Case No. D13/94

Salaries tax – lump sum payment – whether gratuity – whether payment subject to salaries tax.

Panel: William Turnbull (chairman), Nicholas Ian Billingham and Ma Ching Yuk.

Date of hearing: 11 and 14 March 1994.
Date of decision: 27 May 1994

The taxpayer was employed under a continuous employment contract. In the course of that employment contract the employer made a lump sum cash payment to the employee in satisfaction of the right of the employee to receive severance or long service pay. The assessor taxed the lump sum payment as a gratuity. The taxpayer appealed to the Board of Review.

Held:

The payment was not a gratuity. It was a payment by the employer to absolve the employer from legal liabilities. The nature of the payment was the same as that made by an employer either by way of damages for breach of contract or compensation to avoid a claim being made for breach of contract. In the circumstances it was not subject to salaries tax.

Note: A. The Board did not express any view regarding the legal effect of the payment so far as the taxpayer and his employer were concerned. The reason for the payment was what was material.

B. See also cases nos D26/94 and D27/94.

Appeal allowed.

Cases referred to:

D19/92, IRBRD, vol 7, 156
D79/88, IRBRD, vol 4, 160
D12/92, IRBRD, vol 7, 122
D25/92, IRBRD, vol 8, 348
D24/88, IRBRD, vol 3, 289
D15/93, IRBRD, vol 8, 350

[Editor's note: Upon the Chairman's request, the two unreported decisions (D25/92 and D15/93 were published in the third supplement of volume 8.]

Ng Kwok Yin for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

This is an appeal by a salaries taxpayer against an assessment to salaries tax wherein the assessor has assessed to tax a lump sum payment which the Taxpayer claims should not have been taxed:

The facts are as follows:

1. The Taxpayer was employed as a driver by a club commencing on 1 July 1973.

2. In or about 1978 the employment of the Taxpayer as a driver was transferred from the club to a limited company. There was an association between the club and the limited company. The limited company agreed with the Taxpayer that it would be responsible for and recognise his seniority with the club. This meant that the limited company would accept a contingent liability to pay to the Taxpayer severance or long service pay in accordance with the provisions of the Employment Ordinance in respect of the years of service which the Taxpayer had had with the club.

3. Some time in November or December 1988 the limited company informed the Taxpayer that the ownership of the limited company was being changed and restructured. Accordingly with effect from 31 December 1988 the employment of the Taxpayer would be terminated and he would be paid severance pay. He was further informed that he would be offered alternative employment on a new basis. Instead of being employed as a driver only he would be offered new terms under which he would perform the same services as a driver but in addition would perform services as a receptionist and as an escort. With effect from 1 January 1989 his remuneration would remain the same but it would be reviewed after about three months depending upon how his new job had progressed.

4. By written notice dated 11 January 1989 the limited company gave formal notice to the Taxpayer in the following terms:

> 'This company will undergo a restructure in 1989. It has been decided that the employment of all staff of (the limited company) will be terminated on 31 December 1988. Severance payment will be calculated according to years of service. For those who have provided service for more than one year, they will be given one month's salary for each year; those who have worked for less than one year, their payment will be calculated on a pro rata basis.'

5. Subsequently the limited company offered to the Taxpayer the sum of $123,225 which was to be paid to the Taxpayer by the employer in full and final settlement of all claims which might have contingently accrued to the Taxpayer or to which the Taxpayer might have been entitled as at 31 December 1988. This offer was accepted by the Taxpayer who signed a receipt for the monies dated 11 April 1989:

> 'I acknowledge the receipt of severance payment of Hong Kong dollars one hundred and twenty-three thousand two hundred and twenty-five only from (the limited company) for my service from 1 July 1973 to 31 December 1988.'

6. Notwithstanding that the employer had informed the Taxpayer that his employment would be terminated on 31 December 1988, as a matter of fact the employment of the Taxpayer continued unbroken, albeit on new terms and conditions. There was no actual termination of the services of the Taxpayer.

7. After serving on the new employment terms for about three months the limited company revised the salary of the Taxpayer from $5,300 to approximately $5,900 per month retrospectively with effect from 1 January 1989 being the date when the new employment terms had taken effect.

8. The assessor was of the opinion that part of the sum of $123,225 paid to the Taxpayer was a gratuity and that part was severance pay. An assessment to salaries tax was issued dated 18 October 1991 as follows:

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Total income	210,928
Less: severance pay [12 × $5,300]*	63,600
Assessable income	147,328
Less: allowance	45,000
Net chargeable income	102,328
Tax payable thereon	16,482

* Restricted to the maximum amount of severance payment provided by the Employment Ordinance.

9. By letter dated 24 October 1991 the Taxpayer objected to this assessment on the ground that the whole of the lump sum should be exempt from tax.

10. By his determination dated 13 October 1993 the Deputy Commissioner decided that the whole amount of the lump sum payment of $123,225 was assessable to tax and increased the net chargeable income to $210,928 with tax payable thereon of $31,639.

11. The Taxpayer gave notice of appeal dated 2 November 1993 to this Board of Review.

At the hearing of the appeal the Taxpayer appeared in person and after making submissions elected to give evidence and be cross examined.

We totally accept the evidence given by the Taxpayer as being truthful. It was clear that he had no legal or taxation knowledge but this did not detract from the truthfulness of the facts which he told to the Board both in evidence in chief and under cross examination. His submission was that colleagues of his who had received similar treatment from the employer had not been required to pay tax. That the lump sum payment which he received should not be subject to tax and that he had difficulty in understanding what various officers of the Inland Revenue Department had told him from time to time with regard to the nature of the payment and whether or not it was subject to salaries tax.

