

**Case No. D26/22**

**Salaries tax** – salary and leave pay for the garden leave period in the separation agreement – whether subject to Salaries Tax – sections 8(1), 9(1), 9(1)(a), 9(1)(b), 9(1)(c), 9(1A), 9(2), 68(9) of the Inland Revenue Ordinance (the ‘IRO’)

Panel: Maurice Joseph Chan (chairman), Lam Karen and Tsang Wing Ngar Anita.

Date of hearing: 22 July 2021.

Date of decision: 6 January 2023.

Mr A (the ‘Taxpayer’) used to work at Company B, and commenced his employment on 20 April 2015. The Taxpayer was made redundant by a notice dated 27 Mar 2018 (the ‘Redundancy Notice’). Subsequently, the Taxpayer did not accept the terms of the Redundancy Notice; as a result, he was forcibly made redundant on 29 Apr 2018. Thereafter, the Taxpayer and Company B entered into the separation agreement dated 11 Jun 2018 (the ‘Separation Agreement’).

The terms of the Separation Agreement were *inter alia* as followed: (i) the Taxpayer would receive the Wages and Leave Pay during the Garden Leave Period (Clause 2) and an *Ex Gratia* Payment (Clause 3); (ii) The ‘*payments set out in this Agreement are in full and final settlement of his Labour Department Claim and any other claims ...*’ whether statutory or under common law (Clause 7).

The Assessor raised a Salaries Tax Assessment for the Assessment Year of 2018/19 which, *inter alia*, included the *Ex Gratia* Payment, and the Salary and Leave Pay for the Garden Leave Period (between 28 Apr 2018 and 30 Jun 2018) in the Separation Agreement. By 28 Aug 2020, the Assessor accepted that the *Ex Gratia* Payment, as well as the Severance Payment were not taxable, and proposed a revised Salaries Tax Assessment for the Assessment Year of 2018/19 (the ‘Revised Assessment’). The Revised Assessment was upheld by the Determination of the Deputy Commissioner of Inland Revenue on 1 Mar 2021 (the ‘Determination’).

The Taxpayer appealed against the Determination. The Revised Assessment contained certain items relating to the Garden Leave Period. The items which had remained in dispute before this Board of Review were: (i) Salary; (ii) Leave Pay; and (iii) Rental Value of Residence.

**Held:**

1. Income chargeable to Salaries Tax under section 8(1) of the IRO was not confined to income earned in the course of employment, but also embraced payments, viewed as a matter of substance and not merely of form (Fuchs v Commissioner of Inland Revenue [2011] 14 HKCFAR 74, and Commissioner of Inland Revenue v Poon Cho-ming, John [2019] HKCFAR 3 followed).
2. A distinction must be made between a payment in the true nature of a consideration for a full and final settlement of all claims, existing and potential, and of all possible legal rights on the one hand, and a salary and leave pay which were inadvertently labelled as part of a settlement consideration on the other. In the instant case, Clause 7 referred to ‘payments set out in this Agreement’, which encompassed both the Wages and Leave Pay defined in Clause 2, and the *Ex Gratia* Payment in Clause 3. But although Wages and Leave Pay seemingly form part of Company B's consideration for the Taxpayer's releasing his employer of all liabilities, their true nature remained that of salary and leave pay, however Clause 7 had linguistically characterized them as settlement consideration. This must be so regardless of whether the Taxpayer needed to perform any employment duties during the Garden Leave Period, given that the termination of his employment was agreed to officially took effect only upon the close of business on 30 Jun 2018. This approach to the application of the *Fuchs* principles would have justified the Assessor's concession in the Revised Assessment that the *Ex Gratia* Payment could not be chargeable to Salaries Tax, but Wages and Leave Pay could still be.
3. The Board took the view that where a payment was, in its true nature, an employment payment as opposed to a settlement payment, parties could not circumvent the law by labelling it as consideration instead, whether innocently because of a lack of semantic finesse, or deliberately because of a piece of collusive cunning to evade tax.
4. It must follow that if the Salary and Leave Pay could not be disputed as being chargeable to Salaries Tax (which the Board hold was the case here) no objection could possibly be made as to the Commissioner's computation of the value of residence provided by Company B between 1 Apr 2018 and 30 Jun 2018.
5. The Board made an order confirming the Determination, and pursuant to section 68(9) of the IRO, the Board ordered the Taxpayer to pay as costs of the Board in the sum of \$5,000, which shall be added to the tax charged and recovered therewith.

