

Case No. D38/13

Salaries tax – gratuity payment – early retirement requested by the employer – sections 2(1), 8(1), 9(1), 11B, 11C, 11D and 68(4) of the Inland Revenue Ordinance (‘IRO’).

Panel: Chan Chi Hung SC (chairman), Wong Tin Yau Kelvin and Eirene Yeung.

Date of hearing: 8 October 2013.

Date of decision: 13 February 2014.

The Appellant contended the exceptional further gratuity payment paid to him upon his early retirement requested by the employer should not be chargeable to salaries tax.

The Appellant further contended, if the gratuity was chargeable to salaries tax, it should not be fully assessed in the year of assessment 2011/12 but partly in the year of assessment 2011/12 and partly in the year of assessment 2012/13 for his employment was terminated in June 2012.

Held:

1. The Appellant could point to no right under the contract of employment that was abrogated by the request by the employer for his early retirement. The gratuity was not compensation for abrogation of the Appellant’s right for loss of his office or employment.
2. On proper analysis, the gratuity was paid to the Appellant in return for his (previously) acting as an employee. The gratuity, in substance, was ‘income from employment’ and is chargeable.
3. The employment was terminated in December 2011 not in June 2012. The gratuity was paid upon termination in December 2011 and should be fully assessed in the year of assessment 2011/12.

Appeal dismissed.

Cases referred to:

Fuch v Commissioner of Inland Revenue [2011] 2 HKC 422
Dale v de Soissons (1950) 32 TC 118

The Appellant in person and the Appellant's brother-in-law for the Appellant.
Leung Kin Wa, Ong Wai Man Michelle and Wong Pui Ki for the Commissioner of Inland Revenue.

Decision:

Background facts

1. Mr A ('the Appellant') objected to the Salaries Tax assessment for the year of assessment 2011/12 raised on him. The Appellant claims that certain sums received by him from his employer should not be assessable in the year of assessment 2011/12.

2. The Appellant commenced employment with a bank in 1973. As a result of the integration of the bank with another bank, the Appellant was asked to sign a new employment letter which would supersede all the employment letters that the Appellant has signed since he joined in 1973. By a letter dated 23 June 1997 ('the Employment Agreement'), the newly formed company ('the Bank'), offered to employ the Appellant as Position S under, among other terms, the following terms and conditions:

' REMUNERATION

In respect of the position you will hold and the responsibilities given to you, you will receive a basic salary of HKD39,600 per month.

You remuneration will be paid along with local practices, currently over 13 months. It will be reviewed annually in January ...

:

GROUP LIFE AND MEDICAL SCHEMES

In addition to your annual remunerations, you will be entitled to the membership of the existing group life and medical schemes at no cost to you.

PROVIDENT FUND SCHEME

You will be required to join the [Bank B] Provident Fund ...

YEARS OF SERVICE

With reference to your previous employment with [Bank C], your joining date on XX 1973 will be taken into account for the calculation of your seniority.

NOTICE OF TERMINATION

[The Employment Agreement] can be terminated by either party by giving one month's notice of termination of employment in writing or the equivalent of one month's salary payment in lieu of notice must be given by either party ...'

The Appellant signified acceptance of the terms and conditions contained therein on 27 June 1997.

3. By an email sent on 19 July 2011 ('the Email'), the Bank confirmed with the Appellant the following with regard to his early retirement:

- ' - your last day in the office will be end of October; [name omitted here] will officially take over at end of September
- Your last date on payroll will be end of December. All benefits will therefore still be accrued until end of December {holidays entitlement, employer contribution on retirement fund, medical coverage}
- The bank will pay you a lump sump [sic] at December end made of: government retirement for HKD390,000.00 (this is the max amount), unused holidays, and equivalent of 7 months salary (should be – HKD435,000.00)
- [Company D] has agreed to extend your medical coverage and the one of your wife until end of June 2012 (your normal retirement age).

This special arrangement ... has been designed to give you the opportunity to enjoy your retirement earlier while treating you with the recognition you deserve after more than 38 years with the bank...'

