph a Mott MacDonald appears to concede that Mr. Tsai is entitled to long service or severance pay. Paragraph b then states in contradiction that the circumstances giving rise to a long service or severance payment have not arisen.

40. Mr. Li suggests that paragraph a should be read as "merely stating the general statutory and contractual positions" while paragraph b states "an actual fact that no such payment was made as the circumstances did not actually arise". However, there is nothing in the letter to indicate that such was the way in which Mott MacDonald intended its reply to be read. Mr. Li's reading is simply putting a gloss on the letter that is most favourable to the Commissioner's case. It is by no means the only possible reading, much less the literal reading, of Mott MacDonald's April 2005 reply.

41. Mr. Li says that I should strive to read Mott MacDonald's letter in a way that makes sense. But why should this have been the Board's or this Court's approach to the letter as a piece of evidence?

42. The letter is not a statute. It is ungrammatical and does not seem to have been carefully drafted. It is cryptic and raising more questions than answers. What, for example, is meant by "being circumstances giving rise to severance pay and/or long service pay did not occur"?

43. In at least one respect, the letter is plainly wrong (as Mr. Li fairly accepts). This is because paragraph a of the letter refers to Mr. Tsai's entitlement to severance or long service pay under Clause 8 of a contract dated 22 May 1997. That contract was the first under which Mr. Tsai was employed by Mott MacDonald. It ceased to have effect 2 years after it was executed. At the time of Mr. Tsai's dismissal in 2004, the operative terms of employment were those (including Clause 10) of the February 2002 letter.

44. Nonetheless, assume that Mr. Li is right in his suggested construction of Mott MacDonald's letter. I do not see how that would take the Commissioner's argument any further.

45. As the Board pointed out (at Case Stated §30):-

> "MMHK's obligation to make a severance payment or a long service payment to the Taxpayer could not be affected by the view that MMHK held of the matter nor the character of the payment could be altered by the label to it."

46. Whether Mr. Tsai was entitled to long service payment is a question of law. Mott MacDonald's view on its legal position in respect of long service or severance pay would have been irrelevant to the Board's determination of Mr. Tsai's entitlement. In whatever manner Mott MacDonald labelled the gratuity and whether or not it believed the gratuity to be free of any element

of long service or severance pay, could not be of any significant or conclusive evidential value to the Board.

47. In my view, the Board's reasoning on the matters raised by Question 1 was impeccable. The Board made no error of law. I would answer Question 1 in the negative.

*B. Question (2): The effect of Clause 10 on the need to consider EO provisions*

*B.1 Background*

48. Question (2) needs to be understood in the context of EO ss.31Y and 31YAA.

49. The EO provides as follows:-

> "31Y. If an employee becomes entitled to payment of a long service payment ... and:-
>
> (a) because of the operation of the employee's contract of employment, one or more gratuities based on length of service … have been paid to the employee; or
>
> (b) ...
>
> the long service payment is to be reduced by the total amount of all the gratuities and benefits to or in respect of the employee to the extent that they relate to the employee's years of service for which the long service payment is payable.
>
> 31YAA.(1) If:-
>
> (a) because of the operation of the employee's contract of employment, an employee has become entitled to payment of a gratuity based on length of service...
>
> (b) ...
>
> and the employee has been paid a long service payment ..., the gratuity or benefit is, to the extent that it is attributable to the same years of service as those for which the long service payment is payable, is to be reduced by the whole of the long service payment."

50. The function of EO ss.31Y and 31YAA is to obviate the situation where, having paid a contractual gratuity which is at least equal to the long service pay due to an employee, the employer still finds himself required by statute to make a long service payment. EO ss.31Y and 31YAA are a safeguard against the employer being required to make a double payment.

51. Now take a person X who, having been continuously employed for over 5 years, is dismissed by his company. Upon dismissal X is paid an amount A by his company for his years of service. For the purposes of taxation, the question is what part of A consists of long service pay to which X is entitled under the EO and what part constitutes a gratuity by the company for his years of service.

52. If (on an analysis of all relevant circumstances) A is found by the Inland Revenue to consist entirely of gratuity, the whole of A would be subject to tax. On the other hand, if analysis shows that A is partly gratuity and partly long service pay, only that part of A consisting of gratuity will be taxable. That part consisting of long service pay will not be taxed.