**Appeal dismissed and costs order in the amount of \$5,000 imposed.**

Cases referred to:

Fuchs v Commissioner of Inland Revenue [2011] 14 HKCFAR 74  
Commissioner of Inland Revenue v Poon Cho-ming, John [2019] HKCFAR 38  
Richardson v Delany [2001] 74 TC 167  
D88/00, IRBRD, vol 15, 771  
D19/92, IRBRD, vol 7, 156  
D80/03, IRBRD, vol 18, 820

Appellant in person.

Ho Chi Ho, Leung Ching yee and Yu Wai Lim, for the Commissioner of Inland Revenue.

**Decision:**

1. In this Appeal, the appellant taxpayer, Mr A, appeals against the **Determination** of the Deputy Commissioner of Inland Revenue dated 1 Mar 2021. This Determination relates to a revised Salaries Tax Assessment for the **Assessment Year** of 2018/19. That **Revised Assessment** contains certain items relating to a **Garden Leave Period** (between 28 Apr 2018 and 30 Jun 2018) referred to under a **Separation Agreement** dated 11 Jun 2018 entered into between Mr A and his employer, Company B. The items which have remained in dispute before this Board of Review are:

- (1) **Salary;**
- (2) **Leave Pay;**
- (3) **Rental Value of Residence.**

**Factual background leading to the dispute**

2. The relevant material facts leading to the dispute are not controversial. They are summarized as follows:

- (1) By an **Employment Letter** dated 17 Mar 2015, Company B offered to employ Mr A as a Position C; he accepted the offer and commenced his employment on 20 Apr 2015;
- (2) By a **Redundancy Notice** dated 27 Mar 2018, Mr A was informed, *inter alia*, that:
  - (a) Between 27 Mar to 27 Apr 2018, he would be put on garden leave, during which he would be paid salary and benefits in full subject to certain conditions, such as:

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- (i) remaining as Company B's employee, and not being allowed to work for others; and
    - (ii) not attending work unless required to do so, etc;
  - (b) He would be made redundant from 28 Apr 2018, and would be paid some compensation of \$338,152 (which included an estimated severance entitlement), plus Company B's voluntary contributions to his MPF scheme;
  - (c) If he chose not to accept, the payments would be revised in accordance with the severance payment regime under the Employment Ordinance, and an alternative computation for voluntary contributions;
- (3) Subsequently, Mr A did not accept the terms of the Redundancy Notice; as a result, he was forcibly made redundant on 29 Apr 2018, and received a **Severance Payment** of \$44,700;
- (4) Sometime prior to XX May 2018, he lodged a **Labour Claim** with the Labour Department for a number of payments, including wages and annual leave pay from 27 Apr 2018 to 30 Jun 2018, a performance bonus, an *ex gratia* payment and employer's contributions to his MPF;
- (5) On XX May 2018, a **Conciliation Meeting** was held at the Labour Relations Division of the Labour Department at Western Magistracy;
- (6) Thereafter, the parties entered into the Separation Agreement dated 11 Jun 2018. The terms are *inter alia* as follows:
- (a) Mr A would voluntarily resign with effect from close of business on 30 Jun 2018, the **Termination Date (Clause 1)**;
  - (b) He would receive:
    - (i) the **Wages and Leave Pay** during the Garden Leave Period (ie, from the close of business on 27 Apr 2018 to the close of business on the Termination Date) (**Clause 2**);
    - (ii) an **Ex Gratia Payment** of \$659,890 (**Clause 3**);
  - (c) During the Garden Leave Period, he would, *inter alia*, not attend work unless required to do so, and must not work for others (**Clause 4**);
  - (d) The *'payments set out in this Agreement are in full and final*

*settlement of his Labour Department Claim and any other claims ...* ' whether statutory or under common law (**Clause 7**).