The Appellant accepted the offer on 19 July 2011.

4. By a letter dated 26 October 2011 ('the Termination Letter'), the Bank and the Appellant agreed that the Appellant's employment was terminated by reason of early retirement under, *inter alia*, the following terms:

- ' 1. Your employment with the Bank will be terminated with effect from 1st January 2012 ... and your last working day will be 31st October 2011 ...'
- 2. Final Payment Schedule
- ...

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	(HKD)
:	
<u>Salary (1st-31st December 2011)</u>	62,250.00
<u>Leave Pay [“the Leave Pay”]</u>	62,250.00
<u>Long Service Payment [“LSP”]</u>	390,000.00
<u>Gratuity [“the Gratuity”]</u>	435,750.00
<u>Employee Pension Contribution for Dec 2011</u>	(4,668.75)
<u>TOTAL TO BE PAID VIA DEC 2011 PAYROLL</u>	<u>945,581.25</u>

3. You will receive a payment for the amount set out in the above schedule which includes all amounts due to you, or otherwise relating to your employment with the Bank...
4. You and your spouse will continue to be covered under Plan 2 benefit of the Bank’s current group medical schemes at no cost to you until 30th June 2012 and your group life insurance will be terminated with effect from [1st January 2012].
5. You agree not to hold yourself out as representing the Bank or any company in [the Bank’s] group ... from [1st January 2012].’

5. The Bank filed a notification by an employer in respect an employee who is about to cease to be employed in respect of the Appellant and reported the following particulars:

Capacity in which employed:	Organization Manager
Expected date of cessation of employment:	31-12-2011
Reason for cessation:	Retirement
Period of employment:	1-4-2011 – 31-12-2011
Income:	
Salary	\$560,250.00
Leave pay	\$62,250.00
Back pay, terminal awards and gratuities, etc	\$435,750.00
	<u>\$1,058,250.00</u>

6. (a) In his tax return for the year of assessment 2011/12, the Appellant declared that he received income of \$747,000.00 from the Bank for the period from 1 April 2011 to 31 March 2012.
- (b) The Appellant by way of note stated that the difference of \$311,250.00 (‘the Sum’), that is income of \$1,058,250.00 reported by the Bank and income of \$747,000.00 reported by him, was income for the following year of assessment, i.e. 2012/13.

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- (c) The Appellant claimed the deduction of mandatory contributions to recognized retirement scheme of \$56,000.00.

7. In reply to the Assessor's enquiries, the Appellant put forward the following contentions:

- (a) He was paid a sum of \$435,750.00, i.e. the Gratuity, in consideration of the Bank's request for early retirement on 31 December 2011 as his original retirement date should be 30 June 2012.
- (b) The Gratuity represented his 'salary for 2012 plus additional month being the employee pension contribution for the same period (15% per month for 6 month)'.
- (c) He was provided with medical benefit under end of June 2012 which showed that he was paid up to 30 June 2012.
- (d) The Leave Pay should be included in his last month's salary i.e. June 2012. It should not be included in the year 2011.
- (e) The LSP received by him should not be taxable.

8. The Assessor accepted that the LSP should not be taxable but she considered that the Gratuity and Leave Pay should be chargeable to Salaries Tax in the year of assessment 2011/12. The Assessor raised on the Appellant the following 2011/12 Salaries Tax assessment:

Income [Fact (5)]	\$1,058,250.00
<u>Less:</u> Charitable donations	\$2,000.00
Home loan interest	\$8,286.00
Retirement scheme contributions	\$12,000.00
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	\$1,035,964.00
<u>Less:</u> Married person's allowance	\$216,000.00
Dependent parent allowance	\$72,000.00
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Net Chargeable Income	\$747,964.00
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Tax Payable thereon (after tax reduction)	\$103,153.00
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9. The Appellant objected to the assessment on the following grounds:

- (a) The chargeable income for the year 2011/12 should be \$747,000.00 instead of \$1,058,250.00. The Sum was income for the following year.
- (b) He had arranged with the Bank that he would be paid up to his normal retirement age i.e. 30 June 2012 even though he left the Bank at the end of December 2011. The additional 7 months' salary was paid to him in

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advance in December 2011. This was 6-month salary and one month's salary being provident fund made by the Bank i.e. 15% per month for 6 months). The provident fund contribution should not be taxable.

