

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D107/02

Salaries tax – whether the sum payable to the taxpayer was severance payment and should be exempt from salaries tax.

Panel: Patrick Fung Pak Tung SC (chairman), Daisy Tong Yeung Wai Lan and Stephen Yam Chi Ming.

Date of hearing: 12 November 2002.

Date of decision: 9 January 2003.

The taxpayer commenced his employment with Bank A, Hong Kong branch ('Bank A-HK') in 1991. By a letter dated 2 November 1998, Bank A-HK announced that its head office had decided to close the Hong Kong branch in 1999. In the said letter, Bank A-HK offered severance payment to the taxpayer. By another letter dated 10 March 1999, Bank A-HK further offered special retention bonus to the taxpayer.

The taxpayer objected to the salaries tax assessment for the year of assessment 1999/2000 that the severance payment and the special retention bonus were not assessable to tax. The issue before the Board is whether the entirety of the severance payment payable to the taxpayer under the said two letters or only the severance payment under the first letter should be exempt from salaries tax.

The taxpayer gave evidence and produced documentary evidence to show that the employer subsequently issued the second letter for the main purpose of making up a severance pay at the rate of one month's salary for each year of service.

Held:

Having considered the evidence, the Board finds on a balance of probabilities that the position is that as advanced by the taxpayer and agrees with the taxpayer that the entire sum is severance pay and not taxable.

Appeal allowed.

Ngan Man Kuen for the Commissioner of Inland Revenue.

INLAND REVENUE BOARD OF REVIEW DECISIONS

Taxpayer in person.

Decision:

1. This is an appeal by the Appellant ('the Taxpayer') against an assessment for Salaries Tax for the year of assessment 1999/2000 issued by the Respondent ('the Commissioner'). An objection was lodged by the Taxpayer against such assessment. By his letter dated 22 August 2002, the Commissioner made a determination against the Taxpayer whilst reducing the Net Chargeable Income of \$1,948,562 with Tax Payable thereon of \$320,755 to a Net Chargeable Income of \$1,674,875 with Tax Payable thereon of \$274,228. The Taxpayer has brought this appeal against such determination.

The facts

2. The relevant facts are conveniently recited in the determination. We adopt the same as set out below:

- ' (2) The Taxpayer commenced his employment with [Bank A], Hong Kong Branch ["[Bank A-HK]"] on 1 September 1991. [Bank A-HK] operated a defined contribution Provident Fund Scheme ["the Scheme"] and the Taxpayer was a member of the Scheme.
- (3) By a letter dated 2 November 1998 ["the First Letter"], [Bank A-HK] announced that its head office had decided to close the Hong Kong Branch no later than June 1999. In the letter, [Bank A-HK] invited its employees to stay on the employment until the closure of [Bank A-HK's] business and it offered the following payments to them:
 - (a) severance pay equivalent to the employee's monthly salary \times length of service \times 2/3, amount of which was to be set off by [Bank A-HK's] portion of the employee's entitlement under the Scheme;
 - (b) payment in lieu of notice corresponding to the employee's rank; and
 - (c) a further sum equivalent to 50% of the total salary (including basic salary and position allowance but excluding bonus or overtime allowance) paid to the employee during the period from 1 November 1998 to the last day of employment.

INLAND REVENUE BOARD OF REVIEW DECISIONS

The letter further provided that if the employee resigned, for whatever reasons, before the closure of [Bank A-HK's] business, he/she would only be entitled to the severance pay mentioned in Fact (3)(a) above and half of the further sum specified in Fact (3)(c) above. A copy of the First Letter is at Appendix A.

- (4) In recognition of the employee's loyalty and support and as a means to further smoothing its operations, [Bank A-HK], by a letter dated 10 March 1999 ["the Second Letter"], announced the following incentive payment:

"Special Retention Bonus

Subject to [Fact (5)] below, **in addition to** the packages mentioned in [the First Letter] to respective employees, following payments will be added:

- a. A sum equivalent to your **monthly salary** × **length of service** × **1/3, plus**
- b. A further sum equivalent to **employer's portion of your Provident Fund** (as determined by your number of completed years of service according to Section 4b, Chapter 7C Provident Fund Plan of the Staff Handbook)."

A copy of the Second Letter is at Appendix B.