- (7) Subsequently, the Assessor raised a **Salaries Tax Assessment** for the Assessment Year of 2018/19 which, *inter alia*, included the *Ex Gratia* Payment, and the Salary and Leave Pay for the Garden Period; they were all objected to by Mr A, basically on the ground that they are all payments in the nature of Company B's consideration under the Separation Agreement for his full and final settlement of all claims, and therefore, cannot be income from his employment with Company B chargeable to Salaries Tax.
- (8) By 28 Aug 2020, the Assessor accepted that the *Ex Gratia* Payment, as well as the Severance Payment are not taxable, and proposed the Revised Assessment, which effectively contends that the Salary, Leave Pay, and Rental Value of Residence attributable to the Garden Leave Period all remain chargeable to Salaries Tax. This Revised Assessment was upheld by the Determination on 1 Mar 2021.

#### **Mr A's Submissions**

3. At the review hearing and in closing submissions, Mr A's arguments are simple. He contends that the Salary and the Leave Pay are not real income in nature from actual employment with Company B during the Garden Leave Period as per his employment contract; the true nature of these **2 Sums** (ie, the Salary and Leave Pay) are settlement payments in consideration of his releasing Company B from all existing and future claims, and a surrender of all his legal rights. In support of this contention, he cites Clause 7, the language of which is plain and clear. Hence, he argues that the payments under the Separation Agreement cannot possibly amount to any enticement or inducement for his return to work as an employee; and although the 2 Sums are labelled as salary and leave pay, they were not in fact made as rewards or consideration for past present or future services, because all his employment rights have been aborted by the Separation Agreement; they are clearly payments for some other reason.

4. In further support of his contention, he cites the Court of Final Appeal decision in CIR v Poon Cho-ming, John [2019] HKCFAR 38, where it affirms the principles established in Fuchs v CIR [2011] 14 HKCFAR 74, ie, that whereas a payment made in return for being an employee is taxable, whereas a payment that is for something else is not; he contends that these decisions reaffirm the principle that substance must prevail over form, and that true purposes must override mere descriptions or labels; as the amounts are arbitrary, there is no evidence that they reflect performances or services.

5. In Poon, it is true that after an extensive review of the authorities, Mr Justice Bokhary NPJ reaffirmed (in paragraph 14 & 18 thereof) that when applying section 8(1) of the Inland Revenue Ordinance (Chapter 112):

- (1) one must view a payment 'as a matter of substance and not merely of form and without being blinded by some formulae which the parties

may have used'; and

- (2) income chargeable to salaries tax is not confined to income earned in the course of employment but also includes:
  - (a) payments made 'in return for acting as or being an employee';
  - (b) payments made as 'rewards for past services'; or
  - (c) payments made 'by way of inducement to enter into employment and provide future services'.

But payments 'which are for something else do not come within the analysis, and are not chargeable to salaries tax'.

### The Relevant Statutory Provisions

6. But in order to conduct a proper analysis of Mr A's contentions, as well as the Commissioner's rebuttals (and in particular, its contentions relating to rental value of properties), it pays to review the following relevant charging provisions for Salaries Tax and the following authorities. Section 8(1) of the Inland Revenue Ordinance (Chapter 112) ('IRO') provides that:

*'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) *...'*

7. Section 9(1) of the IRO provides that:

*'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,*  
...
- (b) *the rental value of any place of residence provided rent-free by the employer or an associated corporation;*
- (c) *where a place of residence is provided by an employer or an associated corporation at a rent less than the rental value, the excess of the rental value over such rent; ...'.*

8. Section 9(1A) of the IRO provides that:

- ‘(a) Notwithstanding subsection (1)(a), where an employer or an associated corporation —*
- (i) pays all or part of the rent payable by the employee; or*
  - (ii) refunds all or part of the rent paid by the employee, such payment or refund shall be deemed not to be income;*
- (b) a place of residence in respect of which an employer or associated corporation has paid or refunded all the rent therefor shall be deemed for the purposes of subsection (1) to be provided rent free by the employer or associated corporation;*
- (c) a place of residence in respect of which an employer or associated corporation has paid or refunded part of the rent therefor shall be deemed for the purposes of subsection (1) to be provided by the employer or associated corporation for a rent equal to the difference between the rent payable or paid by the employee and the part thereof paid or refunded by the employer or associated corporation.’*

9. Section 9(2) of the IRO provides:

*‘The rental value of any place of residence provided by the employer or an associated corporation shall be deemed to be 10% of the income as described in subsection (1)(a) derived from the employer for the period during which a place of residence is provided ...’.*

### **The Authorities**

10. In Fuchs v Commissioner of Inland Revenue [2011] 14 HKCFAR 74, after an extensive review of the relevant authorities, Mr Justice Ribeiro PJ (in paragraph 17 & 18) indeed reaffirmed that income chargeable to Salaries Tax under section 8(1) of the Ordinance was not confined to income earned in the course of employment, but also embraced payments, viewed as a matter of substance and not merely of form, *‘in return for acting as or being an employee’*, or *‘as a reward for past services or as an inducement to enter into employment and provide future services’*, unless it fell into the scope of *‘something else’*.

