INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D104/99

Salaries Tax – severance payment – whether taxable because of immediate re-engagement.

Panel: Ronny Wong Fook Hum SC (chairman), Walter Chan Kar Lok and Thong Keng Yee.

Dates of hearing: 23 February and 8 November 1999.
Date of decision: 5 January 2000.

The taxpayer was dismissed by Company A on 30 April 1995 and he received $179,170 as severance payment. By a letter dated 1 May 1995, the taxpayer was, however, re-employed by Company A as a technical consultant to work in Company A' s factory in China from 1 May 1995.

The Revenue contends by virtue of the taxpayer' s immediate re-engagement by Company A, there was no dismissal for the purpose of the Employment Ordinance and the taxpayer was therefore not entitled to any severance payment under the same Ordinance.

The taxpayer gave evidence that the employment letter was only finalised in mid-May 1995.

Held:

The question whether the sum was or was not income arising in or derived from the taxpayer' s employment with Company A must be decided by reference to facts objectively ascertained at the time when the payment was promised in favour of the taxpayer.

The Board found that the payment was not sourced from the employment. There was actual loss of employment at the time when the severance payment was promised. The Board found that the new employment letter was only finalised in mid-May 1995 and therefore does not affect the fiscal status of the severance payment (D13/89, D79/88, D43/93, D24/97, D26/94, D25/98 considered).

Appeal allowed.

Cases referred to:

D13/89, IRBRD, vol 4, 242
D79/88, IRBRD, vol 4, 160
D43/93, IRBRD, vol 8, 323
D24/97, IRBRD, vol 12, 195
D26/94, IRBRD, vol 9, 189
D25/98, IRBRD, vol 13, 222

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

Decision:

1. The Taxpayer commenced work with Company A on 5 June 1977. Company A was then carrying on business in a factory in District B [' Factory C'].

2. By an employer' s return dated 30 April 1995, Company A gave notice pursuant to section 52(5) of the Inland Revenue Ordinance (the IRO) of the imminent cessation of the Taxpayer' s employment as a ' supervisor' of the Taxpayer. ' Dismissal' was given as the reason for cessation. For the period between 1 April 1995 and 30 April 1995, the Taxpayer was said to have earned emoluments totalling $209,954 made up as follows:

Nature of emolument	**Referable period**	**Amount $**
Salary/Wages	1-4-1995 to 30-4-1995	18,500
Leave pay	1-4-1995 to 30-4-1995	12,284
Back pay, terminal awards, and gratuities etc	1-4-1995 to 30-4-1995	179,170

3. By letter dated 1 May 1995 signed by the Taxpayer and Mr D, managing director of Company A [' the New Employment Letter'], the Taxpayer was employed as ' technical consultant' for 2 years commencing from 1 May 1995 at a salary of $25,000 per month. The Taxpayer was to work in Company A' s Factory E in China.

4. By a return dated 30 April 1996, Company A reported to the Revenue the earnings of the Taxpayer as ' supervisor' for the period between 1 May 1995 to 31 March 1996 amounting in total to $294,914.

5. In correspondence with the Revenue, Company A asserted that:

(a) '[The Taxpayer] was made redundant on 30 April 1995 due to closure of workshop, the severance payment of $179,170 was paid to him'. 'The breakdown of the severance payment was $15,000 x 2/3 x 17.917 calculated by a formula of monthly wages (not exceed $15,000) x 2/3 x length of service year.'

(b) '... the severance payment of [the Taxpayer] was paid upon the advice of Labour Department as our factory in Hong Kong has been closed and there is no job available for [the Taxpayer]. Before [the Taxpayer] left our Hong Kong factory, he is the factory manager of our Hong Kong factory. As our factory has been moved to China, we need a technical consultant for our plastic injection moulding operation, as [the Taxpayer] has over twenty years experience in this field, we, therefore, negotiated a contract with [the Taxpayer], to appoint him as consultant of our plastic injection operation for a period of two years. [The Taxpayer's] duty before 30 April 1995 is to responsible the day-to-day management of our factory in Hong Kong, while [the Taxpayer's] duty after 1 May 1995 is a technical consultant of our injection moulding operation in China which he is not involved in the day-to-day management and needs to stay in China from Monday to Saturday.'

(c) 'When we decided to close our plant in Hong Kong, we advised [the Taxpayer] and he demanded severance payment as other staffs did in our company. There is no dismissal notice served on [the Taxpayer] alone, however, we did put a notice advising all staffs that we would close the plant on so and so date and there would be no job for them thereafter.'

6. The issue before us relates to the taxability or otherwise of the sum of $179,170 said to have been paid as 'severance payment' in favour of the Taxpayer. The Revenue contends by virtue of the Taxpayer's immediate re-engagement by Company A, there was no 'dismissal' for the purpose of section 31D of the Employment Ordinance (Chapter 57) and the Taxpayer was therefore not entitled to any 'severance payment' under section 31B of the same Ordinance.

Evidence of the Taxpayer

7. The Taxpayer gave sworn evidence before us. The following are salient features of his evidence:

(a) His first wife passed away in 1989. He began his acquaintance with his second wife in China in 1992. He re-married in September 1993.

(b) He commenced working with Company A in 1977. He did not have any written contract of employment.

(c) Company A started a factory in China in about 1989. He travelled to that factory on a ' need' basis in order to teach workers there moulding techniques.

(d) Company A notified all workers in Factory C of the termination of their employment at the end of April 1995. He was the last worker leaving that factory after obtaining his severance pay.

