

**Case No. D22/14**

**Salaries tax** – early retirement – ex-gratia payment – payment in lieu of notice – sections 31R, 31RA, 31S, 31V(1) and 31Y of the Employment Ordinance – sections 8(1), 9(1) and 68(4) of the Inland Revenue Ordinance

Panel: Huen Wong (chairman), Chow Mun Wah Anna and Chyvette Ip.

Date of hearing: 6 August 2014.

Date of decision: 18 November 2014.

The Appellant was required by Company F to retire early.

The Appellant contended that but for his retiring at 58, he would have accrued much more benefits under the ORSO scheme which were not taxable. He argued that the ex-gratia payment ('Sum A') he received from Company F was a compensation as an alternative to a long service payment and another sum ('Sum B') was not related to his work which should not be chargeable to Salaries Tax for the year of assessment 2011/12.

**Held:**

1. Sum A represented part of the contractual payments under Clause VI(b) of the Service Conditions which was clearly derived 'from his employment' with Company F.
2. Sum A was not compensatory in nature. Company F did not have any contractual obligation to employ the Appellant until he reached the age of 60.
3. Under Clause VI of the Service Conditions, Company F was required to give a notice period of three months or pay in lieu for the early retirement of the Appellant.
4. By a letter of 2 August 2011, Company F notified the Appellant of his early retirement and his last date of employment would be 30 September 2011. The Appellant received his salaries for the months of August and September 2011. The Appellant was only entitled to one-month pay in lieu of notice.
5. Sum B was additional remuneration and taxable income.

**Appeal dismissed.**

Cases referred to:

Fuchs v CIR [2011] 2 HKC 422  
Dale v de Soissons (1950) 32 TC 118  
D80/00, IRBRD, vol 15, 715  
D30/12, (2012-13) IRBRD, vol 27, 657  
D80/03, IRBRD, vol 18, 820

Appellant in person.

Yu Wai Lim and Wong Pui Ki for the Commissioner of Inland Revenue.

**Decision:**

**Introduction**

1. Mr A ('the Appellant') objected to the Salaries Tax Assessment for the year of assessment 2011/12 raised on him. He contended that certain sums he had received from his former employer should not be subject to tax.

2. By a letter dated 11 January 1995, the Appellant was offered Position B by Company C. The Appellant accepted the offer on 12 January 1995.

3. By a letter dated 20 June 1997, the Appellant was informed that there had been a change of ownership of Company C when it would change its name to Company D on 1 July 1997. The Appellant was offered revised terms and conditions of employment by Company D as set out in the Grade D Staff Service Conditions ('the Service Conditions'). On 25 June 1997, the Appellant accepted the offer and agreed that he would be bound by the rulings and modifications of the Service Conditions.

4. The Service Conditions contained, among other things, the following clauses:

‘ VI. TERMINATION OF SERVICE BEFORE NORMAL RETIREMENT

Service may be terminated either by the Company or by the employee in the following instances by giving periods of notice or pay in lieu of notice as indicated below:-

	Period of Notice Required
...	...
- Early retirement or redundancy	- three months

## VII. RETIREMENT BENEFITS

Employees will be eligible for retirement benefits, details of which are contained in the [Company D] Retirement Benefit Rules. The Company's official age for normal retirement is 60 but the Company has the right to retire an employee at any age it thinks fit, at its entire discretion.

...

## XI. EARLY RETIREMENT

In circumstances where the Company requires an employee to retire from the service of the Company before reaching normal retirement age, which circumstances do not constitute dismissal or redundancy, then provided the employee concerned has a) reached the age of 50 and has a minimum of ten years continuous service with the Company ... he/she will be entitled to receive:

- (a) an amount equal to the benefit calculated by reference to clause (3)(b) of the "[Company D] Retirement Benefit Scheme"; and in addition
- (b) an amount equal to 1/2 month final basic salary per year of service, up to a maximum total of 12 months final basic salary

...'

5. On 1 August 2005, as a result of business re-organisation, Company D transferred its general insurance business to Company E which later transferred its business to Company F on 27 July 2007. The Appellant's employment was therefore transferred first to Company E and later to Company F. The Appellant accepted the transfer. In the transfer of employment letters on both occasions, it was provided that:

- (a) The Appellant's employment with the previous employer would come to an end. He would be offered new employment with the new employer on the same terms and conditions as his previous employment.
- (b) The Appellant's past services with his previous employer would be counted as continuous services with the new employer.
- (c) The Appellant would remain as a member under the Occupational Retirement Schemes Ordinance ('ORSO') scheme. His account balance in the ORSO scheme of the previous employer would be transferred to

(2015-16) VOLUME 30 INLAND REVENUE BOARD OF REVIEW DECISIONS

the new employer. His years of service would continue to accrue under the scheme and his benefits would not be affected by the transfer.