- (5) To be eligible for the special retention bonus in Fact (4) above, the employee must satisfy, among other things, the following conditions:

- "a. Employees must continue to work for [Bank A-HK] through the very last day until [Bank A-HK] takes the initiative to terminate their services.
- b. Employees must continue to perform their duties to [Bank A-HK's] satisfaction up to end of their services. **Their performance will be evaluated by respective superiors**, which will be taken into consideration when determining one's entitlement of bonus mentioned in [Fact (4)] above, which may result in reduction of the above payments.
- c. Employees must continue to attend their duties punctually. As a measure to keep this morale, [the employee's] special payment as determined in [Fact (4)] above will be deducted by a sum derived from the following formula:

INLAND REVENUE BOARD OF REVIEW DECISIONS

$$(S + L/2) \times \text{monthly salary} \times 1/20$$

where S = no. of sick leave & L = no. of lateness, counted from 11/3/1999 until [the employee's] last date of employment"

- (6) By a notification made under section 52(5) of the Inland Revenue Ordinance ["the Ordinance"], [Bank A-HK] reported that it had made the following payments to the Taxpayer for the period from 1 April 1999 to 30 June 1999:

Salary		\$225,720
Leave pay		86,996
Position allowance		56,430
Bonus		<u>61,126</u>
		430,272
Severance pay	\$736,424	
	[\$94,050 (salary) × 7 303/365 (length of service)]	
Additional severance pay	376,200	
	[\$752,400 × 50%]	
Payment in lieu of notice	<u>188,100</u>	<u>1,300,724</u>
		<u><u>\$1,730,996</u></u>

- (7) In his Tax Return - Individuals for the year of assessment 1999/2000, the Taxpayer declared, among other things, assessable income of \$1,220,322, which was arrived at as follows:

Income from:		
- [Bank A-HK] as per Fact (6)		\$430,272
- [Bank A], Representative Office		<u>790,050</u>
		<u><u>\$1,220,322</u></u>

- (8) The Assessor raised on the Taxpayer the following Salaries Tax assessment for the year of assessment 1999/2000:

Income from [Bank A-HK]		\$1,542,896
	[\$1,730,996 - \$188,100 (payment in lieu of notice)] [Fact (6)]	
<u>Add:</u> Other income [Fact (7)]		<u>790,050</u>
		2,332,946
<u>Less:</u> Charitable donations		35,000
Home loan interest		43,384

INLAND REVENUE BOARD OF REVIEW DECISIONS

Married person's allowance	216,000
Child allowance	30,000
Dependent parent allowance	<u>60,000</u>
Net Chargeable Income	<u>\$1,948,562</u>
Tax Payable thereon	<u>\$320,755</u>

- (9) The Taxpayer objected to the above assessment in the following terms:
- (a) “Deduct my Severance Pay of HK\$736,424 from my assessment income for the Assessment Year 1999/2000
- The above Severance Pay was made to me according to the Employment Ordinance. It is equivalent to one month's salary for each year of my service with [Bank A-HK].”
- (b) “Deduct my Additional Severance Pay of HK\$376,200 from my assessment income for the Assessment Year 1999/2000
- a. Before it was formally closed, much work of [Bank A-HK] had to be completed in order to satisfy the requirements of the Hong Kong Monetary Authority. To ensure that all such formalities could be handled smoothly, [Bank A-HK] offered Additional Severance Pay equivalent to 50% of my salary for each month from 1/11/1998 to 30/6/1999.
- b. The above payment was subject to the condition that I worked for [Bank A-HK] until the very last day of its business. It would be forfeited if, due to whatever reasons, I left [Bank A-HK] on my own accord any time earlier. Due to this arrangement, I gave up some opportunities of changing to another employer and had to work under heavy stress.”
- (10) In support of his objection, the Taxpayer supplied copies of the following documents:
- (a) a copy of the letter dated 6 December 2001 [Appendix C] issued by [Bank B] (previously known as [Bank A]) on the subject of severance pay made to ex-employees of [Bank A-HK];
- (b) a copy of an “Approval/Record Form” dated 1 March 1999 [Appendix D] on the subject of final payment to employees.

INLAND REVENUE BOARD OF REVIEW DECISIONS

(11) At the request of the Assessor, [Company C] supplied a summary showing that a sum of \$372,450.05 was paid to the Taxpayer as the termination benefit of the Scheme, comprising the Taxpayer's portion and the vested benefit of [Bank A-HK's] portion in the sums of \$155,187.51 and \$217,262.54 respectively. A copy of the summary is at Appendix E.

