

**Case No. D29/16**

**Salaries tax** – whether or not the sums were compensation payments for losses resulting from termination of employment – Section 8(2)(cc)(ii), 8(4), 8(5) and 8(6) of the Inland Revenue Ordinance

Panel: Wong Kwai Huen (chairman), Hui Cheuk Lun Lawrence and Wong Wai Yee Pauline.

Date of hearing: 5 October 2016.

Date of decision: 30 November 2016.

The Appellant was under the employment with Company E as a director at all material time. The Appellant's employment with Company E was terminated by reason of job elimination. The Appellant objected to the Salaries Tax Assessment and claimed that Sum A and Sum B were part of the severance package to compensate him for the elimination of his regional position in Hong Kong and thus should not be chargeable to salaries tax.

The issue for the Board to decide is whether payment in lieu of notice received by the Appellant ('Sum A') as well as the accrued benefit he received from the MPF Scheme attribute to the voluntary contributions made by Company E that exceeded the proportionate benefit ('Sum B') should be chargeable to salaries tax.

**Held:**

1. The Board found that Sum A was two month's payment in lieu of notice. For Sum B, it was a portion of the Appellant's vested accrued benefits derived from Company E's voluntary contribution to MPF Scheme. The Appellant's employment with Company E was the source of both Sum A and Sum B.
2. In the present case, Company E was not in breach of any legal or contractual obligation in the termination of the Appellant's employment. The Appellant had not surrendered any contractual rights upon termination of his employment. No part of the Final Payment or Severance Amount was of the nature of compensation payment (Fuchs v Commissioner of Inland Revenue [2011] 2 HKC 422 and Commissioner of Inland Revenue v Elliott [2007] 1 HKLRD 297 followed)
3. The Appellant was paid with Sum A which was payment in lieu of two months' notice that the Appellant was entitled to under terms of the

(2017-18) VOLUME 32 INLAND REVENUE BOARD OF REVIEW DECISIONS

employment. Payment in lieu of notice made in pursuance of a contractual provision, agreed at the outset of the employment, should be viewed as an inducement to enter the employment and was emolument from that employment. It is not open for the Appellant to argue that Sum A is compensation payment since no right of the Appellant under the Employment letter had been abrogated in respect of which his employer would be liable to pay any compensation (EMI Group Electronics Ltd v Coldicott (Inspector of Taxes) [1999] STC 803 followed).

4. Section 8(2)(cc)(ii), 8(4), 8(5) and 8(6) of the Inland Revenue Ordinance provided that MPF withdrawal, which was 100% of his accrued benefits from MPF Scheme, could only be wholly excluded from his chargeable income if the Appellant worked for Company E at least 120 completed months. As the Appellant had only completed 69 months of services with Company E, his MPF withdrawal could not be wholly excluded from his chargeable income.
5. The Appellant had not discharged the onus of proving that the Salaries Tax Assessment is excessive or incorrect under section 68(4) of the Inland Revenue Ordinance. The Appellant's Appeal is dismissed.
6. The Appellant should know the tax implications in his accepting the payment in question given his professional background and his position in his former employer. The Appellant is ordered to pay a sum of \$5,000 as costs of the Board.

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

Cases referred to:

Fuchs v Commissioner of Inland Revenue [2011] 2 HKC 422  
EMI Group Electronics Ltd v Coldicott (Inspector of Taxes) [1999] STC 803  
D80/00, IRBRD, vol 15, 715  
D87/01, IRBRD, vol 16, 725  
Commissioner of Inland Revenue v Elliott [2007] 1 HKLRD 297

Appellant in person.

Lo Hok Leung Dickson, Fu Hoi Kong and Wong Pui Ki, for the Commissioner of Inland Revenue.