6. By a letter dated 2 August 2011, Company F informed the Appellant of his early retirement and his last date of employment was 30 September 2011. Upon early retirement, the Appellant was paid:

- (a) A final payment of \$422,162, including salary in lieu of 3 months' notice of \$98,787 ('the Notice Payment') and an ex-gratia payment of \$275,122 ('the Ex-gratia Payment').
- (b) A sum of \$770,700 which represented his benefit under the retirement plan.

7. In the Notification by an Employer of an Employee who is About to Cease to be Employed, Company F reported in respect of the Appellant the following particulars:

Period of employment:	1 April 2011 to 30 September 2011
Details of income:	\$
Salary	197,574
Leave pay	12,647
Other rewards, allowances or perquisites	<u>324,368</u>
Total	<u>534,589</u>

8. In the Tax Return – Individuals for the year of assessment 2011/12, the Appellant declared an income of \$344,295 from Company F. However, he did not provide a breakdown of his income.

9. A representative of the Respondent ('the Assessor') raised on the Appellant the following Salaries Tax Assessment for the year of assessment 2011/12:

	\$
Income	534,589
<u>Less: Charitable donations</u>	<u>100</u>
Net income	534,489
<u>Less: Married person's allowance</u>	<u>216,000</u>
Net chargeable income	<u>318,489</u>
Tax Payable (after tax reduction)	<u>30,143</u>

10. The Appellant objected to the above assessment on the ground that his income for the year of assessment 2011/12 should be \$344,295. He contended that he was employed by Company F from January 1995 to September 2011 and was required to early retire on 30 September 2011.

(2015-16) VOLUME 30 INLAND REVENUE BOARD OF REVIEW DECISIONS

11. In response to the Assessor's enquiries, Company F provided the following information:

(a) A breakdown showing the Appellant's net income for the period from April 2011 to September 2011 as follows:

	\$
Salary	197,574
<u>Add:</u> Annual leave pay	12,647
Performance bonus	32,610
The Ex-gratia Payment	275,121
Monthly cash allowance	<u>16,637</u>
Sub-total per Notification mentioned in paragraph (7) above	534,589
<u>Add:</u> The Notice Payment	<u>98,787</u>
Total	633,376
<u>Less:</u> Share option contribution	<u>12,111</u>
Net amount	<u>621,265</u>

(b) The Notice Payment was not included in the Notification mentioned in paragraph (7) above.

(c) The Appellant's employment was terminated because of early retirement.

(d) The Ex-gratia Payment was arrived at as follows:

$$\text{Final Month's Salary} \times \text{Eligible Service Years} \times 0.5 \\ (\text{i.e. } \$32,929 \times 16.71 \times 0.5) = \$275,121$$

(e) The Ex-gratia Payment was paid in recognition of the Appellant's contribution to Company F, hard work and commitment during his servicing years.

(f) The Appellant was paid his retirement benefit of \$770,700 under Company F Retirement Plan which was registered under the ORSO. He was not paid any severance payment.

12. Company F provided copies of the following documents:

(a) Yearly movement report showing a monthly breakdown of the Appellant's income for the period from 1 April 2011 to 30 September 2011.

(2015-16) VOLUME 30 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (b) Payment transaction advice dated 7 October 2011 showing the transfer of the final payment as mentioned in paragraph (6)(a) above to the Appellant's bank account.
- (c) Letter dated 14 April 2011 showing the payment of bonus of \$32,610 to the Appellant under the 2010 Bonus Plan and the adjustment of his monthly salary to \$32,929 with effective from 1 April 2011.
- (d) A letter which certified that the Appellant was in the employ of Company F during the period from 12 January 1995 to 30 September 2011 and he left because of early retirement.

13. The Assessor considered that the Ex-gratia Payment was paid in recognition of the Appellant's service with Company F and should be chargeable to tax. He invited the Appellant to withdraw his objection.