(12) Having regard to the First Letter and the Second Letter [Facts (3) and (4), supra], the Assessor reckons that the severance pay of \$736,424 reported by [Bank A-HK] in Fact (6) above comprises the following payments:

Severance pay as per the First Letter	\$273,687
[((\$94,050 (salary) × 7 303/365 (length of service) × 2/3) - \$217,262 ([Bank A-HK's] portion under the Scheme)]	
Special retention bonus as per the Second Letter	462,737
[((\$94,050 (salary) × 7 303/365 (length of service) × 1/3) + \$217,262 ([Bank A-HK's] portion under the Scheme)]	
	<u>\$736,424</u>

(13) According to the Employment Ordinance (Cap. 57), the Taxpayer should be entitled to severance payment in the following amount:

$$\begin{aligned}
 & \$22,500 \times 2/3 \times 7 \ 303/365 \\
 & = \underline{\underline{\$117,452}}
 \end{aligned}$$

(14) The Assessor now accepts that the severance payment of \$273,687 made under the First Letter was not assessable to tax as it was compensation in nature. He however maintains his view that the further sum of \$376,200 [termed as the additional severance pay in Fact (6) above] and the special retention bonus of \$462,737 [Fact (12)] were income derived from the Taxpayer's employment with [Bank A-HK] and should be taxable as such. He considers that the Salaries Tax assessment for the year of assessment 1999/2000 should be revised as follows:

Income previously assessed [Fact (8)]	\$1,948,562
<u>Less: Non-taxable income –</u>	
Severance payment	<u>273,687</u>
Revised Net Chargeable Income	<u>\$1,674,875</u>
Revised Tax Payable thereon	<u>\$274,228''</u>

INLAND REVENUE BOARD OF REVIEW DECISIONS

3. Unless otherwise stated, we shall use the same terminology as appears in the part of the determination set out in paragraph 2 above.

The issue

4. As can be seen from fact (9) set out in paragraph 2 above, at the objection stage, the Taxpayer claimed that both the severance pay of \$736,424 and the additional severance pay of \$376,200 should not be subject to Salaries Tax. In his notice of appeal dated 2 September 2002, the Taxpayer only maintained his claim that the first sum should not be subject to Salaries Tax. He no longer pursued his claim in respect of the second sum of \$376,200.

5. The Commissioner accepts that, despite the fact that the severance pay of \$273,687 payable to the Taxpayer under the First Letter was larger than the severance pay which the Taxpayer would have been entitled to under section 31G(1) of the Employment Ordinance (Chapter 57), the entirety of such sum would not be taxable. The Commissioner, however, does not accept that the severance pay of \$462,737 payable to the Taxpayer is not taxable because it is not in the nature of a true 'severance pay'.

6. The only issue before us is whether the entirety of the severance pay payable to the Taxpayer under the First Letter and the Second Letter in the total sum of \$736,424 or only that part of it under the First Letter in the sum of \$273,687 should be exempt from Salaries Tax.

7. It is settled law that whether a payment is 'severance pay' does not depend merely on the label put upon it by the parties. The true nature of the payment will have to be ascertained from the documents and the circumstances surrounding them.

The Commissioner's case

8. The Commissioner relies mainly on the wording of the First Letter and the Second Letter.

9. The relevant part of the First Letter (dated 2 November 1998) reads as follows:

'As you may aware, some of our staff members have been laid off due to the above reasons. Nevertheless, to ensure a smooth ending of our business, I would like to offer you the following alternative of employment arrangement with effect from 1/11/98 until closure of our business which is expected to be not later than June 1999 though the exact date is not yet crystallized:

1. Notwithstanding the above said closure of our business and subject to (2) & (3) below, the management of [Bank A] reserves the right to terminate your employment contract at any time deemed appropriate and necessary. For

INLAND REVENUE BOARD OF REVIEW DECISIONS

avoidance of doubt, due to different business back ground, such a termination date will not necessarily be the same for staff members of the same category. The decision of [Bank A] is absolute and final.

2. Unless your employment contract is terminated by [Bank A] at an earlier stage, you have to serve the company until the very last day when our office is totally closed for business. On either case when we take the initiative to terminate your employment contract, you will be compensated with the following payments:
 - a. Severance pay equivalent to your monthly salary × length of service × 2/3, amount of which will be set off by employer's portion of your Provident Fund entitlement;
 - b. Payment in lieu of notice corresponding to your rank;
 - c. A further sum equivalent to 50% of total salary (including basic salary and position allowance but excluding bonus or overtime allowance) to be paid to you during the period concerned.
3. If, due to whatever reasons, you resign before end of our business or at any earlier stage to be advised by the company, you will be entitled to payments of 2a & half of 2c above. If it happens to be the case, you have to give proper notice to us as per regulation laid down in Chapter Three Section (B) of our Staff Handbook.'

