

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D104/98

Profits Tax – long service payment – taxpayer re-engaged by the same company under new contract – delayed payment – whether chargeable to tax – sections 31R(2) and 31Y(2) of the Employment Ordinance, Chapter 57.

Panel: Ronny Wong Fook Hum SC (chairman), Arthur Chan Ka Pui and Roderick Woo Bun.

Date of hearing: 17 July 1998.

Date of decision: 26 October 1998.

In 1974 Company A, which operated several businesses and was a wholly owned subsidiary of Company B, employed the taxpayer. In 1987, Company B sold 50% of its interest in Company A to Company C. Company A later assigned in favour of Company B the rest of its businesses. The Deed of Assignment provided, *inter alia*, that Company B would take over the payment responsibilities of long service payments to Company A employees and would calculate such payments from the date that Company A employees commenced employment up to 31 December 1986. Payments by Company B, at that time, were indefinitely delayed.

After the take-over, the taxpayer was immediately re-engaged by Company A. In 1995, Company C sought to dispose of its interest in Company A. Company B sought to pay to Company A employees the delayed long service payments, calculated up to 31 December 1986. The taxpayer received a sum of \$418,750. The chargeability of this sum to tax was challenged.

HELD by the Board:

- (1) There were two classes of case in relation to long service payments. “The question in each case is whether, on the facts of the case, the lump sum paid is in the nature of remuneration or profits in respect of the office or is in the nature of a sum paid in consideration of the surrender by the recipient of his rights in respect of his office.” (per Jenkins LJ in Henley v Murray 31 TC 351, followed in D59/98, IRBRD, vol 13, 367);
- (2) It was the practice of the Revenue not to tax severance and long service payments that are within the provisions of the Employment Ordinance, Chapter 57;

INLAND REVENUE BOARD OF REVIEW DECISIONS

- (3) The 1995 payment to the taxpayer was a delayed payment in light of the taxpayer's length of service with Company A from 1974 to 1987;
- (4) Here, the taxpayer was immediately re-engaged by Company A after the take-over, under a new contract of employment. Thus, he was not entitled to long service payment under section 31R(2) Employment Ordinance as he was not 'dismissed' as defined under section 31Y(2) Employment Ordinance;
- (5) Since the taxpayer was unable to take advantage of the practice adopted by the Revenue, the sum in question was clearly taxable.

Appeal dismissed.

Cases referred to:

D59/98, IRBRD, vol 13, 367

Cheung Lai Chun for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

The appeal

1. Prior to 16 October 1987, Company A operated various businesses including the sale of Chinese native produce & animal by-products, industrial & domestic latex gloves and dyeing materials etc.
2. On 20 April 1974, the Taxpayer commenced his employment with Company A. At that time, Company A was a wholly owned subsidiary of Company B.
3. On 1 January 1987, Company B established a joint venture with Company C. Company B sold 50% of its interest in Company A to Company C. Thereafter Company A was to concentrate in the business of sale and purchase of Chinese native produce and animal by-products. By a deed of assignment dated 16 October 1987 ['the Deed'], Company A assigned in favour of Company B the rest of its businesses. Clause 2 of the Deed provided as follows:

'In consideration of the assignments thereby made by Company A, Company B hereby covenants with Company A to:

- (1) treat its employment of the former employees of Company A in relation to the businesses who are named in Schedule VII hereof as having

INLAND REVENUE BOARD OF REVIEW DECISIONS

commenced on the respective dates stated in the said Schedule instead of on the takeover date for the purpose of calculating the statutory long service and severance payments to such employees in future and to fully indemnify against any claims or demands for such payments from any such employees.

- (2) to assume the liabilities and obligations for statutory long service and severance payments which Company A may owe to its employees in relation to the businesses who remained in the employment of Company A after the takeover date and are named in Schedule VIII hereof to the extent and as if Company B had employed them since the respective commencement dates stated in the said Schedule up to the takeover date'.

4. The Taxpayer was one of the employees named in Schedule VIII of the Deed. He told us in evidence that he and his fellow employees suggested insertion of the clause quoted in paragraph 3 above in the Deed.