**Decision:**

**Introduction**

1. Both parties have agreed to the following facts:

- (1) Mr C ('the Appellant') objected to the Salaries Tax Assessment for the year of assessment 2012/13 raised on him. He contended that certain payments made to him by his former employer upon the termination of his employment should not be chargeable to salaries tax.
- (2) By a letter dated 18 May 2007 ('the Employment Letter'), the Appellant was employed by Company D, a branch of Company E, with effect from 18 June 2007. The Employment Letter provided, among other things, that after completing a probation period of three months, either party might terminate the employment by giving the other party two months' written notice or making a payment in lieu thereof.
- (3) The Appellant's employment with Company E was terminated on 31 March 2013 by reason of job elimination.
- (4) The termination audit list issued by Company E in respect of the Appellant showed the calculation of his final payments, which included the following:

	<u>Calculation</u>	<u>\$</u>
(a) Severance payment (from 18-06-2007 to 31-05-2013)	$\$22,500 \times 2/3 \times (5+348/365)$ years	89,301
(b) Payment in lieu of two months' notice ('Sum A')	$\$2,024,264$ (total wages from 01-03-2012 to 28-02-2013) $\times 2/12$ months	337,377

The Appellant signified his acceptance of the calculation of his final payments. The severance payment and Sum A were paid to the Appellant by a cheque dated 3 April 2013.

- (5) By emails dated 26 April 2013 and 29 April 2013, the Human Resources of Company E notified the Appellant of the following about his concerns on the termination of his employment:
  - (a) Based on the past practice, the severance payment (Sum A) was computed in accordance with the Employment Ordinance.
  - (b) They decided to provide with him 100% vesting in respect of

his benefit under the Company E's retirement scheme ('the MPF Scheme'), notwithstanding that he was entitled to 50% vesting under the terms of the scheme.

- (c) The 750 unvested shares could not be vested, and they would not make a separate payment in lieu of vesting. The provisions of the Long Term Incentive Plan were very specific on the issue.
  - (d) A revised separation letter was enclosed for the Appellant's signature.
- (6) The letter dated 30 April 2013 ('the Separation Letter') issued by Company E to the Appellant set out, among other things, the following terms and conditions in relation to the termination of his employment:
- (a) The statutory severance payment (Sum A) was not being set off against the Appellant's provident fund scheme benefit and Company E was providing additional retirement benefit.
  - (b) The Appellant's entitlement under the MPF Scheme would be dealt with in accordance with the rules of the scheme, save that on an ex-gratia basis, he would be paid on the basis of 100% vesting notwithstanding that he was not entitled to this based on the rules of the scheme.
  - (c) The Appellant would be solely responsible for any tax payable in respect of or arising out of his employment and the payments or benefits provided under the Separation Letter.

The Appellant signified his acceptance of the terms of the Separation Letter.

- (7) The list of terminated members issued by Company F showed that the Appellant's benefit under the MPF Scheme attributable to the employer's voluntary contributions, after applying the 100% special vesting, was \$438,504 as at 31 March 2013.
- (8) (a) Company E filed an original and a revised notification in respect of the Appellant's cessation of employment. The revised notification showed, among other things, the following particulars:
- (i) Period of employment: 01-04-2012 – 31-03-2013
  - (ii) Capacity in which employed: Position G, Company H

(2017-18) VOLUME 32 INLAND REVENUE BOARD OF REVIEW DECISIONS

(iii) Particulars of income:	\$
Salary	1,765,637
Leave pay	26,533
Payment in lieu of notice (Sum A)	337,377
Certain payments from retirement schemes ('Sum B')	186,364
Other rewards, allowances or perquisites	<u>578,165</u>
	<u>2,894,076</u>

(b) Sum B was a new item included in the revised notification, which was calculated as follows:

$$\begin{aligned} &= \$438,504^{[1]} - (\$438,504^{[1]} \times 69^{[2]}/120) \\ &= \underline{\underline{\$186,364}} \end{aligned}$$

1. The Appellant's accrued benefit under the MPF Scheme
2. The Appellant's completed months of service with Company E from 18-06-2007 to 31-03-2013

(9) In his Tax Return – Individuals for the year of assessment 2012/13, the Appellant declared total income of \$2,343,802 (i.e. \$2,894,076 - \$26,533 [leave pay] - \$337,377 [Sum A] - \$186,364 [Sum B]) derived from Company E.