10. The relevant part of the Second Letter (dated 10 March 1999) reads as follows:

'In recognition of your loyalty and support to [Bank A], and also as a means to further smoothening our operations for the months to come, I have had a series of conversations with Head Office and it is my pleasure to announce here today that following incentive payments will be added to employees who satisfied our requirements as follows:

1. Special Retention Bonus

Subject to (2) below, **in addition to** the packages mentioned in our letters dated November 2, 1998 to respective employees, following payments will be added:

- a. A sum equivalent to your **monthly salary × length of service × 1/3**, plus

INLAND REVENUE BOARD OF REVIEW DECISIONS

- b. A further sum equivalent to **employer's portion of your Provident Fund** (as determined by your number of completed years of service according to Section 4b, Chapter 7C Provident Fund Plan of the Staff Handbook).

2. Conditions/Restrictions

In principle, the above payments applied to all employees of categories 2/2J/3 as classified in the above said letter dated 2/11/98. However, to be eligible to the additional payments, employees **must also** satisfy [Bank A] with the following points:

- a. Employees must continue to work for [Bank A] through the very last day until [Bank A] takes the initiative to terminate their services.
- b. Employees must continue to perform their duties to our satisfaction up to end of their services. **Their performance will be evaluated by respective superiors**, which will be taken into consideration when determining one's entitlement of bonus mentioned in (1) above, which may result in reduction of the above payments.
- c. Employees must continue to attend their duties punctually. As a measure to keep this morale, your special payment as determined in (1) above will be deducted by a sum derived from the following formula:

$$(S + L \div 2) \times \text{monthly salary} \times 1/20$$

where S = no. of sick leave & L = no. of lateness, counted from 11/3/1999 until your last date of employment

- d. This special retention bonus was approved separately by the Head Office taking into account of the unique situation of HK Branch. To ensure its smoothness, **no information contained in this letter shall be divulged** to unrelated parties including, but not limited to [ex-Bank A] staff and other overseas branches/subsidiaries of [Bank A]. Any breaches of that will not only lead to non-payment of the above, but may also affect other benefits they are entitled.
- e. For clarification purpose, [Bank A] HK Branch will not conduct annual review of the monthly salary and promotion of position due to the current closure situation.'

- 11. The argument of the Commissioner can be summarized as follows:

INLAND REVENUE BOARD OF REVIEW DECISIONS

- (a) The First Letter and the Second Letter were contemporaneous documents and they set out the agreement between the Taxpayer and his employer.
- (b) The First Letter clearly refers to the payment thereunder as ‘Severance pay’ whereas the Second Letter refers to the payment thereunder as ‘incentive payments’ and ‘Special Retention Bonus’.
- (c) Furthermore, under the First Letter, the Taxpayer would not be entitled to the payment under the Second Letter if he were not to remain in employment until the last day, whereas the Taxpayer would be entitled to the severance pay under the First Letter even if he were to leave the employment early of his own initiative.
- (d) Hence the payment under the First Letter was truly a severance pay but not that under the Second Letter.

The Taxpayer’s case

12. The Taxpayer gave evidence and said that after the employer had issued the First Letter the staff were generally unhappy. They negotiated with the employer who recognised that the general practice was for the staff to be given severance pay at the rate of one month’s salary for each year of service. The employer subsequently issued the Second Letter for the main purpose of making up a severance pay (together with the First Letter) at the rate of one month’s salary for each year of service.

13. The Taxpayer also relies on the said letter dated 6 December 2001 from Bank B (Bank A-HK under its new name) which gives an explanation of the two letters in the following terms:

‘ As per Attachment 1, [Bank A] Hong Kong Branch issued its first letter to our ex-employees on November 2, 1998 that all of them would be entitled to severance pay compensation their loss of employment as follows:

Quote:

- 2 a. Severance pay equivalent to your monthly salary × length of service × 2/3, amount of which will be set off by employer’s portion of your Provident Fund entitlement;

Unquote

INLAND REVENUE BOARD OF REVIEW DECISIONS

After the above letter, we had a second thought to the above payment. Considering that many of our ex-employees might have much difficulties to find another comparable positions in view of the very gloomy economic situation of Hong Kong (which, unfortunately turned out to be true), as per Attachment 2, we issued another letter to the employees announcing the following severance pay compensating their loss of employment would be added:

Quote:

1 a. A sum equivalent to your monthly salary × length of service × 1/3 plus

1 b. A further sum equivalent to employer's portion of your Provident Fund

Unquote

In fact, the concept for the additional payment was to make our final severance pay to our ex-employees compensating their loss of employment equivalent to one moth's [sic] salary × length of service without setting off their entitlement of employer's Provident Fund. It was a general practice adopted by many employers who needed to make their painstaking decision in those years. We understand that such payment was accepted by your Department as tax exempted income in general.'

