Case No. D24/14

Salaries tax – severance payment – sections 8, 9, 11B, 11C, 11D(b) and 68(4) of the Inland Revenue Ordinance – section 31B(1) of the Employment Ordinance

Panel: Chow Wai Shun (chairman), Li Ming Kwong and Pang Melissa Kaye.

Date of hearing: 4 September 2014.
Date of decision: 2 December 2014.

The Taxpayer was terminated by Company A approximately 16 months after his employment. Apart from unpaid wages, unused annual leave and payment in lieu of notice, Company A offered the Taxpayer 'the Sum' if the latter would accept the terms and conditions outlined in the Final Termination Letter. The Taxpayer appealed against the Determination which confirmed that the Sum was taxable, arguing that it was severance payment in nature, it was paid in consideration of his agreeing to surrender or forgo all his pre-existing contractual and legal rights and it did not have any connection with his employment with Company A or services rendered to Company A.

Held:

1. There is no provision which exempts severance payment from Salaries Tax but it has been the established practice of the IRD not to assess to Salaries Tax such payment provided that it is made strictly in accordance with the Employment Ordinance. Section 31B(1) of the EO provides that where an employee who has been employed under a continuous contract for a period of not less than 24 months is dismissed by his employer by reason of redundancy or laid off, the employer shall be liable to pay the employee severance payment. The Taxpayer was employed for just approximately 16 months. Company A did not have to pay the Taxpayer severance payment under the EO even if the Taxpayer was dismissed by reason of redundancy.

2. Despite being repeatedly enquired by this panel, the Taxpayer failed to identify any specific contractual rights he had lost or surrendered such that rendered Company A legal obligation to pay him compensation for loss of such rights. On the other hand, the Sum was paid by Company A after further negotiation initiated by and with the Taxpayer. This was discretionary and on top of what Company A was legally obliged to pay. When prompted by this panel why he thought Company A finally agreed to pay him the Sum, the Taxpayer did refer to his 'performance' which he claimed was 'above

average' although he continued to stress that the Sum was severance payment and served as an exchange for no further legal claims by him against Company A. Taking into account all said and done, we agreed that objectively the Taxpayer's employment with, or his services rendered to, Company A, was the cause of the payment of the Sum. It is ex-gratia, linked with the Taxpayer's 'performance' when he was in employment with Company A, but not compensation payment of any sort. Alternatively, the Taxpayer failed to discharge the burden of proof under section 68(4) of the IRO.

Appeal dismissed.

Cases referred to:

Fuchs v CIR [2011] 2 HKC 422
Hunter v Dewhurst 16 TC 605
Henley v Murray 31 TC 351
Dale v de Soissons 32 TC 118
Comptroller-General of Inland Revenue v Knight [1973] AC 428
Mairs v Haughey [1994] 1 AC 303
D80/00, IRBRD, vol 15, 715
D87/01, IRBRD, vol 16, 725
D4/05, (2005-06) IRBRD, vol 20, 256
D58/08, (2009-10) IRBRD, vol 24, 126
D21/09, (2009-10) IRBRD, vol 24, 517
D12/11, (2011-12) IRBRD, vol 26, 220
D8/13, (2013-14) IRBRD, vol 28, 270

Appellant in person.
Chan Siu Ying Shirley, Yau Yuen Chun and Lee Shun Shan for the Commissioner of Inland Revenue.

Decision:

1. The Appellant appeals against a Determination of the Deputy Commissioner of Inland Revenue dated 29 January 2014 in respect of the Salaries Tax Assessment for the year of assessment 2011/12 raised on him ('the Determination').

2. The Respondent raised no issue on the timing of lodging the appeal by the Appellant. The Appellant called no witness and did not adduce any further documentary evidence at the hearing. He did not dispute over the facts upon which the Determination was arrived at either.

3. In such circumstances, we find the following facts relevant to this appeal:

(1) By a letter dated 11 May 2010 ('the Employment Contract'), Company A offered to employ the Appellant as Position B, commencing from 17 May 2010. The terms of employment included, among other things, the following:

(a) Clause 4 Notice

The contract could be terminated by either party by giving 2 months' notice in writing or payment in lieu of such written notice.

(b) Clause 8 Remuneration

(i) Company A should pay the Appellant a basic remuneration of $161,459 per month.