5. In 1995, Company C sought to dispose of its holding in Company A. In view of that, Company B paid to the employees of Company A lump sums representing 'long service payment' covering the period from the date the employees joined Company A to 31 December 1986. Accordingly the Taxpayer received a lump sum of \$418,750 ['the Relevant Sum'] from Company B on 30 September 1995 computed as follows:

$$\$38,000^{***} \times 2/3 \times 12.715^{###} \times 130\% = \$418,747 \text{ (rounded up to } \$418,750)$$

*** The sum of \$38,000 was the Taxpayer's salary as at 31 August 1995.

12.715 was the Taxpayer's years of service with Company A up to 31 December 1986.

6. Company B filed a return dated 16 October 1995 in respect of the sum of \$418,750. That sum was divided into two parts in this return. The first part amounting to \$348,750 was said to be 'back pay, terminal awards, and gratuities, etc. paid on 30 September 1995'. The second part amounting to \$70,000 was said to be 'long service payment made in accordance with the Employment Ordinance on 30 September 1995'. 31 December 1986 was given as the date of the cessation of the Taxpayer's employment. He was said to have been transferred to an associated company on 1 January 1987.

7. The issue before us relates to the chargeability or otherwise of the sum of \$418,750.

The applicable principles

8. The authorities have recently been reviewed by this Board in D59/88, IRBRD, vol 13, 367.

INLAND REVENUE BOARD OF REVIEW DECISIONS

9. The Board there adverted to the decision of the Court of Appeal in *Henley v Murray* 31 TC 351.

a. According to Lord Evershed, 2 classes of cases have to be distinguished:

- i. The first class of case is where the employers remain liable under the contract for the remuneration they had contracted to pay though they gave up their right to call upon the employee to perform the duties under the contract which he was bound to perform. In this class of cases, the remuneration so paid is taxable.
- ii. The other class is where ‘the contract goes altogether and some sum becomes payable for the total abandonment of all the contractual rights which the other party had under the contract.’ In this latter class of cases, the receipt is not taxable.

b. Jenkins L J put the matter succinctly thus:

‘... the question in each case is whether, on the facts of the case, the lump sum paid is in the nature of remuneration or profits in respect of the office or is in the nature of a sum paid in consideration of the surrender by the recipient of his rights in respect of his office.’

10. Payments designated as severance payments or long service payments do not per se attract exemption from profits tax liability. It is however the practice of the Revenue not to tax severance payments and long service payments that are within the provisions of the Employment Ordinance. An employee who is immediately re-engaged under a new contract of employment is not entitled to long service payment under section 31R(2)(a) of the Employment Ordinance. There is no ‘dismissal’ as defined by section 31Y(2) of the Employment Ordinance. In those circumstances, the employee in question would not be covered by the practice adopted by the Revenue and his receipts would be taxed by the Revenue.

Our decision

11. The arrangements between the parties amounted to this:

- a. In 1987, the Taxpayer’s then contract of employment with Company A was terminated by Company A.
- b. By virtue of such termination, the Taxpayer was entitled to receive from Company A long service pay computed in accordance with his then length of service. Had such payment been effected, there would have been no doubt that the same is taxable. The payment would clearly be a lump sum in the nature of remuneration or profits in respect of the

INLAND REVENUE BOARD OF REVIEW DECISIONS

Taxpayer's employment. The Taxpayer would not be able to take advantage of the practice adopted by the Revenue as he was immediately re-engaged by Company A.

- c. Company A however was not in a financial position to make such payment. Their obligation was assumed by Company B.
- d. Payment was indefinitely postponed. It was eventually made by Company B in 1995 on the basis of the Taxpayer's 1995 earnings but in the light of his length of service with Company A in 1987.

12. On this analysis, we are of the view that the sum in question is clearly taxable. The sum is referable to the Taxpayer's employment with Company A up to 1987. Company B undertook to discharge on behalf of Company A its liability towards the Taxpayer. The delay in payment by Company B on behalf of Company A was compensated by adopting the 1995 earnings. The sum in question is therefore a delayed payment of a sum referable to the Taxpayer's employment by a company associated with his employer and on behalf of his employer.

13. For these reasons, we dismiss the taxpayer's appeal.