INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D16/95

Salaries tax – termination of employment – what constitutes income – section 8(1) and 9(1) of the Inland Revenue Ordinance.

Panel: Ronny Wong Fook Hum QC (chairman), David A Morris and Gerald Hin Tsun To.

Date of hearing: 8 March 1995.
Date of decision: 16 May 1995.

The taxpayer was an employee who terminated his employment by resignation at the request of the employer. The employee was paid certain benefits on the termination of his employment. The employee argued that some of the lump sum payments were not assessable to salaries tax. The taxpayer submitted that these were payments made by his employer to obtain his resignation.

Held:

The payments in respect of lay off/long service allowance was not taxable. The other items in dispute all arose from the employment of the taxpayer and were correctly assessed to tax.

Appeal partly allowed

Cases referred to:

Hochstrasser v Mayes [1960] AC 376
Du Cros v Ryall 19 TC 444
Henley v Murray 31 TC 351
D79/88, IRBRD, vol 4, 160
D43/93, IRBRD, vol 8, 323

S P Barns for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

I. THE FACTS

1. Over 10 years ago, the Taxpayer was an employee with Company A. As a result of corporate re-structuring, he was transferred to work with Company B.

2. On 1 February 1992, Company B published to its employees 2 documents setting out its 'human resources policy' in relation to 'separation of employment' and 'layoff allowance'.

(a) In relation to 'separation of employment':

(i) Company B drew a distinction between 'voluntary separation' and 'involuntary separation'.

(ii) Involuntary separation may arise from 'consistent poor performance' and 'excessive tardiness'. 'Whenever deemed appropriate, termination by [Company B] shall be preceded by the issuance of counselling letter'.

(b) In relation to 'layoff allowance':

(i) Company B made provision for payment of layoff allowance. The purpose of such payment was to financially assist a regular employee laid off because of lack of work.

(ii) It was not payable to an employee 'who terminates employment voluntarily, or who is discharged, or who resigns at [Company B's] request'.

(iii) Layoff allowance was to be computed at the rate of two-thirds of a month's pay for every year of service.

3. The Taxpayer occupied the position of regional sales manager on 1 April 1992. A performance review conducted by his superiors dated 2 May 1992 indicated his 'performance exceeds expectation'.

4. Thereafter relationship between the parties deteriorated. On 25 August 1992, Company B wrote to the Taxpayer regarding his continued struggle to control sudden dozing during business day. Company B warned the Taxpayer that his health and his career were all at stake.

5. The situation did not improve. A meeting then took place between the Taxpayer and his immediate supervisor, Mr X, on 10 September 1992.

(a) According to Company B, the Taxpayer 'was given the option of resigning or being discharged from service. He chose to resign. Prior to his resignation, there was no discussion of any financial incentive to induce his resignation'. Company B emphasised that the Taxpayer 'did not leave Company B's employment on his own accord'.

(b) According to the Taxpayer, 'Mr X advised me the management's decision of requesting me to resign and they would offer me the lay-off benefit. Mr X also advised that if I do not accept the offer, the management will initiate the

discharge process … which would not be pleasant to both the company and myself. I accepted Mr X's suggestion to resign'. The Taxpayer said he then had a meeting with a Mr Y. He orally agreed with Mr Y the amount of his compensation. In the presence of Mr Y, he signed a letter of resignation and a document confirming his obligations under a previous 'memorandum of employee's agreement' in relation to intellectual property rights.

(c) Mr Barns, senior assessor of the Inland Revenue Department, had very fairly accepted the Taxpayer's version of what transpired between the parties.

6. By a letter dated 11 September 1992, Company B outlined the following benefits that 'will be paid to [the Taxpayer] on 28 October 1992, as a result of [the Taxpayer's] resignation from [Company B]':

Payment	**Method of Computation**	**Amount $**
Item 1: Lump sum payment from the retirement scheme	Average of 36 months salary × 10.83 years of service × Resignation factor of 0.5	233,836
Item 2: Layoff/Long service allowance	2/3 of final monthly salary × 10.83 years of service	368,238
Item 3: Pro-rated portion of 13th month fixed salary	Based on service of 305 days	42,500
Item 4: Lump sum payment of 28 days untaken annual leave for 1991-1992	$51,000 x 28/20.75	68,850
Item 5: Monthly salary up to 31.10.1992	$51,000 per month	51,500

7. The disputes between the parties relate to items 2, 3 & 4 outlined above totalling $479,588. Of this sum, the Revenue contends that only $108,300 (that is $15,000 × 2/3 × 10.83) being the amount of long service payment which the Taxpayer was entitled to in accordance with the Employment Ordinance, was not taxable. We have reservations as to the basis of this concession.

II. THE STATUTORY PROVISIONS

1. Section 8(1) of the Inland Revenue Ordinance (the IRO) provides:

'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; and

(b) any pension.'

2. Section 9(1) of the IRO provides that income from an office or employment includes:

> *'(a) any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or other.'*

III. THE APPLICABLE PRINCIPLES

1. The question is whether each of items 3, 4 & 5 constitutes income arising in or derived from the office or employment of the Taxpayer.