10. In reply to the Assessor's enquiries, the Bank provided the following information and document:

- (a) The Appellant's date of birth was XX June 1957. The Bank's normal retirement age was 60 years old. Therefore, the Appellant's normal retirement date should be XX June 2012. The request of early retirement was initiated by the Bank and was agreed by the Appellant.
- (b) The Appellant's last day of employment with the Bank was 31 December 2011.
- (c) The breakdown of the Appellant's monthly remuneration for the period from 1 April 2011 to 31 December 2011 was as follows:

<u>Month</u>	<u>Salary</u>	<u>Employee contribution</u>	<u>Net Pay</u>
	\$	\$	\$
Apr	62,250.00	4,668.75	57,581.25
May	62,250.00	4,668.75	57,581.25
Jun	62,250.00	4,668.75	57,581.25
Jul	62,250.00	4,668.75	57,581.25
Aug	62,250.00	4,668.75	57,581.25
Sep	62,250.00	4,668.75	57,581.25
Oct	62,250.00	4,668.75	57,581.25
Nov	62,250.00	4,668.75	57,581.25
Dec	62,250.00	4,668.75	57,581.25
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	560,250.00	42,018.75	518,231.25
The Gratuity	435,750.00	-	435,750.00
The Leave Pay	62,250.00	-	62,250.00
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	1,058,250.00	42,018.75	1,016,231.25
LSP	390,000.00	-	390,000.00
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	1,448,250.00	42,018.75	1,406,231.25

- (d) The Appellant joined the Bank's Provident Fund for the period from 1 April 2011 to 31 December 2011. The Appellant did not make provident fund contributions for the months from January to March 2012 as his last employment date with the Bank was 31 December 2011.
- (e) The Appellant's payroll statement for December 2011 showed that the Gratuity, the Leave Pay and the LSP were deposited into the Appellant's bank account on 20 December 2011.

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(f) The Gratuity was calculated as \$62,250.00 x 7 months.

(g) The Leave Pay was calculated as follows:

Monthly wage (i)	\$62,250.00
No. of unused annual leave (ii)	22 days
The Leave Pay (i) x (ii)/22	\$62,250.00

(h) The LSP was calculated as follows:

Last month wage	\$62,250.00 (Maximum amount: \$22,500.00)
Reckonable years of service	38 years and 306 days
The LSP	$\$22,500 \times \frac{2}{3} \times (38 \text{ years} + 306/365 \text{ days})$ =\$582,575.34 (Maximum amount: \$390,000.00)

11. The Assessor was of the view that the Gratuity and the Leave Pay were accrued to the Appellant in the year of assessment 2011/12. Accordingly, the Sum, which comprised the Leave Pay of \$62,250.00 and part of the Gratuity in the amount of \$249,000.00 being 4 months' salary (i.e. \$62,250.00 x 4 months), were correctly chargeable to Salaries Tax in the year of assessment 2011/12. She explained to the Appellant and invited him to withdraw the objection.

12. The Appellant declined to withdraw the objection.

13. The Assessor maintains the view that the Sum was correctly chargeable to tax in the year of assessment 2011/12. On the other hand, the Assessor considers that the amount of contribution to recognized retirement schemes allowable to the Appellant should be \$9,000.00 instead of \$12,000.00. Accordingly, the 2011/12 Salaries Tax assessment should be revised as follows:

Income	\$1,058,250.00
<u>Less:</u> Charitable donations	\$2,000.00
Home loan interest	\$8,286.00
Retirement scheme contributions	\$9,000.00
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	\$1,038,964.00
<u>Less:</u> Married person's allowance	\$216,000.00
Dependent parent allowance	\$72,000.00
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Revised Net Chargeable Income	\$750,964.00
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Tax Payable thereon (after tax reduction)	\$103,663.00
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Determination by the Deputy Commission of Inland Revenue

14. Salaries Tax assessment for the year of assessment 2011/12 under Charge Number X-XXXXXXXX-XX-X, dated 10 December 2012, showing Net Chargeable Income of \$747,964 with Tax Payable thereon of \$103,153.00 is increased to Net Chargeable Income of \$750,964.00 with Tax Payable thereon of \$103,663.00 ('the Determination').