53. Assume that under his employment contract, X received A as a reward for his services. X' s contract makes no reference to any part of A being paid to X as long service pay. A was simply calculated by reference (say) to a formula stipulated in X' s employment contract.

54. Of course, independently of the operation of X' s contract, having served more than 5 years, X would be entitled under the EO to a long service payment L.

55. Consider the situation where A exceeds L.

56. EO s.31Y applies where there is an entitlement to long service pay but such a payment has not been made and instead the employee has received a contractual gratuity.

57. If EO s.31Y is applicable, any long service pay due to X under the EO should be reduced by the amount of gratuity already received by X. Since in our example A exceeds L, X' s long service payment would be reduced to nil. X would not be receiving any long service payment. From the Inland Revenue' s viewpoint, the entire of A would be taxable as a pure gratuity received by X pursuant to his contract.

58. EO s.31YAA applies where a long service payment has been made to an employee who is entitled to a contractual gratuity but to whom such gratuity not yet been paid.

59. If EO s.31YAA is applicable, any gratuity due to X should be reduced by the amount of long service payment already received by X pursuant to the EO. Since in our example A exceeds L, X' s gratuity would not be A but only an amount equal to A minus L. From the Inland Revenue' s viewpoint, only the amount A minus L would be subject to tax.

60. The real issue facing the Board was, having determined that Mr. Tsai was entitled to long service payment, how should one regard the gratuity which was paid to Mr. Tsai? Was the $251,280 to be treated as pure gratuity or partly gratuity and partly long service pay?

61. The answer to the issue depended on whether the situation here fell within s.31Y or s.31YAA. In other words, the Board had to determine whether long service payment was made before or at the same time as any gratuity element (in which cases s.31YAA would apply) or whether Mr. Tsai's gratuity was paid without Mr. Tsai first having received any long service pay (in which case s.31Y would apply).

62. The Board resolved the issue by reference to Clause 10 of the February 2002 letter. The Board noted that by the terms of Clause 10 Mott MacDonald contracted that the cost of any service or long service pay due to Mr. Tsai would be "borne" by it and "deducted from the gratuity" otherwise payable contractually to Mr. Tsai.

63. The Board held that logically this must mean that Clause 10:-

> "did not exonerate MMHK from its [statutory] obligation to make payment of severance payment and long service payment even when a gratuity was payable... That being the case, ... when a severance payment or a long service payment was due to the Taxpayer, MMHK must first pay to the Taxpayer firstly the severance payment or the long service payment and then the gratuity. Thus notwithstanding the fact that MMHK labelled the entirety of the Sum as gratuity, whether inadvertently or otherwise, ... the Sum must consist of, firstly the long service payment to which the Taxpayer was entitled and secondly, the gratuity equal to 25% of the salary drawn, less the MPF contribution and the amount of long service payment due to the Taxpayer."

64. As far as the Board was concerned, Clause 10 makes it clear that, notionally if not actually, long service pay must be deemed to have been paid by Mott MacDonald in advance of the payment to Mr Tsai of his gratuity. It would not be possible to make a gratuity payment in advance of the payment of long service pay, because by the terms of Clause 10 itself Mr. Tsai's gratuity was net of the long service pay due to him.

*B.2 The Commission's submission*

65. Mr. Li submits that the Board erred in its conclusions regarding Clause 10.

66. Mr. Li says that under EO ss.32 and 70 deductions from wages or other sums due to an employee otherwise than in accordance with the EO are prohibited. Accordingly, Mr. Li asserts that Clause 10 could not have enabled MMHK to recoup any long service payment due under the EO from Mr. Tsai's gratuity.

67. I cannot accept Mr. Li's argument. No one is suggesting, certainly neither the Board nor Mr. Tsai, that Mr. Tsai's wages or entitlements have been reduced otherwise than in accordance with the EO.

68. All the Board was saying (I believe rightly) was that, given Clause 10, Mott MacDonald must be regarded as having paid long service pay to Mr. Tsai in advance or at the same time as his gratuity. If statutory sanction is required for the deduction pursuant to Clause 10 of long service pay from any contractual gratuity, such is to be found (as the Board itself observed) in EO s.31YAA.

69. The Board consequently did not err in its construction of Clause 10 and its consequences. I would answer Question (2) in the negative.

*C. Question (3): The application of EO ss.31Y and 31YAA*

70. Given my view that the Board rightly held that Mr. Tsai was entitled to long service (as opposed to severance) pay, it is unnecessary to consider the application of EO ss.31I and 31IA.