(e) Company A then offered him employment in Factory E in China, He visited that factory but discovered that his duties differed from those described to him when the employment was offered in Hong Kong. He left Factory E for further negotiations with Mr D. The New Employment Contract, although dated 1 May 1995, was signed in Hong Kong only after the further negotiations which the Taxpayer had with Mr D.

(f) He is particularly aggrieved by the fact that most of his former colleagues did not receive any assessment. He is puzzled by what he regards as unfair treatment by the Revenue.

8. According to the movement records of the Taxpayer produced by the Revenue, he left Hong Kong on 1 May 1995 and returned to Hong Kong on 4 May 1995.

The statutory provisions

9. Section 8(1) of the IRO 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 ...'.

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

' 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 ...'

11. In D13/89, IRBRD, vol 4, 242, the Board of Review considered section 8 of the IRO and said this:

> *'These words are very wide, and in construing section 8(1) effect have to be given to them. There is in our view no room for reading into section 9(1) some implied limitation such as "provided that the income is received by him in the nature of a reward for services past, present of future" or "provided that the payment is made in reference to the services the employees renders by virtue of his office". To do so is to read into the statute words which are simply not there.'*

The relevant authorities

12. In D79/88, IRBRD, vol 4, 160, on resignation from his employment, the taxpayer received an ex-gratia payment from his employer paid pursuant to a confidential policy of the employer. The Board held that the payment was taxable as the sum in question was a gratuity arising from the taxpayer's employment of profit with his employer. It arose from nothing else.

> *'the payment was on account of the Taxpayer's resignation, not dismissal; there was no question of the payment being made in the nature of "compensation for loss of employment"...'*

13. In D43/93, IRBRD, vol 8, 323, because of adverse business circumstances the employer decided to close down the department which the taxpayer managed. The employer and the taxpayer entered into negotiations and arrived at a termination package which included a termination gratuity calculated on the basis of 12 months' salary. The Board emphasised that '*the label which the parties give to a payment is not the governing factor. What we must do is to look at the real nature of the payment. The real nature of the payment in this case before us was compensation for loss of office.*' The Board was of the view that '*this payment neither arose out of employment contract of the Taxpayer nor was it in return for services rendered by the Taxpayer to his employer. It was the opposite. It was a payment made to terminate the contractual obligations of the employer and to compensate the Taxpayer for what would otherwise have been a breach of contract.*'

14. The authorities were extensively reviewed by the Board in D24/97, IRBRD, vol 12, 195. The Board observed that 2 different approaches can be discerned from the cases. The wider approach considers that '*We should not read into the legislation implied limitation such as "provided that the income is received by him in the nature of a reward for service past, present or future". We do not need to know if the payment might have been for compensation for loss of employment or a reward for services rendered in the past or as an inducement to continue with the service during the employment. Indeed it could be for a combination of one or more of those reasons. All we need to know is that the payment was sourced from the employment.*' By contrast, the narrower approach enjoins the Board '*to examine the reason for the payment and be satisfied that the payment was to the employee*

for services and not as compensation for loss of employment.' On the facts in that case, the Board concluded that a non statutory severance payment is taxable.

15. The Revenue drew our attention to D26/94, IRBRD, vol 9, 189 and D25/98, IRBRD, vol 13, 222. In both cases the taxpayers were paid ' long service payment' by their employers on termination of their initial employments. Both of them were immediately re-employed under a new contract on the day following the termination of the old one. The Board in D25/98, IRBRD, vol 13, 222 said that:

> *' The key consideration here is whether there was a loss of employment. If there was and the Sum was compensation for such loss, then it is not income arising from employment within the meaning of section 8 of the Inland Revenue Ordinance, Chapter 112. If there was no loss of employment, then the Sum cannot be compensation for such loss and must be treated as a payment arising out of the Taxpayer' s employment. This appears to be the decision of this Board in D26/94 ...'*

The Board further observed that '*... if the new employment were not to take effect until a few days after the termination of the previous contract of employment section 31T(2) might well not be applicable.'*

Our decision

16. The primary question is whether the sum in question was or was not income arising in or derived from the Taxpayer' s employment with Company A. This question must be decided by reference to facts objectively ascertained at the time when the payment was promised in favour of the Taxpayer. If it was contemplated at that juncture that there would not be any break in the employment nexus between the Taxpayer and his employer, that would be a material factor in considering the nature of payment. Conversely, if at that juncture, there was in fact a break in the employment nexus, then that would indicate that the payment in question was severance payment and/or compensation for loss of employment.

17. If we adopt the wider approach described in D24/97, IRBRD, vol 12, 195, we are of the view that the payment in question was not *sourced* from the employment. The payment did not arise from a clause in the Taxpayer' s contract of employment with Company A. Company A paid on the advice of the Labour Department who probably took the general view in relation to all Company A' s employees that there were dismissals within the meaning of the Employment Ordinance leading to statutory entitlements for severance payment.

18. Does the re-employment of the Taxpayer by Company A make any difference? On the evidence before us, we find that the Taxpayer was afforded treatments similar to those extended to other employees of Company A when he was promised and received the payment in

question. Although he visited the factory in China prior to 30 April 1995, there was no question of re-engagement when the issue of severance payment arose. As summarised in paragraphs 5(b) and 5(c) above, Company A clearly admitted that they put up a notice advising all staff that no job would be available to them after closure of their plant in Hong Kong and the Taxpayer forthwith demanded severance payment. We further accept the Taxpayer' s case that the New Employment Letter was only finalised in mid-May 1995. The New Employment Letter does not therefore affect the fiscal status of the severance payment. There was actual loss of employment at the time when the severance payment was promised. His re-engagement was not immediate but several days after the termination of his previous employment.

19. For these reasons, we allow the Taxpayer' s appeal and discharge the assessment.