This Appeal

15. The Appellant, in the course preparation for this Appeal, raised a more fundamental objection to the Determination (see issue (a) in paragraph 16 below).

The Issues

16. The issues raised in this Appeal for the Board's decision are:

- (a) whether the Gratuity in the amount of \$435,750.00 paid to the Appellant by his former employer, the Bank, upon the Appellant's early retirement, should be chargeable to Salaries Tax at all; and
- (b) if the Gratuity is chargeable to Salaries Tax, whether it should be fully assessed in the year of assessment 2011/12 or partly in the year of assessment 2011/12 and partly in the year of assessment 2012/13.

The Relevant Legislation

17. Section 2(1) of the Inland Revenue Ordinance ('the IRO') defines:

' "year of assessment" (課稅年度) means the period of 12 months commencing on 1 April in any year'.

18. Section 8(1) of the IRO is the charging provision in respect of Salaries Tax which 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) *...'*

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

' Income from any office or employment includes –

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- (a) *any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others ...* [Emphasis added]

20. 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.’

21. Section 11C of the IRO provides that :

‘For the purpose of section 11B, a person shall be deemed to ... cease ... to derive income from a source whenever and as often as he ... ceases –

- (a) *to hold any office or employment of profit; ...’*

22. Section 11D of the IRO further provides that:

‘For the purpose of section 11B-

- (a) *income which has accrued to a person during the basis period for a year of assessment but which has not been received by him in such basis period shall not be included in his assessable income for that year of assessment until such time as he shall have received such income, when notwithstanding anything contained in this Ordinance, an additional assessment shall be raised in respect of such income:*

...

- (b) *income accrues to a person when he becomes entitled to claim payment thereof:*

Provided that –

- (i) ...

- (ii) *subject to proviso (i), any payment made by an employer to a person after that person has ceased or been deemed to cease to derive income which, if it had been made on the last day of the period during which he derived income, would have been included in that person’s assessable income for the year of assessment in which he ceased or is deemed to cease to derive income from that*

employment, shall be deemed to have accrued to that person on the last day of that employment.’

23. 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 Relevant Case Law

24. Fuchs v Commissioner of Inland Revenue [2011] 2 HKC 422 (‘Fuchs’) at paragraph 22:

‘ 22. *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: In the light of the terms on which the taxpayer was employed and the circumstances of the termination, is the sum in substance “income from employment”? Was it paid in return for his acting as or being an employee? Was it an entitlement earned as a result of past services or an entitlement accorded to him as an inducement to enter into the employment? If the answer is “Yes”, the sum is taxable and it matters not that it might linguistically be acceptable also to refer to it as “compensation for loss of office” or something similar. On the other hand, the amount is not taxable if on a proper analysis the answer is “No”. As the “abrogation” examples referred to above show, such a conclusion 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. In the present appeal, the principal dispute between the taxpayer and the Revenue involves rival contentions along the aforesaid lines.’*

Analysis and Decision

Whether the Gratuity in the sum of HK\$435,750.00 is chargeable?

25. The test having been so clearly elucidated in the above passage quoted from the judgment by Ribeiro PJ, it serves no useful purpose for this Board to attempt to explain the test, or to yet add another linguistic formulation.

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26. The difficulty is in applying the test to the facts of a particular case, and the present case is quite a borderline case.

