Case No. BR 116/77

Board of Review:

L. J. D'Almada Remedios, *Chairman*, Charles A. Ching, W. T. Grimsdale, Edward J. Lawrence, M*embers*.

9th June 1978.

Salaries tax – employer terminating contract of employment – employee waiving all claims against employer on payment of bonuses, salary in lieu of notice, housing allowance and *ex-gratia* payment – whether every item of payment assessable to tax.

Salary in lieu of notice not taxable as being in the nature of compensation.

The appellant was employed by a company at a monthly salary of $10,500 with an annual bonus equal to 2 months' salary, plus an accommodation allowance up to a maximum of $3,500 per month. The contract of employment could be terminated by either party giving 6 months' notice to the other; or by the company paying 6 months salary in lieu of notice.

In late 1975 the company sought to terminate the contract of employment, making it known to the appellant that if he did not resign, he would be dismissed.

Following negotiations the company proposed final severance of the appellant's employment by payment of a total sum of $200,000 made up as follows-

(a)	Superannuation contributions for period 1.1.72 to 31.12.75	$ 20,400.00
(b)	5% compound interest thereon	2,331.23
(c)	80% of the company's contribution	18,184.98
(d)	Bonus for year ended 31.12.75	21,000.00
(e)	6 month's salary in lieu of notice	63,000.00
(f)	6 month's housing allowance	21,000.00
(g)	Ex-gratia payment	54,083.79
		$200,000.00

The company's offer was conditional upon it being accepted in full and final settlement of all claims arising out of or in connection with the employment of the appellant. The appellant accepted the conditional offer and signed an acknowledgment to that effect.

The Commissioner's determination was that the whole of the sum of $200,000 (apart from items *(a)*, *(b)* and *(c)* comprising the superannuation fund) was assessable to salaries tax as being income or profit arising from employment.

On appeal it was contended by the appellant that the sum being compensation paid to him for the unilateral discharge of his employment was not chargeable to tax.

Decision: Appeal allowed. Assessment to be adjusted to the extent that the only item liable to salaries tax was the $21,000 bonus earned during employment.

Appellant in person.
C. Brockelbank, Crown Counsel, for the Commissioner of Inland Revenue.

Cases referred to:-

1. Seymour v. Reed, 11 T.C. 625.
2. Hochstrasser (H.M. Inspector of Taxes) v. Mayers, 38 T.C. 673.
3. Dixon v. Stenor Limited, (1973) I.C.R. 157.

Reasons:

The relevant facts are:-

(1) The Appellant was employed by a Company at a monthly salary of $10,500.00 with an annual bonus of an amount equal to 2 months' salary plus a refund of the actual sum paid by him as rent and rates for accommodation in Hong Kong up to a maximum of $3,500.00 per month. It was a term of the employment that the Appellant's contract could be terminated at any time by either the Appellant or the Company giving to the other 6 months' notice in writing or by the Company paying to the Appellant a sum equivalent to 6 months' salary in lieu of notice.

(2) In the third quarter of 1975 the Company made it known to the Appellant that it no longer wished to continue its employer/employee relationship with the Appellant. The Appellant was given to understand that if he did not resign he would be dismissed.

(3) The Appellant did not wish to either resign or be dismissed but having no other alternative he wrote to the Company on the 19th November 1975 suggesting that he take his 7-week leave entitlement from the 20th November 1975 and proposed that his letter be treated as a notice given on the 10th January 1976 for his employment to cease 6 months from that date.

(4) The Appellant's proposal was accepted by the Company through one of its officers, Mr. B.

(5) On the 13th January 1976 the Appellant was informed that the Board of Directors of the Company proposed a final severance of the Appellant's employment by

payment of a sum of $200,000. The Company's breakdown figures in regard to that sum were as follows:-

(a)	Employee's contribution toward the Staff Superannuation Fund for the period 1.1.72 to 31.12.75	-	$ 20,400.00
(b)	5% compound interest thereon	-	2,331.23
(c)	80% of the Company's contribution	-	18,184.98
(d)	Bonus for year ended 31.12.75	-	21,000.00
(e)	Six month's salary in accordance with the contract	-	63,000.00
(f)	Six months' housing allowance	-	21,000.00
(g)	*Ex-gratia* payment	-	54,083.79
			$200,000.00

The offer was conditional upon it being accepted in full and final settlement of all claims arising out of or in connection with the employment of the Appellant.