14. The Appellant declined to withdraw his objection and contended that:

- (a) Before the year 2000, all staff who joined Company F was entitled to participate in its ORSO scheme. Whenever a member of staff resigned, early retired or retired at the age of 60, he would be entitled to receive the benefits under the ORSO scheme which was not subject to any tax. Hence, the Appellant argued that all his retirement benefits including the sum of \$700,000 under the ORSO scheme should not be chargeable to any tax.
- (b) If he had not been required to early retire at the age of 58, his retirement benefit under the ORSO scheme at the retirement age of 60 should have been more than \$1 million instead of \$700,000.
- (c) In order to save costs and avoid affecting the morale in Company F, the Appellant was required to retire early and he was offered a long service fund.
- (d) If his employment had been terminated by Company F instead of early retirement, he should not have to pay any tax before 1 April 2012.
- (e) The income reported in his tax return i.e. \$344,295 was computed as follows:

	\$
Salary (\$32,929 for 6 months from April to September 2011)	197,574
Annual leave pay	12,647
Bonus	32,610

(2015-16) VOLUME 30 INLAND REVENUE BOARD OF REVIEW DECISIONS

	\$
Cash allowance	2,677
The Notice Payment	<u>98,787</u>
Total	<u>344,295</u>

- (f) He had omitted to include part of the cash allowance of \$13,960 (i.e. \$16,637 - \$2,677) for the months from April to August 2011 in his tax return.
- (g) His income for the year of assessment 2011/12 should only be \$259,468. He agreed that the whole cash allowance of \$16,637 as mentioned in (11)(a) above should be subject to tax. However, the Notice Payment should not be included as it was not related to his work but paid to compensate his early retirement.
- (h) For each change of his employment, he was informed that the terms and conditions of his employment remained unchanged but he did not read those contracts.

15. In support of his objection, the Appellant provided a copy of the annual benefits statement as at 31 December 2010 showing the retirement benefit under the Company F Retirement Plan he could have received under normal retirement, resignation, death and ill health.

16. In response to the Assessor's further enquiries, Company F confirmed, *inter alia*, that:

- (a) The Appellant was paid a retirement benefit of \$770,700. He was not entitled to any severance payment or long service payment.
- (b) The Ex-gratia Payment did not represent any severance payment or long service payment.
- (c) Company F initiated the discussion with the Appellant for early retirement.
- (d) The Appellant was early retired pursuant to clause XI of the Service Conditions.
- (e) The Ex-gratia Payment represented the amount provided in clause XI of the Service Conditions.
- (f) As the Appellant was given a notice period of 2 months, he should therefore be entitled to payment in lieu of 1-month notice only pursuant to clause VI of the Service Conditions.

(2015-16) VOLUME 30 INLAND REVENUE BOARD OF REVIEW DECISIONS

17. The Assessor considered that the Ex-gratia Payment which was paid pursuant to the Service Conditions should be subject to tax. As the Appellant was given a 2-month notice on 2 August 2011 that he would be early retired on 30 September 2011, the Assessor considered that an amount of \$65,858 (i.e. monthly salary of \$32,929 x 2) ('the Additional Notice Payment') included in the Notice Payment should also be subject to tax. The Assessor proposed to the Appellant that the Salaries Tax Assessment for the year of assessment 2011/12 should be increased as follows:

	\$
Income	534,589
<u>Add:</u> The Additional Notice Payment	<u>65,858</u>
	600,447
<u>Less:</u> Charitable donations	<u>100</u>
Net income	600,347
<u>Less:</u> Married person's allowance	<u>216,000</u>
Net chargeable income	<u>384,347</u>
Tax Payable (after tax reduction)	<u>41,338</u>

18. The Appellant raised his objection to the assessment to the Commissioner of Inland Revenue. In his Determination dated 26 March 2014 ('the Determination'), he rejected the objection.

### **The Issues**

19. The issues for the Board's decision are:

- (a) whether the ex-gratia payment in the sum of \$275,122 ('Sum A') received by the Appellant from Company F upon his early retirement should not be chargeable to Salaries Tax; and
- (b) whether a sum in the amount of \$65,858 ('Sum B') received by the Appellant from Company F upon his early retirement was a payment in lieu of notice and should not be chargeable to Salaries Tax.

### **The Relevant Legislation**

20. At the review hearing, the Representative of the Respondent ('the Respondent') has referred the Board to the follow statutory provisions:

#### ***Inland Revenue Ordinance (Chapter 112) ('IRO')***

- (1) Section 8(1) of the IRO provides that '*Salaries tax shall ... be charged for each year of assessment on every person in respect of his income*



*arising in or derived from Hong Kong from ... any office or employment of profit ...'*

- (2) Section 9(1) defines '*Income from any office or employment*' to include '*any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others ...*'
- (3) Section 68(4) of the IRO provides that '*The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.*'