(ii) Company A should pay the Appellant a guaranteed cash bonus of $2,402,500 ('Guaranteed Bonus') in June 2011.

(iii) Company A should pay the Appellant a performance bonus at its sole discretion. The bonus would be paid on the normal pay day in June and related to the period from April 1 to March 31 of preceding fiscal year. The Appellant would not be entitled to any discretionary bonus if he was not in the employment with Company A on the bonus payment date.

(c) Clause 12 Confidentiality

The Appellant should neither during his employment nor after termination used or disclosed any trade secrets or confidential information relating or belonging to Company A or its associated company.

(d) Clause 16 Post-termination restrictions

The Appellant should not without prior written consent of Company A:

(i) during the employment period and for a period of 3 months after termination engage in any business which was in competition with the business being carried out by Company A.

(ii) during the employment period and for a period of 6 months after termination solicit or engage any staff or agent of Company A or its associated company or induce any such persons to cease working for Company A or its associated company whether in Hong Kong or elsewhere.

(iii) during the employment period and for a period of 6 months after termination canvass, solicit or approach with the relationship of Company A and its associated company with any of the clients, suppliers or agent of Company A and its associated company to whom the Appellant had dealings with in the course of his employment with Company A during the period of 6 months immediately preceding the date of termination of the employment.

The Appellant accepted the offer and agreed to the terms stated in the Employment Contract.

(2) By a letter dated 7 September 2011 ('the Initial Termination Letter'), Company A confirmed that the Appellant's position had become redundant and his employment with Company A would end with effect on the same day under the following terms and conditions:

(a) Company A would pay the Appellant the following payments within 7 business days of the acceptance date:

	$
Unpaid wages	37,674
Unused annual leave	58,390
Payment in lieu of notice (2 months' salary)	322,918
	418,982
Less: Employee's mandatory pension contribution	1,000
Net Chargeable Income	417,982

(b) The Appellant's entitlement under Company A's retirement scheme would be dealt with according to the rules of the scheme.

(c) The Appellant agreed not to use or divulge confidential information for Company A or its associated companies which included trade secrets, know-how, client lists, employee information, marketing and business plans, information regarding customers, prospective customers or competitors.

(d) The Appellant acknowledged that the terms of his departure from Company A were strictly confidential and he agreed not to disclose,

communicate, publicize the terms to anyone except his immediate family, professional advisors and relevant tax authorities.

(e) The Appellant undertook not to knowingly make, publish, issue or procure negative statements concerning Company A, its associated companies and their officers or employees.

The Appellant did not acknowledge receipt of the Initial Termination Letter.

(3) The Appellant and Company A thereafter exchanged various emails regarding the termination. Matters discussed were as follow:

(a) By an email sent on 9 September 2011, the Appellant requested Company A to clarify the payment of bonus on a pro-rata basis, the enforceability of the non-competition clause in the Employment Contract and the meaning of redundancy in his context.

(b) By an email sent on 12 September 2011, Company A replied the Appellant that:

(i) he was not entitled to bonus as payment of bonus, pursuant to clause 8 of the Employment Contract, was at Company A's sole discretion.

(ii) the waiver of non-competition clause was subject to his signing of the Initial Termination Letter.

(iii) his position as Position B has been eliminated and, under Hong Kong law, Company A had the right to terminate his employment by making 2 months' payment in lieu of notice.

(c) By an email sent on 10 October 2011, the Appellant requested for one month salary as compassionate payment together with waiver of post-termination restrictions.

(d) By an email sent on 11 October 2011, Company A asked the Appellant to confirm whether his requests were as follow:

(i) payment of additional one month salary;

(ii) agreement of releasing Company A from claims; and

(iii) confirmation from Company A that he would not be bound by any non-competition clause.

(e) By an email sent on 11 October 2011, the Appellant responded by requesting additional two months' salary (i.e. total three months' salary) and releasing him from all post-termination restrictions.

(f) By an email sent on 12 October 2011, Company A replied that it was inconsistent with its understanding and it was prepared to pay one month's salary only.

(4) Company A replaced and superseded the Initial Termination Letter by a letter dated 30 November 2011 ('the Final Termination Letter'), which contained the following terms and conditions:

(a) Preamble

Company A wrote to confirm that the Appellant would like to voluntarily resign his position and his employment with Company A would end on 7 September 2011.