71. Those latter sections mirror ss.31Y and 31YAA. They operate in similar fashion to obviate double payment in respect of severance pay and gratuity. The 2 sections are only raised by Question (3) to cover the possibility that Mr. Tsai's gratuity constituted partly of severance pay.

72. Mr. Li notes that, over Mr. Tsai's entire employment of more than 5 years, Mr. Tsai received gratuities totalling some $1.45 million. These (Mr. Li says) would have reduced any long service pay to nil. It follows (Mr. Li concludes) that EO s.31Y and not s.31YAA should have apply contrary to the Board's conclusion.

73. Again I cannot accept Mr. Li's submission. I do not think that the conclusion follows from the premises.

74. I do not understand how the fact that Mr. Tsai may have received gratuities in the course of earlier renewals or extensions of his contract was relevant to the Board's analysis. Presumably, Mr. Tsai paid salaries tax on those gratuities in previous years, as and when the latter were received.

75. The question before the Board was whether, at the end of his service of more than 5 years, Mr. Tsai was entitled to long service pay and whether any such pay constituted an element of the $251,280. Upon analysis of Clause 10, the Board held that, of such amount, $103,196 must have been long service pay (calculated by reference to Mr. Tsai's having been employed since 15 May 1997).

76. I see no flaw in the Board's reasoning. More specifically, I do not see how previous gratuities, on which salaries tax has been assessed and paid in earlier financial years up through 31 March 2003, can now be used to reduce to nil the long service pay to which Mr. Tsai became entitled at the end of financial year 1 April 2003 to 31 March 2004. Mr Li's submission would lead to double taxation.

77. I would answer Question (3) in the negative.

*D. Question (4): Payment of $103,196 as long service pay*

78. Mr. Li says that the Board should have considered Mott MacDonald's intention as a compelling guide to the nature of the $251,280.

79. Mr. Li argues that the evidence is all one way that, in paying the $251,280, Mott MacDonald was merely intending a contractual gratuity.

80. In particular, Mr. Li points to Mott MacDonald's letter of 1 April 2005 and its calculation sheets for the $251,280 gratuity. No reference is made in such documents to a long service payment having been made to Mr. Tsai.

81. Mott MacDonald (Mr. Li notes) did not even give written particulars of any purported long service pay to Mr. Tsai pursuant to EO s.31ZE. Failure to comply with EO s.31ZE without reasonable excuse is a serious matter (Mr. Li observes) which is punishable by a fine. This all indicates (Mr. Li reasons) that Mott MacDonald did not intend to make a long service payment.

82. I am not persuaded by Mr. Li.

83. First, I have already dealt with the letter of April 2005. For the reasons stated, I do not regard it as impressive evidence. In my opinion, the Board correctly treated the facts and matters stated in the letter as unhelpful to its determination.

84. Second, as a general principle, it is unclear to me why the Board should have restricted itself to Mott MacDonald's views. Why, for instance, could not the Board place greater weight (as it did) on the mutual intention of the parties as evidenced by Clause 10 of their contract?

85. Take Mott MacDonald's internal calculation sheets and its compliance or non-compliance with EO s.31ZE.

86. Mott MacDonald's unilateral description of the $251,280 cannot affect the true nature of the payment as a matter of law and logic.

87. Mott MacDonald may have honestly believed that the $251,280 was pure gratuity. For this reason, it may have supposed that it was under no obligation to comply with EO s.31ZE. But such belief would have failed to take proper account of its obligation under Clause 10.

88. There is no suggestion anywhere that the rigours of Clause 10 were varied or relaxed by the mutual agreement or conduct of the parties. There is no suggestion, for example, of any change agreed between the parties to the stipulation that the costs of any long service pay would be borne by the employer. Given that is so, Mott MacDonald' s unilateral contrary belief (if it held such) would simply have been erroneous.

89. I would answer Question (4) in the negative.

## *III. CONCLUSION*

90. Questions (1) to (4) have all been answered against the Commissioner. For that reason, at the end of the oral hearing before me, I dismissed the Commissioner' s appeal.

91. At the oral hearing, I also made an Order that Mr. Tsai (who was absent) was to have his costs, such costs to be taxed if not agreed.

(A. T. Reyes)
Judge of the Court of First Instance
High Court

Mr Herbert Li, SGC instructed by the Department of Justice, for the Appellant

Respondent in person - absent