2. In considering the statutory language, we derive assistance from the following much quoted passage in the speech of Lord Radcliffe in Hochstrasser v Mayes [1960] AC 376

> *'For my part, I think that their meaning is adequately conveyed by saying that, while it is not sufficient to render a payment assessable that an employee would not have received it unless he had been an employee, it is assessable if it has been paid to him in return for acting as or being an employee.'*

3. In Du Cros v Ryall 19 TC 444 the Taxpayer there was employed under an agreement as general manager of a company for 15 years. His employment was terminated prior to expiration of the 15 years period. He sued his employer for wrongful repudiation. The suit was compromised and a sum was agreed as damages. Finlay J took the view that the amount so agreed was merely damages payable in respect of the repudiation of the agreement and as the price for the cancellation of the agreement. He held that the same was not taxable.

4. In Henley v Murray 31 TC 351 the Taxpayer was the managing director of a property company. He was entitled to various benefits under his service agreement. The company experienced financial difficulties. Assistance would only be forthcoming if the Taxpayer were to sever his relationship with the company. The Taxpayer agreed to resign on terms including payment of a sum calculated from the date of his resignation to the date of termination of his service agreement. The Court of Appeal held that the sum was not taxable. According to Lord Evershed, 2 classes of cases have to be distinguished. The first class of case is where the employers remain liable under the contract for the renumeration 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. The employee remains taxable for his receipt in this class of cases. 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 [See page 363]. Jenkins LJ put the matter succinctly thus [at page 367]:

> *'… the question in each case is whether, on the facts of the case, the lump sum paid is in the nature of renumeration 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.'

The Court of Appeal took the view that the case before them involved a taxpayer submitting to pressure to put an end to his contract *'not for nothing, but provided that certain sums which were already due and unpaid were paid, and also, that there should be paid as a lump sum a further sum of money as compensation or consideration … for his giving up altogether his contractual rights …* [page 360]. The sum in question was held not taxable.

5. In D79/88, IRBRD, vol 4, 160 the Board of Review was of the view that:

The Inland Revenue Ordinance lays down a relatively straightforward code for the imposition of tax. By the definition of "income from employment" in section 9(1)(a), the statute specifically sweeps within the tax net payments received by an employee which can be categorised broadly as gratuities. The word "gratuity" is an ordinary word in the English language and connotes a gift or present usually given on account of past services. Obviously, where the circumstances of the case show that the payment was made on account of something else (for example, in settlement of a claim for damages for wrongful dismissal), then, whatever label is used, the payment cannot properly be regarded as a "gratuity" in the ordinary sense.'

6. In D43/93, IRBRD, vol 8, 323

'… the employer decided to terminate the employment of the Taxpayer. To do this according to the contract between the employer and the Taxpayer it was necessary for the employer to wait for a period of nine months and then to give three months' notice of termination. No doubt to follow such a procedure would have caused difficulties. It had been decided to close down the department which the Taxpayer managed with immediate effect. It was not possible to relocate the Taxpayer within the structure of the employer. The employer would then have been in the position of continuing to employ a person … In such circumstances it is customary for the employer to negotiate an amicable settlement with the employee. The question for breach of contract does not arise because there had not as yet been any such breach. Clearly the taxpayer had valuable contractual rights which the employer wishes to extinguish. Terms of settlement were agreed between the employer and the Taxpayer which included the sum of $737,460 being compensation for loss of employment. According to the Commissioner's own guidelines a payment made as compensation for the loss of employment and a payment made in settlement of a claim for damages for wrongful dismissal are not assessable to salaries tax. It is quite clear to us on the evidence and facts before us that the sum of $737,460 which we have described as a severance payment was a payment made to terminate the employment of the Taxpayer and compensate him for loss of his employment. If the payment had not been made the Taxpayer would have been entitled to claim damages for wrongful dismissal…'

7. We are indebted to Mr Barns for drawing our attention to these authorities.

IV. OUR FINDINGS AND DECISION

1. It is not the Taxpayer's case that none of the 5 items outlined above is taxable. It is accepted by the Taxpayer that at least item 5 comprising of monthly salary up to 31 October 1992 is within the tax net. It would be wrong therefore to approach this case on the basis that all 5 items are part of one entire consideration in return for the Taxpayer's resignation.

2. Little evidence was adduced by the Taxpayer on the nature of items 3 & 4. We are not told why those two items should not be regarded as the accrued entitlements of the Taxpayer arising from his contract of employment which crystallised on his resignation.

3. We are of the view that item 2 is not income arising in or derived from the Taxpayer's office or employment.

4. The employer wished to get rid of the Taxpayer. The employer could have followed their procedure for termination which would have given arise to disputes as to whether they were entitled to invoke the same. The employer opted to avoid any unpleasantness. They wished to secure the immediate departure of the Taxpayer. The agreement reached was a compromise between the parties whereby the employment relationship was terminated. This specific item was put in as a sweetener in favour of the Taxpayer. The sum in question was paid in consideration of the Taxpayer accepting an outright severance. It was not a sum paid to him pursuant to the terms of his then employment.

5. We are of the view that item 2 falls within the side of the line as delineated by Henley v Murray and D43/93. We would discharge the assessment in relation to that item but confirm the assessment on items 3 & 4.