The representative for the Commissioner was of great help to the Board. Though he was firmly of the opinion that the whole amount of the lump sum should be assessed to salaries tax he did his best to place before the Board any matters which were in favour of the Taxpayer, bearing in mind that the Taxpayer was unrepresented and had no legal or taxation knowledge. The representative for the Commissioner should be commended in this regard.

The representative for the Commissioner submitted and cross examined the Taxpayer on the basis that his employment had not terminated on 31 December 1988 even though the employer had stated it would be terminated and the Taxpayer was under the misapprehension that it had been so terminated. Having heard the submission from the representative for the Commissioner and having heard the evidence we agree entirely with the Commissioner that there was no termination of employment. The Taxpayer had become confused because the Chinese name of the limited company had changed and he thought that this meant that there had been a change of legal entity. Of course a change of name does not mean a change of legal entity. As a matter of fact the employment of the Taxpayer continued unbroken throughout the period in question. The terms of his employment changed significantly but that did not constitute a termination of employment and re-employment.

The representative for the Commissioner submitted that the lump sum payment was a gratuity paid by the employer to the employee in respect of past services and was accordingly fully taxable. He submitted that if there had been a termination of employment the Taxpayer would have been entitled to the benefit of a concession which the Commissioner grants in such circumstances. The concession is to relieve from salaries tax assessment that part of a severance payment which is covered by the entitlement of a Taxpayer under the terms of the Employment Ordinance. As there was no termination of

employment in the present case there could be no entitlement to any payment under the Employment Ordinance and accordingly the concession could have no application. The representative for the Commissioner submitted that as the concession had no application and as the payment was a gratuity paid by the employer to the employee it was taxable under the provisions of section 9(l)(a) of the Inland Revenue Ordinance. The representative for the Commissioner referred us to the following cases and authorities:

D19/92, IRBRD, vol 7, 156
D79/88, IRBRD, vol 4, 160
D12/92, IRBRD, vol 7, 122
D25/92, IRBRD, vol 8, 348
D24/88, IRBRD, vol 3, 289
D15/93, IRBRD, vol 8, 350

Part V A of the Employment Ordinance (Chapter 57)

This is a very interesting case and turns entirely on the nature of the lump sum payment. We agree with the representative for the Commissioner that it could not be a severance payment because there was no termination of employment.

However we are not able to accept that it was a gratuity. The representative submitted that the word gratuity should be given its normal dictionary meaning and has no special meaning within section 9(l)(a) of the Inland Revenue Ordinance. This is correct and has been accepted as being correct by previous Boards of Review (for example D79/88). However this was not an ex-gratia payment made by the employer without any legal obligation. It was in fact a payment made by the employer to buy off rights to which the Taxpayer was contingently entitled. The best evidence that we have of this is the Taxpayer's own answers to questions put to him in cross examination. When asked about the nature of the lump sum payment the Taxpayer replied:

> 'By seniority I meant the company absolved itself from the responsibility it had to me under the employee/employer relationship. It also means that by getting this money the benefits and seniority I enjoyed with this company would come to an end.'

When asked:

> 'So when you said you lost your seniority you mean you lost your service of fifteen and a half years with the company?'

He replied:

> 'It means the company has absolved itself from responsibility as far as the employer/employee relationship is concerned. Just like it is stipulated in the labour law I have to be paid a certain amount of money after I have asked for a certain number of years. It put an end to all these.'

We accept the truth of these statements. So far as the Taxpayer and the employer were concerned the lump sum payment was to absolve the employer from its ongoing and increasing liability to the Taxpayer with regard to his years of service. As at that date he had been working for fifteen and a half years. Though part of that period had been with a different employer the limited company had agreed with the Taxpayer to include his earlier service in their obligations. The Employment Ordinance provides for a multiple of years of service based upon the retirement pay of the employee with a cap on the maximum amount. The effect of these provisions are that as the salary of an employee increases so the lump sum liability of the employer increases. It was this obligation which the employer wished to crystallise once and for all. The ownership of the employer was changing and the new owners did not wish to have an ongoing and increasing liability to the Taxpayer. They thought that by making a lump sum payment to the Taxpayer they could discharge their ongoing and increasing liability for past services. They offered the Taxpayer a lump sum equal to one and a half month's pay for each year of service and the Taxpayer accepted the offer. The offer was based on one and a half month's pay because the Taxpayer had over 10 years of the existing service.

In view of the facts as we have found them there can be no question of the lump sum payment being a gratuity. It was not an ex-gratia payment. It was a payment to buy off ongoing contractual or legal obligations.

In the course of the hearing we asked the representative for the Commissioner whether he could cite any cases similar to the present one and it was pointed out that all of the cases which he had cited referred to termination of employment where severance pay or a gratuity had been paid. The representative was unable to cite any authority to the Board in this regard.

It appears to the Board that the nature of the payment in this case is the same as that which is made by an employer either by way of damages for breach of contract or as a lump sum compensation payment to avoid a claim being made against the employer by the employee. It was not a gratuity. In such circumstances we find the entire sum not to be taxable within the terms of section 9(1)(a) of the Inland Revenue Ordinance.

As two of the cases cited before the Board were unreported decisions this Board has directed the Clerk to the Board of Review to request the Attorney General to publish the two decisions in question. One is particularly interesting as it relates to a payment by a third party in respect of the liabilities of a previous employer. As it is not material to the decision which we have reached we do not comment on whether or not we would have chosen to follow that decision if it had been relevant.

We have not expressed any views as to what may be the legal effect of the agreement which the Taxpayer reached with the employer so far as the provisions of the Employment Ordinance are concerned. Whether the payment of the lump sum will be effective in absolving the employer is not for this Board to decide.

For the reasons given we allow this appeal and direct that the assessment against which the Taxpayer has appealed should be referred back to the Commissioner to be reduced by the removal therefrom of the total amount of $123,225.