(6) The Appellant, without rejecting the offer of $200,000 took issue in regard to the accuracy, arithmetic, etc. of some items which for the purpose of this appeal, we find unnecessary to particularize.

(7) On the 27th January 1976 the Chairman of the Board of Directors wrote to the Appellant as follows:-

"Thank you for your letter of 23rd January which due to the vagaries of the post only arrived yesterday afternoon.

I am afraid that there is some misunderstanding about the position and this I should like to clarify-

1. Where payment of salary in lieu of notice is made employment ceases at the date of such payment. See Freidman on The Modern Law of Employment at page 471.

2. The Directors resolved – without going into any detailed figures – that if the amounts legally due to you in lieu of notice should come to less than HK$200,000 they would be prepared to authorise payment of HK$200,000 provided, and provided only, that you signed an acknowledgement to the effect that this represented full and final settlement of all claims against the Company. I attach an acknowledgement of this kind on the enclosed carbon copy and payment will be made if you will be kind enough to sign and return it. In default of such signature I am afraid that the Directors' resolution will lapse and you will accordingly become entitled to no more than what is legally payable.

Needless to say the contents of this letter will have no effect at all upon any arrangements for your future relationships with the Company which Mr. B may lawfully have agreed with you."

(8) The form of acknowledgement enclosed in the Company's letter for acceptance by the Appellant was as follows:-

"I hereby agree and undertake to accept the sum of HK$200,000 (Two hundred thousand dollars) in full and final settlement of all claims against the company arising out of or in connection with the termination of my employment with the Company."

(9) On the 28th January 1976 the Appellant duly signed the acknowledgement referred to above whereupon his account was credited with the sum of $200,000.

On the evidence, it is sufficiently clear that the Company did not ultimately accept the Appellant's proposal for employment to cease in July, 1976. The Company desired earlier determination and hence the offer to bring about immediate severance. The inclusion in the offer of six months' salary in lieu of notice is consistent with this inference. Not only was the Appellant called upon to resign but, strictly speaking, it was the Company who, having rejected the Appellant's proposal, terminated the services of the Appellant.

The offer of $200,000 by the Company was conditional upon the payment being accepted in 'full and final settlement of all claims against the Company'. The condition attached to payment would, in our view, include – as far as the Company is concerned – any other form or type of claim or complaint which the Appellant may be minded to pursue such as those outlined in one of his letters to the Company.

The Appellant's case is that the Company's breakdown items comprised in the sum of $200,000 are misleading. He made it known to the Company that he did not agree with the accuracy of those items. He states that his acceptance of $200,000 was on the basis of the acknowledgement sent to him for signature to the effect that it is in full and final settlement of all claims 'arising out of or in connection with the termination of employment'.

The Appellant argues, therefore, that the whole of the $200,000 is not exigible to salaries tax because it was not derived from any office or employment held by him; nor did it form, in part or in total, payment or reward for any services performed by or expected of him. It was the compensation paid to him for the unilateral discharge of his employment against his will.

The issue before us is this: On the facts are we justified in concluding that the whole of $200,000 represents 'compensation' for termination of contract? If not, what part thereof can be attributed to a payment caught under section 9 of the Inland Revenue Ordinance to which the Appellant would be chargeable to tax.

As the Commissioner's determination is that the whole of the sum of $200,000 (save for the amounts comprised in this Superannuation Fund) is assessable to tax it is important that some fundamental principles be borne in mind. The mere fact that a payment in question is made to an employee as the result of or in connection with his employment is not enough to render him liable to tax: **Seymour v. Reed**[1] The circumstances under which the payment was made must all be taken into account. 'Not every payment made to an employee is necessarily made to him as a profit arising from his employment.'