11. In Commissioner of Inland Revenue v Poon Cho-ming, John [2019] HKCFAR 38, the Court of Final Appeal also (in paragraph. 14 & 79) indeed reaffirmed the principles in Fuchs on section 8(1) of the IRO.

12. However, the Commissioner also effectively contends that notwithstanding

the above general principles, settlement payments are still chargeable to Salaries Tax. In support of this contention, the Commissioner cites:

- (1) Richardon v Delany [2001] 74 TC 167, where payments made for a garden leave period arising from a settlement agreement were still held to be taxable income. In that case, the taxpayer's employment was expressly agreed to be terminable by either party on 18 months' notice in writing, but the employer could also terminate it immediately by paying salary in lieu of notice. In the events which followed, the employer gave a notice of termination to the taxpayer at some future unspecified date and instructed him to take 'garden leave' on full salary and benefits. But on the same day, the employer also sent another letter on a without prejudice basis, proposing a termination date and a payment. Subsequent negotiations led to an agreement (akin to a settlement agreement), on the employer's proposed date of termination, and a revised sum of the payment for the garden leave period. The High Court took the view that notwithstanding the without prejudice agreement, the employer had acted in pursuance of its rights under the contract of employment by giving written notice. It also held that in the absence of any identifiable breach of contract, the source of the payment must lay in the employer's discretion under the employment agreement to make a payment in lieu of the remaining notice period. In other words, the payment had arisen from the taxpayer's employment contract and thus was taxable;
- (2) D88/00 15 IRBRD 771, where the taxpayer was given notice by his employer on 17 June 1997 for termination of his employment, and where under a general release agreement, the taxpayer and his employer mutually agreed that his last working date was 14 August 1997 and that the taxpayer did not need to attend office and perform duties after that date although his employment with his employer would be formally terminated with effect from 1 October 1997. The taxpayer claimed that a sum being his salary and supplementary allowance for the period from 15 August to 30 September 1997 was not taxable as it should be treated as severance payment, and he was not required to report to work during the said period. The Board decided that the taxpayer's employment with his employer subsisted right up to 30 September 1997. Reference was also made to D19/92 7 IRBRD 156 where the Board pointed out that there was nothing in section 8 or 9 of the Ordinance which limited taxable payments to remuneration for services rendered or to be rendered. Section 8 related to income from a source, namely the employment. Although the taxpayer was not required to work between 14 August and 30 September 1997, the Board decided (see paragraph 8 to 10) that the sum arose in, or was derived from the taxpayer's employment with his employer, and therefore was liable to Salaries Tax;



- (3) In D80/03 18 IRBRD 820, the taxpayer was given notice by her employer on 31 January 2002 that her employment would be terminated and that the period from 31 January to 30 March 2002 would constitute the 2- month notice period. During the notice period, the taxpayer was not required to report to work but her employer reserved the right to require her to return to the company to handle job-related matters. The Board found that the taxpayer was given two months' notice of termination by her employer pursuant to her employment contract and 30 March 2002 was the last day of her employment. The salaries she received during the 2-month notice period were income chargeable to Salaries Tax;

### Analysis

13. Although in all these cases cited by the Commissioner, some kind of settlement agreements or termination negotiations were involved, none of them suggest that the payments made thereunder were expressly stated to be in consideration of the employee forsaking any existing and future potential claims or legal rights, as we have here in the instant case between Mr A and Company B. Clause 7 is the crux of Mr A's arguments and emphasis, which, apparently, are non existent in all the Commissioner's 4 cases above.