(10) The Assessor raised on the Appellant the following Salaries Tax Assessment for the year of assessment 2012/13:

	\$
Income	2,894,076
<u>Less: Total deductions</u>	<u>16,950</u>
	2,877,126
<u>Less: Total allowances</u>	<u>404,000</u>
Net Chargeable Income	<u>2,473,126</u>
 Tax Payable thereon (after tax reduction)	 <u>398,431</u>

(11) The Appellant objected to the above assessment claiming that Sum A and Sum B were part of the severance package to compensate him for the elimination of his regional position in Hong Kong, and his actual income for the year of assessment 2012/13 should be \$2,370,335 (i.e. \$2,894,076 - \$337,377 [Sum A] - \$186,364 [Sum B]).

(12) The Assessor explained to the Appellant that Sum A was a contractual payment whilst Sum B was an additional retirement

benefit provided to him in excess of the proportionate benefit, and hence both sums should be chargeable to salaries tax. The Assessor invited the Appellant to withdraw his objection.

### **The Issues**

2. The issue for the Board to decide is whether payment in lieu of notice received by the Appellant ('Sum A') as well as the accrued benefit he received from the MPF Scheme attributable to the voluntary contributions made by Company E that exceeded the proportionate benefit ('Sum B') should be chargeable to salaries tax.

### **The Statutory Provisions**

3. The Respondent referred the Board to the following statutory provisions:

(1) Section 8(1) of the Inland Revenue Ordinance ('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) Sections 9(1)(a) and 9(1)(ae) of the IRO 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 ...'* (section 9(1)(a)).

*'so much of the accrued benefit that an employee has received, or is taken to have received, from a mandatory provident fund scheme as is attributable to voluntary contributions paid to the scheme by the employee's employer that exceeds the proportionate benefit calculated in accordance with section 8(5)'* (section 9(1)(ae)).

(3) Section 8(2)(cc)(ii) of the IRO provides that, subject to sections 8(4) and 8(5), there should be excluded from the charge to salaries tax:

*'a sum equal to so much of the accrued benefit received from the approved trustee of a mandatory provident fund scheme, whether in a lump sum or (if applicable) as an instalment, on the ground of retirement, death, incapacity, terminal illness, termination of service, or taken to have been received from the approved trustee of such a scheme as provided by subsection (9), as is attributable to voluntary contributions paid to the scheme by an employer'*.

(4) Section 8(4) of the IRO provides that, the amount may be excluded under Section 8(2)(cc)(ii) of the IRO should be:

*‘... to the extent that it is attributable to voluntary contributions made by the person’s employer and does not exceed the proportionate benefit calculated in accordance with subsection (5)’.*

- (5) Section 8(5) of the IRO provides the formula for calculating the proportionate benefit as follows:

‘

$$PB = \frac{CMS}{120} \times AB$$

where —

*PB* is the proportionate benefit to be calculated;  
*CMS* is the number of completed months of service that the person has completed with the employer; and  
*AB* the amount of the person’s accrued benefit’.

- (6) Section 8(6)(b) defines ‘accrued benefit’ in relation to a person who is a member of a mandatory provident fund scheme as follows:

*‘... the person’s accrued benefits attributable to voluntary contributions paid to the scheme in respect of the person for that service.’.*

- (7) 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’.*

## **The Case Law**

4. The Respondent referred to the following authorities:

### ***Payment received from the employment***

- (1) In Fuchs v Commissioner of Inland Revenue [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’. Chargeable income is not confined to income earned in the course of employment but also payment made in return for acting as or being an employee, as a reward for past

services, or as an inducement to enter into employment and provide future services.

- (2) Where a payment falls within the test, it is assessable and the fact that, as a matter of language, it is described in some other terms, such as 'compensation for loss of office', does not displace liability to tax. The applicable test gives effect to the statutory language and other possible characterizations of the payment are beside the point if, applying the test, the payment is 'from employment'.

***Payment in lieu of notice***

- (3) In EMI Group Electronics Ltd v Coldicott (Inspector of Taxes) [1999] STC 803, Chadwick LJ decided that a payment in lieu of notice made in pursuance of a contractual provision, agreed at the outset of the employment, which enabled the employer to terminate the employment on making that payment was an emolument from that employment. An employee's entitlement to the payment in lieu of notice was a security, or continuity, of employment, which the employee required as an inducement to enter the employment. The payment was therefore paid to the employee for acting as or being an employee and was an emolument from being or becoming an employee.

