Case No. D12/11

Salaries tax – payment on termination of employment – whether employment income – sections 2(1), 8(1), 9, 11B, 11C and 11D and 68(4) of the Inland Revenue Ordinance.

Panel: Kenneth Kwok Hing Wai SC (chairman), Christina W W Lee and Young Yee Kit Jessica.

Date of hearing: 22 October 2009.
Date of decision: 18 July 2011.

The appellant's employment terminated on 31 December 2006. The total sum of $1,000,000 he received from his former employer (by two instalments 'Sum A' and 'Sum B' of $500,000 each) was assessed to salaries tax for the 2006/07 year of assessment.

The appellant contends that:

- Sum A which was paid on 31 December 2006, was an 'ex-gratia payment' and should be exempt from Salaries Tax;
- Sum B which was paid on 31 December 2007, should be an assessable income for the 2007/08 year of assessment under Profits Tax.

Held:

1. There was only one single payment of $1,000,000 comprising both Sum A and Sum B in recognition of the appellant's contribution, not two separate payments for different reasons.

2. A gratuity is within the definition of 'income'. From the million-dollar-payment letter from the former employer, it is clear that the gratuity, comprising both Sum A and Sum B, was a payment as a reward for past services.

3. The independent contractor assertion for Sum B is inherently improbable, the terms of the alleged agreement are vague and do not make commercial sense.

4. Both Sum A and Sum B are assessable to salaries tax in the year of assessment 2006/07.

Appeal dismissed.

Cases referred to:

Seymour v Reed [1927] AC 554
Fuchs, Walter Alfred Heinz v Commissioner of Inland Revenue (2010-11) 25 IRBRD 541
Hochstrasser v Mayes [1960] AC 376
Henley v Murray (1950) 31 TC 351
Shilton v Wilmshurst [1991] 1 AC 684
Henry v Foster (1931) 16 TC 605
Comptroller-General of Inland Revenue v Knight [1973] AC 428
Williams v Simmonds (1981) 55 TC 17
Dale v de Soissons (1950) 32 TC 118
EMI Group Electronics v Coldicott [1999] STC 803

Taxpayer in person.
Chan Wai Lin, Chan Man On and Wong Pui Ki for the Commissioner of Inland Revenue.

Decision:

Introduction

1. The appellant was employed by his former employer ('the former employer') as a manager. His employment terminated on 31 December 2006.

2. He was paid a total of $1,000,000 by the former employer by 2 instalments:

(1) 50% of which, that is $500,000, was paid during the 2006/07 year of assessment ('Sum A'); and

(2) the remaining 50%, that is $500,000, was paid in December 2007 ('Sum B').

3. The respondent assessed both Sums to salaries tax for the 2006/07 year of assessment.

4. By letter dated 27 May 2009, the appellant appealed on the grounds that (written exactly as it stands in the original):

(1) Sum A was an 'ex-gratia payment essentially caused by [the former employer's] objective to provide long service payment to an aged

> employee on the occasion of retirement, in order to provide some assistance for the post-retirement living of the employee. As such "Sum A" should be allowed to be exempt from Salaries Tax'; and
>
> (2) With respect to 'Sum B':
>
> After a careful re-think recently, I am of the view that embodied in 'the Letter' there was in substance a contract between [the former employer] and me for the provision of services by me in the capacity as an independent contractor in the year of assessment 2007/08. 'Sum B' was only payable to me in year of assessment 2007/08 (i.e. in late December 2007) subject to my undertaking to assist the Accounts Department with the history of some cases in year of assessment 2007/08. It appears that 'Sum B' should be dealt with as an assessable income for year of assessment 2007/08 under Profits Tax, rather than accrued as an assessable income of year of assessment 2006/07 under Salaries Tax.'

The relevant facts

5. Based on the documents placed before us and some of the facts stated in paragraph 1 of the Determination which were not disputed by the appellant, we make the following findings of facts.

6. On 1 July 1978, the appellant commenced his employment with another company in the former employer's group of companies.

7. On 1 April 1981, the appellant's employment was transferred to the former employer on the same terms of employment.

8. By a circular in Chinese dated 22 March 1985, the former employer informed all employees of the introduction of a new employment benefit. This benefit was for employees aged 55 or above receiving a monthly salary and had been employed for a minimum of 10 years. Such an employee might apply for retirement and the group would vet the application and depending on the employee's service attitude, attendance and work performance, the employee who qualified would be paid a retirement allowance of not less than 20 days' salary for each year of service.