(b) Clause 1 Payment

In addition to the payment in paragraph 3(2)(a), Company A would pay the Appellant a special payment of $161,459 ('the Sum'). The Sum would be made provided that the Appellant accepted the terms and conditions outlined in the Final Termination Letter before the close of business of that day. If the Appellant did not accept the terms and conditions outlined in the Final Termination Letter, he would be entitled to the minimum payments already paid and provided to him under the Employment Ordinance ('the EO') and the terms of the Employment Contract. In the event he chose not to sign the Final Termination Letter, the understanding of the Initial Termination Letter would prevail.

(c) Clause 2 Retirement Schemes

The Appellant's entitlement under Company A's retirement schemes has already been settled with him in accordance with the rules of the schemes.

(d) Clause 4 Release and waiver

The Appellant agreed that his acceptance of the Sum was in full and final settlement of claims against Company A, its associated companies and their employees and officers, and he hereby remitted, released and forever quitted all claims (other than those

relating to the enforcement of the Final Termination Letter) which he had, might have, or would have been entitled to bring if not for his agreement to the terms of the Final Termination Letter. He agreed not to bring any claims, suits, demands or seek any other legal recourse against Company A, its associated companies and their employees or officers in respect of any claim, whether known or unknown and whether or not presently existing.

(e) Same as those stated in paragraph 3(2)(c) to (e).

(5) Company A filed a notification by an employer of an employee who is about to cease to be employed in respect of the Appellant which showed, among other things, the following particulars:

(a) Period of employment:	01-04-2011 – 07-09-2011
(b) Capacity in which employed:	Position B
(c) Particulars of income:	$
Salary	844,968
Leave pay	58,390
Other rewards	
The Sum	161,459
The Guaranteed Bonus	2,402,500
Total	3,467,317

(6) The Appellant in his Tax Return – Individuals for the year of assessment 2011/12 declared that he was unemployed.

(7) The Assessor raised on the Appellant the following Salaries Tax Assessment for the year of assessment 2011/12:

	$
Assessable Income [paragraph 3(5)(c)]	3,467,317
Tax Payable thereon (after tax reduction)	508.097

(8) The Appellant objected to the assessment on the ground that the Sum was not taxable and that he had made contributions to retirement scheme of $6,000.

(9) The Assessor agreed that contributions to retirement scheme of $6,000 should be allowed for deduction but was of the view that the Sum should be chargeable to tax. According, the Assessor proposed to revise the 2011/12 Salaries Tax Assessment as follows:

	$
Income previously assessed (paragraph 3(7))	3,467,317
Less: Contributions to retirement scheme	6,000
Revised Assessable Income	3,461,317
Revised Tax Payable thereon (after tax reduction)	507,197

(10) The Appellant maintained that the Sum should not be chargeable to Salaries Tax for the following reasons:

(a) The Sum was in the nature of severance payment surrounding involuntary termination.

(b) The Sum was offered by Company A in consideration of his agreeing to surrender or forgo his pre-existing contractual rights and other legal rights.

(11) The Appellant further contended as follow:

(a) The Sum was paid in December 2011, 3 months after the employment has terminated. It would be far fetching to regard it as earnings from ordinary duties.

(b) He was continuously employed by Company A one year after his first-year contractual employment. A reasonable conclusion was that the employment was extended at the end of year one for at least another year. Had he been employed towards his second year contract which could have been signed in force, he would have not only enjoyed the severance payment, but also shared the year-end cash bonus, which was allocated by Company A on a quarterly basis. The involuntary termination had removed his right to the cash bonus for the period that he had served Company A (June to September 2011), but also the statutory right to severance payment.

(c) That Company A did not have to pay severance payment by law does not negate the judgment or decision of classifying the Sum as tax-free payment in lieu of forced termination.

(d) By luring employees to sign the termination letter on an individual basis, Company A had discreetly avoided to roll out the redundancy program and reduced their restructuring costs at the expense of the employees that were victimized.