The authorities show that to be a profit arising from the employment the payment must be made in reference to the services the employee renders by virtue of his office and it must be something in the nature of a reward for services past, present ro future: per Upjohn J. in **Hochstrasser (H.M. Inspector of Taxes) v. Mayers**[2]; approved by Jenkins and Pierce L.JJ. in the Court of Appeal and by Viscount Simonds in the House of Lords.

It goes without saying that one must look to the character of the payment to determine its true nature. We are not to be tied down to the label which any of the parties may think fit to ascribe to any particular payment since it is the substance of the matter, viewed in the light of the evidence, that must decide what in truth was the real bargain.

On the facts, we do not accept the Appellant's contention that the entire sum $200,000 was compensation for abrogation of the contract and nothing else. This proposition involves the corollary that it was open to the Appellant to claim all and any other payment due to him unconnected with severance which in our view is untenable by the very fact that the Company made it clear and plain to the Appellant in its letter referred in fact (7) above that payment is subject to the express proviso that it represented full and final settlement of all claims by the Appellant against the Company in respect of which the Company particularised some of the payments intended to be covered by such sum.

In the circumstances, it only remains for us to consider what part of the $200,000 represent taxable earnings. In so doing we will now list hereunder the breakdown items as labelled by the Company comprised in the figure of $200,000 with our comments and findings.

The Superannuation Fund: Items (a), *(b)* and (c) in Fact (5) amount, to a sum of $40,916 which the Commissioner agrees is exempt from tax under section 8(2)*(cb)*.

Bonus for year ended 31.12.75: The bonus of $21,000 was earned by the Appellant for services rendered while he was employed by the Company. It is taxable as part of his emoluments. It does not escape tax simply because it was included to form part of a lump sum payment.

Salary in lieu of notice: The Appellant's employment can be terminated by the giving of six months' notice in writing. This is consistent with the position in Common Law where

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[1] 11 T.C. 625.
[2] 38 T.C. 673.

the length of reasonable notice in the case of an employment of the same discription as that held by the appellant would be not less than six months. The Appellant was not given the requisite notice of dismissal; so he was paid six months' salary in lieu of notice. The nature of such payment is, in essence, compensation or damages resulting from the Company's failure in giving the requisite notice.

> 'If a man is dismissed without notice but with money in lieu, what he receives is, as a matter of law, damages for breach of contract. During the period to which money in lieu relates, he is not employed by his employer.' **(Dixon v. Stenor Limited[3]).**

The fact that the parties decided to spell out their Common Law rights in the contract and in so doing quantified the measure of damages payable upon such eventuality does not, for that reason, convert the payment into something else different in character to what it actually is. Such payment is neither a wage nor a premium payment but liquidated damages for loss of opportunity to earn similar income if reasonable notice is not given. The money so paid in lieu of notice is, therefore, not taxable.

Six Months' Housing Allowance: This item is refereable to a sum of $21,000 for what the Company has thought fit to describe as 'housing allowance' to cover rent and rates for the Appellant's tenancy after employment has ceased. This sum is not taxable. There is no obligation on the part of the Company to let the Appellant have housing allowance when he is no longer employed by the Company. It did not accrue to the Appellant by virtue of his office or employment. It was not a reward for his services. On the facts, we are unable to regard it as a cash allowance or a gift. There was no love between the Company and the Appellant. In our view, it was a convenient mode of describing a payment made in consideration of the Appellant waiving all claims against the Company.

Ex-Gratia Payment: The Company has expressly made it known to the Appellant that it would be prepared to pay the Appellant more than what the Company thinks the Appellant would be entitled to conditional upon the Appellant accepting the Company's offer in full and final settlement. We do not find this item to be a payment intended as a reward for the Appellant's past services, It is in a broken sum of $54,083.79. In substance we think it is what the Company was prepared to throw into the kitty to finalize the severance of the Appellant's employment and to obtain from the Appellant a waiver of all claims against the Company. The payment was not, therefore, something which accrued to the Appellant by virtue of his office or employment.

To summarise: The only item out of the sum of $200,000 liable to salaries tax is $21,000 being the bonus earned by the Appellant during his employment. The case is, therefore, remitted to the Commissioner to make the necessary adjustments.

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[3] (1973) I.C.R. 157 at 158.