9. By letter dated 10 July 2006, the appellant wrote to the former employer applying for retirement allowance in these terms (written exactly as it stands in the original):

> 'Due to decline in personal health, I am afraid that I am no longer able to discharge my duties properly.
>
> Having reached the age of 57 and completed 28 years' of service in the company, I hereby make an application for retirement and would be most

grateful if you would kindly grant me retirement allowances and allow me to retire by 10 August 2006.

Your sympathetic consideration of my application will be deeply appreciated.'

10. By letter dated 29 November 2006, the former employer wrote to the appellant as follows (written exactly as it stands in the original):

' I refer to our recent discussion on your impending retirement on 1 January 2007 and am pleased to advise you that the Personnel Department will credit your bank account with the followings:

a) your salary calculated up to and including 31 December 2006;

b) 165 days in lieu of earned annual leave which you have not taken amounting to $397,650.00;

c) the employer's provident fund of HK$1,704,730.99; and

d) an ex-gratia payment of HK$1,000,000.00 in recognition of your contribution, 50% of which is payable on 31 December 2006 and the rest payable on 31 December 2007. You have kindly undertaken to assist the Accounts Department with the history of some cases where your assistance is required.

I would like to take this opportunity to express my deep appreciation to you for your long service and your contribution to the Company and wish you all the best in the future.'

11. In his composite tax return for individuals for the year of assessment 2006/07, the appellant:

(1) reported salary income of $1,617,035[1] for the 7-month period from April to December 2006;

(2) claimed deduction of $12,000[2] for mandatory contribution to a recognised retirement scheme;

(3) claimed deduction of $2,500 as 'annual membership registration renewal fee of [a professional body]'; and

[1] According to the former employer, this comprised salary in the sum of $650,700, leave pay in the sum of $394,035, back pay, terminal awards and gratuities etc. in the sum of $500,000 and other rewards, allowances or perquisites in the sum of $72,300.

[2] Which appears to be for a 12-month period.

(4) claimed exemption of the inclusion of Sum A as 'ex-gratia gift as a token of personal esteem on the occasion of retirement'.

12. By letter dated 28 November 2007, the appellant wrote to the respondent alleging that (written exactly as it stands in the original):

> ' The payment of the said ex-gratia gift to me by my former employer was non-contractual, and was not for services rendered. I had no automatic entitlement right to such a gift on retirement; the payment was made by my former employer on compassionate grounds, having regard to my declining health conditions (in particular the weakening in ability to hear and becoming quite absent-minded) which adversely affected my job performances, so that it was appropriate for me to quite the job and to retire.'

13. By its letter dated 15 July 2009 to the respondent, the former employer asserted that (written exactly as it stands in the original):

> ' (1) … it was not a condition for [the appellant] to offer assistance to our Company after his retirement so as to get the second instalment of the ex-gratia payment on 31 December 2007.
>
> (2) Assuming [the appellant] did not offer assistance as required by our Company, it is confirmed that the second instalment of the ex-gratia payment would still be paid to him on 31 December 2007.
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> (3) The management of the Company decided to pay a discretionary ex-gratia payment of HK$1,000,000.00 to [the appellant] in recognition of his contribution to the Company. The determination of the quantum of the ex-gratia payment was not based on any quantitative factors.
>
> (4)(b) It is confirmed that our Company did not pay any other retirement allowances to [the appellant] because:
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> (i) the retirement allowance in full is not applicable to every staff; and
>
> (ii) the ex-gratia payment was a partial substitute for the retirement allowances.'

The relevant statutory provisions

14. Section 2(1) of the Inland Revenue Ordinance, Chapter 112, defines 'year of assessment' as meaning 'the period of 12 months commencing on 1 April in any year'.

15. Section 8 is the salaries tax charging provision. It provides that:

> *'(1) 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 ...*
>
> *(1A) For the purposes of this Part, income arising in or derived from Hong Kong from any employment-*
>
> *(a) includes, without in any way limiting the meaning of the expression and subject to paragraph (b), all income derived from services rendered in Hong Kong including leave pay attributable to such services".*

16. Section 9 defines 'income from any office or employment' to include 'any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others'. It should be noted that this definition is not identical with the description in r. 1 of Sch. E, of 'salaries, fees, wages, perquisites or profits whatsoever' from an office or employment of profit which applied at the time of Seymour v Reed [1927] AC 554[3].