That letter was signed by a Mr D, described as 'General Manager FEG Business Division'.

14. The Taxpayer further relies on a copy of the said internal 'Approval/Record Form' of the employer dated 1 March 1999 approving the payment of a severance pay to staff at the rate of one month's salary for each year of service.

15. The Taxpayer still further relies on a calculation sheet dated 26 June 1999 annexed to a notification by the employer to the Inland Revenue Department ('IRD') under section 52(5) of the Inland Revenue Ordinance (Chapter 112) dated 28 June 1999 ('the Notification') which contains the following particulars:

'DUE TO CLOSURE OF THIS BRANCH, THE FOLLOWING PACKAGE HAS BEEN PAID TO THE ABOVENAMED AS SEVERANCE PAY:

(HK\$)

(1) SEVERANCE PAY ACCORDING TO
YEARS OF SERVICE (NOTE 1)

EQUIVALENT TO ONE MONTH'S SALARY

INLAND REVENUE BOARD OF REVIEW DECISIONS

FOR EACH YEAR OF SERVICE

HK\$94,050.00 × 7.8301 (YEARS) × 1

736,424.38

...

(NOTE 1) : THIS COMPANY WILL WITHDRAW ITS BUSINESS FROM HK AND HAD ANNOUNCED ITS CLOSURE ON 1/11/98. ACCORDINGLY, ALL EMPLOYEES HAVE BEEN ARRANGED TO BE LAID OFF ON VARIOUS STAGES DEPENDS ON SCHEDULE OF EACH DEPARTMENT.

THE AMOUNT INDICATES ON ITEM (1) ABOVE IS A SEVERANCE PAY BASED ON YEARS OF SERVICE OF EMPLOYEE CONCERNED.'

Our finding

16. The Commissioner has challenged the documents referred to in paragraphs 13, 14 and 15 in the following manner:

- (a) Mr D probably did not have personal knowledge of the matters relating to the First Letter and the Second Letter in 1998 and 1999.
- (b) The 'Approval/Record Form' does not show that it had been fully circulated within the employer bank or fully endorsed with approval.
- (c) The Notification was signed by the Taxpayer himself who was in charge of the personnel department of the employer.

17. Having considered all the circumstances, we find on a balance of probabilities that the position is that as advanced by the Taxpayer rather than that adumbrated by the Commissioner. In particular, we take into consideration the following factors:

- (a) There was no difficulty on the part of the employer to make both payments under the First Letter and the Second Letter in the nature of severance pay. It would have made no difference to the employer.
- (b) The way that the sums were made up (that is, 2/3 and 1/3 of monthly salary) is consistent with the evidence that the staff wanted one month's salary for every year of service in accordance with the general practice. We have not heard any serious dispute by the Commissioner that this is indeed a very common practice in the business sector. Furthermore, it does not appear that the IRD has written

INLAND REVENUE BOARD OF REVIEW DECISIONS

any letter disputing what is said in the last part of the letter from Bank B as set out in paragraph 13 above.

- (c) The documents in support referred to in paragraphs 13, 14 and 15 also lend support to the Taxpayer's version. As at 28 June 1999 when the Notification was lodged with the IRD, the present issue had not surfaced.
- (d) Furthermore, we are impressed by the frank disclosure by the Taxpayer to the IRD of another calculation sheet also dated 26 June 1999 which was given to the Taxpayer by the employer as a detailed breakdown of the sums paid which document clearly undermines his case. This in fact adds to his creditability.

Conclusion

18. As regards the challenge to the documents by the Commissioner as summarised in paragraph 16 above, we conclude as follows:

- (a) We are not convinced that Mr D as a responsible officer holding a senior position in a bank would sign the said letter dated 6 December 2001 recklessly.
- (b) As regards the 'Approval/Record Form', we think that the probability is that the rest of the administration in the bank did give their approval in line with the other departments which had given their approval, resulting in the issuance of the Second Letter a few days later.
- (c) The Taxpayer prepared and signed the Notification in his official capacity for and on behalf of Bank A-HK, and the point about the Notification being signed by the Taxpayer himself is counter-balanced by the points we have made in paragraph 17(c) and (d) above.

19. In the circumstances we agree with the Taxpayer that the entire sum of \$736,424 is severance pay and not taxable.

20. We therefore allow the Taxpayer's appeal.