(e) In investment banking industry, it was common practice that respectable employers offered severance payment (usually three months' salaries) to all employees they laid off, regardless of the years of services rendered. They did this partly because the EO was not practical in addressing the losses those employees suffered following the termination of employments, partly because they admitted the fact that the involuntary termination was of little connection to the performance of the employees that were terminated.

(12) In reply to the Assessor's enquiries, Company A or through its representative, Company C, provided the following information:

(a) Company A undertook restructuring in September and October 2011. Company A initiated the termination of employment and the Appellant's position was not assumed by anyone after his departure.

(b) The monthly breakdown of the Appellant's remuneration provided showed that the sum equaled the Appellant's one month basic remuneration. It was paid in addition to the minimum requirement of the EO and the Employment Contract. It was paid at Company A's sole discretion.

(c) Company A did not have any legal obligation to extend the Appellant's employment at the end of year one for at least another year. Neither did Company A have legal obligation to make discretionary bonus to the Appellant as he was not an employee of Company A as at the bonus payment date.

(d) The Sum was made in consideration of a waiver of all and any legal claims that the Appellant might have against Company A. Company A finally released the Appellant from the non-competition clause but not other post-termination restrictions.

(13) The Determination confirmed that the Sum was taxable although reduced the assessable income with tax payable for the year of assessment 2011/12 as set out in paragraph 3(9) above.

Grounds of appeal and the Appellant's submissions

4. The Appellant's case can be summarized as follow:

(1) The Sum was severance payment in nature.

(2) The Sum was paid in consideration of his agreeing to surrender or forgo all his pre-existing contractual and legal rights; and

(3) The Sum did not have any connection with his employment with Company A or services rendered to Company A.

Our analysis

5. The issue for us is whether the Sum is subject to salaries tax.

The statutory provisions

6. Section 8 of the Inland Revenue Ordinance ('IRO') provides:

'*(1) 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…'

7. Section 9 of the IRO provides:

'*(1) 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…'

8. Section 11B of the IRO provides that the assessable income of a person in any year of assessment shall be the aggregate amount of income accruing to him from all sources in that year of assessment. For the purpose of section 11B, section 11C provides that a person shall be deemed to cease to derive income from a source whenever and as often as he ceases to hold an employment. However, section 11D(b) provides that income accrues to a person when he becomes entitled to claim payment thereof and proviso (ii) of the section provides that any payment made by an employer to a person after that person has ceased or been deemed to cease to derive income shall be deemed to have accrued to that person on the last day of that employment.

9. Section 68(4) of the IRO places the onus of proving that the assessment appealed against is excessive or incorrect on the Appellant.

Is the Sum severance payment?

10. There is no provision in the IRO which exempts severance payment from Salaries Tax but it has been the established practice of the IRD not to assess to Salaries Tax such payment provided that it is made strictly in accordance with the EO. Is the Sum severance payment within the meaning of the EO?

11. Section 31B(1) of the EO provides that where an employee who has been employed under a continuous contract for a period of not less than 24 months is dismissed by his employer by reason of redundancy or laid off, the employer shall be liable to pay the employee severance payment.

12. The Appellant was employed by Company A for just approximately 16 months, less than 24 months, from 17 May 2010 to 7 September 2011. Company A did not have to pay the Appellant severance payment under the EO even if the Appellant was dismissed by reason of redundancy.

Is the Sum compensation payment for surrendering or forgoing the Appellant's pre-existing contractual and legal rights OR income from employment?

13. In Fuchs v CIR [2011] 2 HKC 422, Ribeiro PJ held that whether a payment is chargeable to Salaries Tax turns on the construction of section 8(1) of the IRO. The test is whether such payment is 'income from any office or employment of profit'. How the payment is labelled and called does not necessarily matter. Chargeable income is not confined to income earned in the course of employment but embraces payment made in return:

(1) for acting as or being an employee; or

(2) as a reward for past services; or

(3) as an inducement to enter into employment and provide future services.