17. Sections 11B, 11C and 11D deem income received after the cessation of employment year of assessment to have accrued on the last day of employment:

> *'11B. 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.'*
>
> *'11C. For the purpose of section 11B, a person shall be deemed to commence or cease, as the case may be, to derive income from a source whenever and as often as he commences or ceases –*
>
> *(a) to hold any office or employment of profit ...'*
>
> *'11D. 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 ...*

[3] At page 559.

> *(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.'*

18. Section 68(4) provides that:

> *'The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.'*

The applicable principles

19. Fuchs, Walter Alfred Heinz v Commissioner of Inland Revenue (2010-11) 25 IRBRD 541 is a salaries tax case which went all the way to the Court of Final Appeal, having leapfrogged the Board of Review.

20. Ribeiro PJ held[4] that whether a payment is taxable turns on the construction of section 8(1) – whether it is within the definition of 'income' and whether an amount constitutes income 'from' the taxpayer's 'employment'. Chargeable income is:

- not confined to income earned in the course of employment; but
- embraces payment made in return:
  - for acting as or being an employee; or
  - as a reward for past services; or
  - as an inducement to enter into employment and provide future services.

[4] The other 4 judges agreed with the judgment of Ribeiro PJ.

Where a payment falls within the test, it is assessable and the fact that, as a matter of language, it may also be possible to describe the purpose of that payment in some other terms, for example as 'compensation for loss of office' does not displace liability to tax. Characterisation as 'redundancy payment' is of no legal significance once the conclusion has been reached that the sums in question were in substance income deriving from the taxpayer's employment and so within the charge to salaries tax.

> *'14. Whether a payment received by an employee on termination of his employment is taxable turns on the construction of section 8(1): Is such payment "income ... from ... any office or employment of profit"? As we have seen, section 9 defines "income" widely to include "any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance". There is no dispute that Sums B and C come within that definition. The key issue is therefore whether those amounts constitute income 'from' the taxpayer's "employment".'*
>
> *'17. In my view, the same approach should be adopted in the construction of section 8(1) of the Ordinance. Income chargeable under that section is likewise not confined to income earned in the course of employment but embraces payments made (in Lord Radcliffe's terms) "in return for acting as or being an employee", or (in Lord Templeman's terms) "as a reward for past services or as an inducement to enter into employment and provide future services". If a payment, viewed as a matter of substance and not merely of form[5] and without being "blinded by some formulae which the parties may have used",[6] is found to be derived from the taxpayer's employment in the abovementioned sense, it is assessable. This approach properly gives effect to the language of section 8(1).*
>
> *18. It is worth emphasising that a payment which one concludes is "for something else" and thus not assessable, must be a payment which does not come within the test. As Lord Templeman pointed out, it is only where "an emolument is not paid as a reward for past services or as an inducement to enter into employment and provide future services but is paid for some other reason, [that] the emolument is not received "from the employment"."[7] Thus, where a payment falls within the test, it is assessable and the fact that, as a matter of language, it may also be possible to describe the purpose of that payment in some other terms, eg, as "compensation for loss of office", does not displace liability to tax. The applicable test gives effect to the statutory language and other possible characterisations of the payment are beside the point if, applying the test, the payment is "from employment".*

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5 Hochstrasser v Mayes [1960] AC 376 at 390.

6 Henley v Murray (1950) 31 TC 351 at 365.

7 Shilton v Wilmshurst [1991] 1 AC 684 at 689 (emphasis supplied). See also Henry v Foster (1931) 16 TC 605 at 634, per Romer LJ, cited in Section D.2 below.

19. As the decided cases show, a variety of payments may fall outside the test. Thus, it is well-established that damages obtained in a suit for wrongful dismissal or a payment under a settlement agreement reached in such a suit are not regarded as income from employment.[8] *Such a sum is properly regarded as deriving from a cause of action arising after the contract has been discharged by breach.*[9] *To take another example, in the Hochstrasser case, the sum in question was a payment to indemnify an employee who had purchased a house under a housing scheme set up by the employer, but who had then had to sell it at a loss when directed by the employer to work elsewhere in the country. The indemnity was held not to come within the test. As Lord Radcliffe put it:*

> *"... the circumstance that brought about his entitlement to the money was not any services given by him but his personal embarrassment in having sold his house for a smaller sum than he had given for it. I regard the employer's payment as being in substance a free benefit conceded to the employee."*[10]