***Payment received upon termination of employment***

- (4) In D80/00, IRBRD vol 15, 715, the Board, 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 or not, derived the following principles:
  - (a) A payment would be taxable if it is in the nature of a gift on account of past services. The word 'gratuity' connotes a gift or present usually given on account of past services.
  - (b) 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.
  - (c) It is not the label, but the real nature of payment, that is important.
  - (d) The way in which the sum in question was arrived at is a material factor in determining the real nature of the payment.



- (e) It would not be right for the Board to take the say-so of an employee or that of the representative of the employer in determining what is the real nature of the payment.
  - (f) It is the Board's responsibility to find objectively on the basis of the evidence before it what is the real nature of the payment.
- (5) In D87/01, IRBRD vol 16, 725, the Board held that, simply because the amount in dispute was paid to the Appellant on the occasion of the termination of his employment did not follow that the amount cannot be liable to salaries tax. The test for salaries tax liability was not a 'but for' test; rather, it was whether the sum arose from the employment for services past, present or future.

### ***Compensation for loss of rights***

- (6) In Commissioner of Inland Revenue v Elliott [2007] 1 HKLRD 297, the Court of Appeals held that:

*'Payments received as compensation for loss of office were not chargeable to salaries tax. In applying this principle, there was a critical distinction between where the contract of employment persisted, where the employer remained liable for the remuneration it had contracted to pay, notwithstanding that it did not require the employee to render service; and where the contract itself went altogether, where some amount became payable for the consideration of the total abandonment of all the contractual rights which E had under the contract.'*

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

5. The Appellant claimed that Sum A and Sum B were compensation payments for all his losses resulting from the termination of his employment with Company E and thus should not be chargeable to salaries tax.

- (a) It was stated in the Termination Audit List ('the List') that the total severance amount was US\$58,479 ('the Severance Amount'), which was equivalent to HK\$453,212. The Severance Amount included Sum A of HK\$337,377 which was calculated as two months' salary together with other compensations. However, the whole Severance Amount should be regarded as a compensation for the loss of income due to job elimination as well as the loss on restricted stock unit value.
- (b) Sum B was a compensation payment to him for loss of vesting rights under the MPF Scheme. He considered he should be entitled to

100% vesting right under the MPF Scheme and Company E agreed to compensate him for the loss of his vesting right.

### **Finding**

6. This is a very straightforward case. The facts presented to the Board at the hearing involved no more than those stated in paragraph 1(1)-(12) above.

7. The Appellant was under the employment with Company E as a director at all material time. Under the terms of his employment, he was entitled to two months' written notice or payment in lieu thereof upon termination of his employment. The List clearly showed that Sum A was two months' payment in lieu of notice. For Sum B, it was a portion of the Appellant's vested accrued benefits derived from Company E's voluntary contribution to MPF Scheme. The Appellant's employment with Company E was the source of both Sum A and Sum B.

### **Lump Sum Payment**

8. According to the List, the Appellant could receive a payment of \$1,170,736.35 ('the Final Payment') upon cessation of his employment with Company E. Company E had made a payment of \$717,524.37 to the Appellant on 20 March 2013 through bank transfer and the balance of \$453,211.98 (i.e. the Severance Amount) was deposited into the Appellant's bank account on 5 April 2013.

9. The Board accepts the Respondent's submission that the Final Payment was a balancing total covering the salary, leave entitlement, payment in lieu of notice, statutory severance payment and MPF contributions. The quantum of each item could be ascertained as each of them was calculated on a specific basis by reference to the terms of employment contract and statutory provisions.

10. From the facts before the Board, the Appellant cannot argue that he accepted a lump sum payment upon termination of his employment and he treated the payment as one sum representing his statutory entitlements and compensation. He did not bother himself with what the sum was composed of. It is therefore proper and reasonable for the Respondent to ascertain the taxable portion of the Final Payment by reference to their specified nature. It should be noted that the Respondent had accepted that certain amount included in the Final Payment, such as the statutory severance payment, was not taxable income of the Appellant.