14. Regarding whether a payment is made as consideration for abrogating the employee's rights under the employment contract, Ribeiro PJ, after considering Hunter v Dewhurst 16 TC 605, Henley v Murray 31 TC 351, Dale v de Soissons 32 TC 118, Comptroller-General of Inland Revenue v Knight [1973] AC 428 and Mairs v Haughey [1994] 1 AC 303, stated:

> ' *In situations like those considered above, since the employment is brought to an end, it will often be plausible for an employee to assert that his employment rights have been "abrogated" and for him to attribute the payment received to such "abrogation", arguing for an exemption from tax. It may sometimes not be easy to decide whether such a submission should be accepted. However, the operative test must always be the test identified above, reflecting the*

> *statutory language… As the "abrogation" examples referred to above show, such a conclusion [being not taxable on a proper analysis] may be reached where the payment is not made pursuant to any entitlement under the employment contract but is made in consideration of the employee agreeing to surrender or forgo his pre-existing contractual rights.*'

15. We accept the Respondent's submission that, as set out above, the rights at stake must be contractual rights, which are to be ascertained by the objective facts and circumstances including scrutinizing the terms of the employment contract. On the other hand, these cannot simply be rights which the taxpayer may subjectively think that he had lost. This is in line with the approach taken by this Board in decisions cited by the Respondent in support, including D80/00, IRBRD, vol 15, 715; D87/01, IRBRD, vol 16, 725; D4/05, (2005-06) IRBRD, vol 20, 256; D58/08, (2009-10) IRBRD, vol 24, 126; D21/09, (2009-10) IRBRD, vol 24, 517; D12/11, (2011-12) IRBRD, vol 26, 220; and D8/13, (2013-14) IRBRD, vol 28, 270.

16. Did the Appellant surrender or forgo any of his pre-existing contractual rights in return for the Sum?

17. By the Employment Contract, Company A employed the Appellant as Position B commencing from 17 May 2010 at a monthly remuneration of $161,459. The employment was not for a fixed term but was terminable by either party by giving the other 2 months' notice in writing or by payment in lieu of notice.

18. By the Initial Termination Letter, Company A notified the Appellant that his employment was to be terminated on the same day and that it was prepared to pay the Appellant 2 months' remuneration in lieu of notice. Company A further agreed to pay the Appellant salary for the period from 1 to 7 September 2011 and payment in lieu of leave. Company A subsequently deposited the total amount into the Appellant's bank account despite the ongoing negotiation between them. Company A also settled with the Appellant his retirement benefits.

19. As such, the Appellant had received all he was entitled. Company A was not in breach of the Employment Contract in terminating the employment.

20. There was no evidence that the Initial Termination Letter and the Final Termination Letter created any legal liability on Company A to pay Appellant compensation. We also accept the Respondent's submission that both the confidentiality clause and the non-disparagement clause were general terms and did not impose any additional restriction on the Appellant. They are just basic obligations of any employee.

21. Despite being repeatedly enquired by this panel, the Appellant failed to identify any specific contractual rights he had lost or surrendered such that rendered Company A legal obligation to pay him compensation for loss of such rights, except freedom of opinion and speech and the right to take legal action to resolve dispute, which he

said the governing law clause of the Employment Contract embraced. He has misconceived what a governing law clause is all about and we find no merit at all in this submission.

22. On the other hand, the Sum was paid by Company A after further negotiation initiated by and with the Appellant. This was discretionary and on top of what Company A was legally obliged to pay.

23. Company A reported the Sum as 'Other Rewards, Allowance OR Perquisites' in the notification by an employer of an employee who is about to cease to be employed.

24. When prompted by this panel why he thought Company A finally agreed to pay him the Sum, the Appellant did refer to his 'performance' which he claimed was 'above average' although he continued to stress that the Sum was severance payment and served as an exchange for no further legal claims by him against Company A.

25. Taking into account all said and done, we agree with the Respondent that objectively the Appellant's employment with, or his services rendered to, Company A, was the cause of the payment of Sum. It is ex-gratia, linked with the Appellant's 'performance' when he was in employment with Company A, but not compensation payment of any sort.

26. Alternatively, the Appellant failed to discharge the burden of proof under section 68(4) of the IRO.

27. Even though the Appellant received the Sum several months after the termination of his employment with Company A, the Sum is deemed to have accrued to him on the last day of his employment by virtue of sections 11B, 11C and 11D(b) proviso (ii). Accordingly, the Sum is chargeable to Salaries Tax in the year of assessment 2011/12.

Conclusion

28. For the reasons and analysis set out above, we dismiss the Appellant's appeal and confirm the revised assessment as set out in paragraph 3(9) above.