***Employment Ordinance (Chapter 57) ('EO')***

- (4) Sections 31R, 31RA and 31S of the EO provides that an employee who has been employed for not less than 5 years of service under a continuous contract shall be entitled to long service payment ('LSP') if he:
  - (a) is dismissed by reason other than serious misconduct or redundancy; or
  - (b) terminates his contract and he is not less than 65 years old; or
  - (c) terminates his contract on the ground of ill health with certification that he is permanently unfit for the work he is employed at the relevant times; or
  - (d) dies in service.
- (5) Section 31V(1) provides that the amount of LSP payable for a monthly rated employee is calculated at two-thirds of his last full month's wages, or two-thirds of \$22,500, whichever is less for every year (and pro rata as respects an incomplete year) of employment subject to a maximum payment of \$390,000.
- (6) Section 31Y provides that if an employee has been paid occupational retirement scheme benefits, the amount of LSP an employee is entitled is to be reduced by the total amount of the benefits to the extent that they relate to the employee's years of service for which the long service payment is payable.

### The Relevant Case Law

21. In its submission, the Respondent referred to the follow authorities:
- (1) The issue whether a sum received upon termination of employment is chargeable to Salaries Tax was examined extensively by the Court of Final Appeal in Fuchs v CIR [2011] 2 HKC 422.
  - (2) In Fuchs, the Taxpayer was employed by a bank for an initial term of three years subject to negotiations for prolongation. In the event of termination by the bank, his employment contract provided for the payment of two sums; namely (1) two annual salaries and (2) an average amount of the bonuses paid in the three previous years of employment, as agreed to be compensation or liquidated damages. Before the end of the initial three years' term, the employer bank was taken over by another bank. As part of the resultant re-organisation, the Taxpayer's employment was terminated. A termination agreement was made between him and his employer under which the Taxpayer was paid three sums called A, B and C. Sum A was a sum equivalent to the Appellant's salary for the remaining term of the employment contract (12 months); Sum B was two annual salaries and Sum C was the average amount of the bonuses paid in the three previous years. The Taxpayer contended that all three Sums were not taxable. The Revenue conceded that Sum A was a non-taxable compensation but maintained that Sum B and Sum C should be assessed.
  - (3) Mr Justice Riberio PJ held that the key issue of deciding whether a payment received by an employee upon the termination of his employment was taxable was whether such payments constituted income from the Taxpayer's employment.

His conclusion was as follows:

*'It follows, in my view, that Sums B and C were paid in satisfaction of the rights which had accrued to the Appellant under clause 9(c) and were plainly amounts derived "from his employment". They were not sums paid in consideration of the abrogation of the Appellant's rights under the employment contract. Like Colonel de Soissons [in Dale v de Soissons (1950) 32 TC 118], Mr Fuchs surrendered no rights. Instead, by negotiation, he augmented his clause 9(c) rights by securing an additional year's salary represented by Sum A. Sum B and C accordingly come within the charge to salaries tax contained in section 8(1). This conclusion is reached on reasoning which proceeds much along the lines of the Court of Appeal's approach.'*

(2015-16) VOLUME 30 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (4) In D80/00, IRBRD, vol 15, 715, the taxpayer commenced his employment with the employer in March 1996. The terms of his employment provided if the Appellant's service was terminated by the employer, his employer should have a discretion to pay him an additional amount, in aggregate, with the amount of benefits under retirement scheme. The taxpayer was made redundant by the employer. Upon redundancy, the taxpayer was paid leaving service benefits under the retirement scheme and a 'top-up supplement'. The taxpayer contended that he expected to work for the employer until the year 2047 but he was laid off. Thus, he considered that the top-up supplement was in the nature of an ex-gratia redundancy payment which the employer was morally, though not legally obliged to pay and should not be taxable.
- (a) Having reviewed a number of authorities on the question of whether a payment made by an employer to an employee upon termination of the employment is chargeable to Salaries Tax, the Board derived the following principles:
- ‘ (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 or a payment in lieu of or on account of severance pay is not taxable;*
- (3) *it is not the label, but the real nature of the payment, that is important;*
- (4) *the way in which the sum in question was arrived at is a material factor in determining the real nature of the payment.’*
- (b) The Board found that the top-up supplement was an ex-gratia payment made on account of past services and was not a compensation for loss of office. The Board decided that the top-up supplement was thus taxable.
- (5) In D30/12, (2012-13) IRBRD, vol 27, 657, the taxpayer retired from work at 54 years old. According to his employment contract, pre-retirement funds could be paid to the taxpayer at the employer's discretion based on his past performance, loyalty and seniority. His employer paid him a gratuity upon early retirement which was assessed to Salaries Tax. The taxpayer contended that the gratuity included a LSP of \$390,000 which should not be taxable. The Board found that the

gratuity was a reward for past services paid to the taxpayer pursuant to his employment contract and was income from an office or employment within the meaning of section 8(1) of the IRO. The Board further found that the appellant was not entitled to any long LSP because: (a) he was not dismissed by the former employer, (b) his employment was not terminated at the age of 65 or above or ill health.