11. The Appellant contended that the Severance Amount should be regarded as a compensation for the loss of his income and should not be chargeable to salaries tax. At the hearing, the Appellant appeared to hold a lot of resentment against his former employer. However, it is totally irrelevant to this appeal. The Board cannot deal with matters relating to their relationship which is unconnected with the Appellant's tax liability.

(2017-18) VOLUME 32 INLAND REVENUE BOARD OF REVIEW DECISIONS

12. In the present case, Company E was not in breach of any legal or contractual obligation in the termination of the Appellant's employment. Regarding the share units awards, it was clearly stated in sections 1 and 2 of the relevant share unit award certificates that the awards would be cancelled upon termination of the Appellant's employment. As confirmed by Company E, the Appellant had no rights to claim the unvested shares. In Company E's email dated 26 April 2013, the Appellant had already been advised that the unvested shares could not be vested and Company E would not make a separate payment in lieu of vesting. In short, the Appellant had not surrendered any contractual rights upon termination of his employment. Following the authority of Elliott and Fuchs, no part of the Final Payment or Severance Amount was of the nature of compensation payment.

***Sum A***

13. The Employment Letter provided that the Appellant or Company E could terminate the employment by giving the other party two months' notice in writing or payment in lieu of notice. The Appellant was paid Sum A which was payment in lieu of two months' notice that the Appellant was entitled to under terms of the employment. As decided in the EMI case, payment in lieu of notice made in pursuance of a contractual provision, agreed at the outset of the employment, should be viewed as an inducement to enter the employment and was an emolument from that employment. It is not open for the Appellant to argue that Sum A is compensation payment since no right of the Appellant under the Employment Letter had been abrogated in respect of which his employer would be liable to pay any compensation.

***Sum B***

14. The Appellant further contended that Sum B was a compensation payment to him for his loss of vesting rights under the MPF Scheme.

15. According to Company E's email dated 29 April 2013, it was decided that the Appellant would be provided with 100% vesting notwithstanding that he was entitled to 50% under the terms of the MPF Scheme. Company F confirmed that the Appellant did receive \$438,503.78 ('MPF Withdrawal'), which represented 100% of his accrued benefits derived from Company E's voluntary contribution to the MPF Scheme.

16. The Board found that since the Appellant should only be entitled to 50% vesting, what he had actually received (i.e. 100% of his accrued benefits) represented an extra amount which should be regarded as an ex-gratia payment. Again, there is no evidence to show that the sums was a compensation payment.

17. Sections 8(2)(cc)(ii), 8(4), 8(5) and 8(6) of the IRO provided that MPF Withdrawal, which was 100% of his accrued benefits from MPF Scheme, could only be wholly excluded from his chargeable income if the Appellant worked for Company E at least 120 completed months. As the Appellant had only completed 69 months of services with Company E, his MPF Withdrawal could not be wholly excluded from his chargeable income.

### **Conclusion**

18. All other submissions made by the Appellant including the injuries he had sustained at the time of termination of his employment, the assessor having failed to ascertain the 'true facts' from Company E and lengthy negotiations between him and Company E are all irrelevant. The so-called 'true facts' were, simply put, that Company E should not have eradicated his position irrespective of whether they were legally entitled to do so; and had Company E not eradicated his position, he would have received his share unit awards and 100% of his accrued benefit under the MPF Scheme. As a result, he treated all payments, Sum A and Sum B as one lump sum representing or containing compensation he believed he was entitled to irrespective of the relevant statutory tax treatments to the payment he had received. Such an argument is unsustainable.

19. The Board finds that the Appellant has not discharged the onus of proving that the 2012/13 Salaries Tax Assessment is excessive or incorrect under Section 68(4) of the IRO. The Appellant's appeal is dismissed.

### **Costs**

20. This is a hopeless case, the Appellant should know the tax implications in his accepting the payment in question given his professional background and his position in his former employer. The Appellant is ordered to pay a sum of \$5,000 as costs of the Board.