27. A forceful point argued in support of the Appellant's contention is that the further payment of the Gratuity was not paid pursuant to his entitlement under his employment contract. Although it was calculated by reference to 6 months' emolument (totalling 7 months' salary), the same period of employment had the Appellant been employed until his normal retirement age (i.e. by June 2012 instead of December 2011), it actually was paid not in accordance with any formulae, nor indeed any right under the contract of employment between the Appellant and his employer, unlike the sums B and C in Fuchs, unlike the 10,000 pounds paid in Dale v De Soissons, and unlike the other cases when the relevant payments were in fact provided for in the respective employment contracts both as to the amounts and the circumstances when they were payable (which accorded with the actual circumstances of the termination of the relevant employment in those cases).

28. That issue of fact contended for by the Appellant is also supported by the evidence from the Email (19 July 2011) and 2 letters (23 July 2013 and 30 September 2013) from the employer. The Email stated that 'This special arrangement is...exceptional'. The letter dated 23 July 2013 stated that 'the gratuity was paid to you at the discretion of the Bank...'. The second letter (30 September 2013) stated more clearly that 'It was an exceptional arrangement which is not under the Bank's retirement practice'. Although they are hearsay evidence which carry less weight than the case had the statement maker been called as a witness and cross-examined, and though an employer's own view as to the employer and employee's respective right in relation to the employment might not be a correct one, considering all the evidence of this case (including, apart from the above, the *viva voce* evidence of the Appellant, the letter dated 25 March 2013 from the employer to IRD explaining the payments, and the letter dated 23 June 1997 from the employer to the Appellant stating the terms of employment when the Appellant first began his employment), the Board has come to a clear decision that the Appellant has no legal right to any part of the Gratuity. The fact that medical benefits were continued for the same period of 6 months did not detract from the above analysis, as they were also not pursuant to any legal entitlement under the contract of employment.

29. Thus, as analysed above, the Gratuity cannot be an 'entitlement' earned because of the Appellant's employment. In the above analysis, the fact that the Gratuity was described by the employer as 'gratuity' carries little weight, as it was the substance and not label that matters.

30. On the other hand, was the Gratuity compensation for abrogation of the Appellant's right for loss of his office or employment (or whatever similar nature, irrespective of the labels, which in substance was as such)? The answer must be no, if no right, for which the Appellant could point to under the contract of employment, was abrogated by the request by the employer for his early retirement (the argument holds even

assuming that early retirement had been unilaterally imposed by the employer without any consent from the Appellant, but for the Gratuity).

31. Further, there is no evidence that then (in 2011) Appellant *bona fide* believed that he had a legally enforceable right against his employer for requesting his early retirement and the employer was aware of such belief by the Appellant, and his employer compensated him by the Gratuity because of that *bona fide* belief by the Appellant.

32. It might be that the reality was that the employer perceived that it would suffer, in terms of morale of other staff, or in terms of its image as a reputable bank or a responsible employer, if the employer insisted on its strict right not to pay any part of the Gratuity. But these, even if true, are quite irrelevant.

33. In the words of the employer, the Gratuity was paid so as ‘treating you with the recognition you deserve after more than 38 years with the bank’; i.e. as a gesture of goodwill in reward for his long service of employment to the employer.

34. Thus, as a matter of fact and degree, the Gratuity was paid to the Appellant in return for his (previously) acting, for a long period, as an employee. The Gratuity, in substance, was ‘income from employment.’

35. Thus, this ground of appeal fails.

The period for which the Gratuity was chargeable

36. Although the Gratuity was calculated by reference to the further period of employment had the Appellant not early retired, the Gratuity was a lump sum quantified and paid solely at the discretion of the employer as a gesture of goodwill for long past employment, and not for any employment, in substance, beyond 31 December 2011. Although medical benefits continued for the notional period, that is insufficient to change the fact as to the date of cessation of employment. The Board finds that the employment was terminated in December 2011, not June 2012 as the Appellant contended. The Gratuity was paid in December 2011, upon termination. Thus the Gratuity accrued in the year 2011/12, but not partly in 2011/12 and partly in 2012/13 as the Appellant contended.

37. Thus, this ground of appeal also fails.

Conclusion

38. For the above reasons, the appeal is wholly dismissed and the Determination of the Deputy Commissioner is upheld in full.