- (6) In D80/03, IRBRD, vol 18, 820, the taxpayer's employer, pursuant to her employment agreement, gave her notice that her employment would be terminated two months from the date of the notice. But she was not required to report to work during that two-months' notice period. The taxpayer contended that her employment ceased on the date she received the notice, and that the salary she received during those two months was a payment in lieu of notice and should not be taxable. The Board found that the employer had given her a notice period of two months and her last date of employment was two months after she received the notice. Thus, she was not entitled to any payment in lieu of notice.

### **The Appellant's Grounds of Appeal**

22. The Appellant's contentions as follows:

- (a) He had worked for Company F for more than 16 years and would reach the age of 60 after working 2 more years. The retirement fund operated by Company F under the ORSO Scheme was to compensate a member of staff upon his resignation or retirement and the sum received would not be taxable. The amount of benefit received upon resignation and retirement was different.
- (b) He was required by Company F to retire early. Had he retired at the normal retirement age of 60, he would have received a higher sum from Company F's retirement scheme. The benefits he received from the retirement scheme at present was therefore based on resignation and not retirement. Sum A was paid to him to compensate for his early retirement and should not be taxable.
- (c) In his written closing submission, the Appellant argued that Sum A was described as 'a special payment' as an alternative to a long service payment. An employee would take it to mean that the special payment was likewise also not taxable.
- (d) Sum B was not related to his work and should not be taxable either. He assumed that it was paid to compensate for his early retirement just like a long service payment. That explained why Company F did not report Sum B to the Revenue.

- (e) After his early retirement, he worked in another company with a reduced income. Hence, he should not be charged Provisional Salaries Tax for the year of assessment 2012/13 based on his income from Company F.

## **Finding**

### ***Sum A***

23. The issues involved in this appeal case have already been thoroughly considered and decided upon in all the authorities and previous decisions of this Board as cited in the submissions of the Respondent.

24. It is abundantly clear that Sum A represented part of the contractual payments made by Company F to the Appellant under Clause VI(b) of the Service Conditions. This sum, which was described as a special payment in the Appellant's final pay slip, clearly derived 'from his employment' with Company F. This was indistinguishable from the ex-gratia payment involved in the Fuchs case.

25. The Board decided that Sum A was not compensatory in nature. The Appellant accepted the Services Conditions which remained unchanged despite a series of changes of employers. Under the Service Conditions, Company F was entitled to retire the Appellant at any age before he turned 60 subject to giving his contractual notice and his eligibility for retirement benefits. The Appellant had accepted these terms of employment. It was disingenuous of him to argue that he did not read the terms each time there was a change of employer. It is therefore not open to the Appellant to argue that but for his retiring at 58, he would have accrued much more benefits under the ORSO scheme which were not taxable and hence the special payment was a compensation. It should be noted that Company F simply did not have any contractual obligation to employ the Appellant until he reached the age of 60. The truth is that the Appellant's employment terminated when he turned 58. It mattered not whether the Appellant called it a resignation or retirement. The money represented payments which the Appellant received derived from his employment as provided for in the Service Conditions and was therefore taxable.

### ***Sum B***

26. Under Clause VI of the Service Conditions, Company F was required to give a notice period of three months or pay in lieu for the early retirement of the Appellant.

27. By a letter of 2 August 2011, Company F notified the Appellant of his early retirement and his last date of employment would be 30 September 2011. That is to say Company F had only given the Appellant two months' notice. The evidence is that the Appellant continued to receive his salaries for the months of August and September 2011. Company F should therefore be required to pay only one month salary in lieu of the balance of the three-month notice period.

(2015-16) VOLUME 30 INLAND REVENUE BOARD OF REVIEW DECISIONS

28. The Board accepts the views of the Respondent. The Appellant was only entitled to one-month pay in lieu of notice in the sum of \$32,929. Since the Appellant was paid a sum of \$98,787, Sum B which was the balance of  $\$98,787 - \$32,929 = \$65,858$ , was therefore additional remuneration and taxable income.

***Provisional Salaries Tax 2012/2013***

29. The Appellant did not advance any argument in this respect. It coupled with the fact that provisional salaries tax of 2012/13 was not dealt with in the Determination. Hence, this Board refrains from making any decision in this regard.

**Conclusion**

30. The Appellant has failed to discharge the onus under Section 68(4) of the IRO proving that the assessment under appeal is excessive or incorrect.

31. The appeal is dismissed.