14. However, notwithstanding this key difference, the Board is not inclined to accept Mr A's apparently powerful observations. Given that the parties are all agreed that one must look at the substance of the payments and not their labels, so as not to be blinded by some formulae which the parties may have used, then clearly, a distinction must be made between a payment in the true nature of a consideration for a full and final settlement of all claims, existing and potential, and of all possible legal rights on the one hand, and a salary and leave pay which are inadvertently labelled as part of a settlement consideration on the other. In the instant case, Clause 7 refers to 'payments set out in this Agreement', which encompasses both the Wages and Leave Pay defined in Clause 2, and the *Ex Gratia* Payment in Clause 3. But although Wages and Leave Pay seemingly form part of Company B's consideration for Mr A's releasing his employer of all liabilities, their true nature remains that of salary and leave pay, however Clause 7 has linguistically characterized them as settlement consideration. This must be so regardless of whether Mr A needed to perform any employment duties during the Garden Leave Period, given that the termination of his employment were agreed to officially take effect only upon the close of business on 30 Jun 2018. This approach to the application of the Fuchs principles would have justified the Assessor's concession in the Revised Assessment that the *Ex Gratia* Payment could not be chargeable to Salaries Tax, but Wages and Leave Pay could still be.

15. The Determination does not state the basis for the Assessor's concession in treating the Severance Payment as being unchargeable to Salaries Tax. We presume that it was a concession pursuant to the Inland Revenue Department's prevailing assessment practice not to tax severance payments made in accordance with the Employment Ordinance. But because no issue arises from such a concession, there is no need for the

Board to ascertain the basis of such a concession.

16. Another way to test the correctness of this decision of the Board is to ask the question whether, given the language of Section 9(1)(a) and Mr Justice Bokhary's dicta in Poon, it can ever be construed, that a payment, which in the ordinary course of employment is undeniably in the nature of salary, could ever be deemed to be the 'something else' outside the ambit of Sections 8(1) and 9(1)(a), just because the parties, happened to have blindly formulated that payment item also as a component of the consideration for full and final settlement of all existing and potential claims. It is rather fortuitous on Mr A's part that Clause 7 of the Separation Agreement happened to have included the 2 Sums of Clause 2, as part of the settlement consideration. What would happen if Company B's draftsman took the more logical approach by treating salary as salary, leave pay as leave pay, and the *Ex Gratia* Payment as the consideration for a full and final settlement under a settlement agreement? Had he called a spade a spade and not something else, all these issues which have misled and agonized Mr A might not have arisen. The Board therefore takes the view that where a payment is, in its true nature, an employment payment as opposed to a settlement payment, parties cannot circumvent the law by labelling it as consideration instead, whether innocently because of a lack of semantic finesse, or deliberately because of a piece of collusive cunning to evade tax. For all the above reasons, this Board is not inclined to adopt Mr A's approach to statutory interpretations.

17. As for the remaining issue in respect of the Rental Value of Residence over the Garden Leave Period, Mr A has not made any written submission specifically relating to the Commissioner's application of sections 9(1)(b), 9(1)(c), 9(1A) and 9(2) above. We cannot see how the Commission's contentions regarding such an application can be faulted. Clearly, the combined effect of these provisions is that:

- (1) the value of the residence provided by Company B is \$42,702, being \$427,021 (ie, the total Company B salary and leave pay reported by Mr A for 1 Apr 2018 to 30 Jun 2018 of the Assessment Year) x 10%;
- (2) the value of the residence provided by Company D is \$210,209, being \$2,114,972 (ie, the total Company D income accruing to Mr A between 3 Jul 2018 to 31 Mar 2019 of the Assessment Year) x 10%.

18. Further, it must follow that if the Salary and Leave Pay cannot be disputed as being chargeable to Salaries Tax (which we hold is the case here) no objection can possibly be made as to the Commissioner's computation of the value of residence provided by Company B between 1 Apr 2018 and 30 Jun 2018. It is also obvious that the Company D income between 3 Jul 2018 and 31 Mar 2019 cannot even be said to be unchargeable because the Company D income has nothing to do with the Separation Agreement.

## Conclusion and costs

19. For all the above reasons, Mr A's Appeal is dismissed, and the Board makes an order confirming the Determination, and pursuant to Section 68(9) of the IRO, the Board

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orders Mr A to pay as costs of the Board in the sum of \$5,000, which shall be added to the tax charged and recovered therewith.