20. Conversely, in many cases, there will be little doubt that a payment is assessable as "income from employment". This is so where, for instance, the sum is plainly an entitlement under the contract of employment, such as a lump sum stipulated to be payable in the event of early termination as in Williams v Simmonds[11] *and Dale v de Soissons*[12] *or an amount paid pursuant to a clause enabling the employer to terminate by making a payment in lieu of notice as in EMI Group Electronics v Coldicott.*[13]'

'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

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[8] Henley v Murray (1950) 31 TC 351 at 363, 366-367; Comptroller-General of Inland Revenue v Knight [1973] AC 428 at 433.

[9] The position regarding liquidated damages stipulated in a contract may well differ and I would keep that question open.

[10] Hochstrasser v Mayes [1960] AC 376 at 392.

[11] (1981) 55 TC 17.

[12] (1950) 32 TC 118, discussed below.

[13] [1999] STC 803.

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 ...'

'27. In the course of his submissions, Mr Barlow also characterised Sums B and C as a "payment for early termination without cause" and as a "redundancy payment". For the reasons set out in Section D.1 above, it is my view that such characterisations are of no legal significance once the conclusion has been reached that the sums in question were in substance income deriving from the taxpayer's employment and so within the charge to salaries tax. I will therefore say no more about those submissions.'

Sum A

21. The appellant shifted his grounds on the reasons for payment of Sum A.

22. Whether it was an 'ex-gratia gift as a token of personal esteem on the occasion of retirement' as he alleged in his composite tax return quoted in paragraph 11 above, or as alleged by him in his letter quoted in paragraph 12 above, or as alleged by him in his notice of appeal quoted in paragraph 4 above, a gratuity is within the definition of 'income'.

23. On the question of whether Sum A was 'from' employment, we do not find the appellant's changing versions helpful to his credibility or to the weight to be attached to his versions.

24. It is clear from the letter from the former employer dated 29 November 2006[14] that the gratuity was a payment as a reward for past services. The million dollar payment was 'in recognition of your [that is the appellant's] contribution' and the former employer took 'this opportunity to express my deep appreciation to you for your long service and your contribution to the Company'.

25. Applying Fuchs, we find that Sum A was within the definition of income and that Sum A was from the appellant's employment.

Sum B

[14] See paragraph 10 above.

26. We have no hesitation in rejecting the independent contractor assertion. Our reasons are as follows:

(1) Sum B was 'the rest' of the million dollar *ex-gratia* payment[15]. There was *one* single payment 'in recognition of your contribution', not two separate payments for different reasons.

(2) The reason given by the appellant for resignation[16] was that the appellant was 'no longer able to discharge [his] duties properly' because of failing health[17]. Against such background, it is inherently improbable for the appellant and the former employer to agree to engage the appellant as an independent contractor, bearing in mind that the appellant's desired retirement date had already been extended by more than 4 months[18].

(3) Whether the appellant has reached an agreement with the former employer is a question of fact known to the appellant. It is not something which emerges 'after a careful re-think recently'. We do not find the appellant's recent assertion credible.

(4) The terms of the alleged agreement are vague and do not make commercial sense. The appellant alleged that he was to provide services 'in the year of assessment 2007/08'. That leaves a gap of 3 months from January 2007 to March 2007 unaccounted for.

27. The respondent sought to rely on parts of the former employer's letter dated 29 November 2006[19]. The truth of the contents has not been attested by any witness and there is no person to provide answers to questions which arise from various parts of the letter. We attach no weight to this letter.

28. To sum up, we find as a fact that there was only one single payment of $1,000,000 comprising both Sum A and Sum B. For reasons given in paragraphs 21 – 25 above and applying Fuchs, we find that Sum B was within the definition of income and that Sum B was from the appellant's employment. By reason of sections 11B, 11C and 11D, Sum B was assessable to salaries tax in the year of assessment 2006/07.

Conclusion and disposition

[15] See paragraph 10(d) above.
[16] See paragraph 9 above.
[17] See also the letter dated 28 November 2007 quoted in paragraph 12 above.
[18] See paragraphs 9 and 10 above.
[19] See paragraph 13 above.

29. For reasons given above, we dismiss the appeal and confirmed the assessment appealed against as increased by the Deputy Commissioner by his Determination dated 29 April 2009.