

Case No. D17/05

Salaries tax – whether or not the payment was in the nature of compensation for loss of rights – sections 8(1), 9(1)(a) & 68(4) of the Inland Revenue Ordinance (‘the IRO’).

Panel: Anna Chow Suk Han (chairman), Peter R Griffiths and Malcolm John Merry.

Date of hearing: 14 April 2005.

Date of decision: 17 May 2005.

By a memorandum dated 9 February 2001 (‘the Memorandum’), the taxpayer was offered by Legal Firm B the position of associate with effect from 9 May 2001 or such earlier date as mutually determined. The Memorandum clearly stated *inter alia* that the job offer did not have a fixed term.

By a letter dated 19 February 2002 from Legal Firm B, the taxpayer was given a 70 days’ notice (longer than 45 days’ prior notice that was originally agreed in the Memorandum) that his employment would be terminated with effect from 1 May 2002. The taxpayer was paid a total of HK\$115,385 equal to five weeks of base pay which Legal Firm B named as ‘separation payment’ (‘the Sum’) in consideration of his continuous services for Legal Firm B for the entire notice period and his waiver of all claims against Legal Firm B.

On appeal, the taxpayer contended that the Sum was a separation/severance payment given to him because of the termination of the employment and not because of the services rendered by him under his contract of employment with Legal Firm B. The Sum, as argued by the taxpayer, was to assist him in the notice period in which he was to seek alternative employment and also to secure from him a waiver of all his claims against Legal Firm B. On the other hand, the Revenue contended that the Sum was not intended to be a compensation to the taxpayer for loss of his employment but was for securing the taxpayer’s services during the entire notice period and should therefore assessable to salaries tax.

The issue before the Board was therefore whether or not the Sum was chargeable to salaries tax.

Held:

1. The Board made clear that how Legal Firm B labeled the payment was not a

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

decisive factor but the nature of the payment was. To be eligible for a severance payment (see section 31B(1) of the Employment Ordinance), an employee must have been employed by the employer for not less than 24 months. In this case, the taxpayer was employed by Legal Firm B for less than 24 months; he was not entitled to a severance payment under the law. Hence, the Sum was not a severance payment.

2. For a sum to be compensation for the loss of right under a contract, the breach of the contract must be identified (Richardson v Delaney followed). The Board found no evidence to support the taxpayer's contention that Legal Firm B was in breach of his contract of employment. On the contrary, during the investigation and at the hearing, the taxpayer admitted that he did not have any claims against Legal Firm B. The Board took a view that there could not be a breach of contract on the part of Legal Firm B for not fulfilling the taxpayer's expectation to be employed for a longer period of time, since the taxpayer's employment with Legal Firm B was one without a fixed term. A longer notice period given could not be construed as a breach of contract by Legal Firm B either, since this was accepted by the taxpayer. Hence, there was no loss of rights of the taxpayer under his contract of employment with Legal Firm B.
3. Accordingly, the Board came to a decision that the Sum was an additional payment to the taxpayer for his services until the expiration of the entire notice period; it was an income from the taxpayer's employment with Legal Firm B and was therefore taxable.

Appeal dismissed.

Cases referred to:

Hochstrasser v Mayes [1960] AC 376
Henley v Murray [1950] 1 All ER 908; 31 TC 351
Mairs v Haughey [1994] 1 AC 303
D16/95, IRBRD, vol 10, 144
D90/96, IRBRD, vol 11, 727
D24/94, IRBRD, vol 12, 195
D167/98, IRBRD, vol 14, 25
D2/99, IRBRD, vol 14, 84
D80/00, IRBRD, vol 15, 715
D87/01, IRBRD, vol 16, 725

Richardson v Delaney [2001] 74 TC 167

Taxpayer in person.

Wong Kai Cheong and Lai Wing Man for the Commissioner of Inland Revenue.

Decision:

1. Mr A ('the Taxpayer') has objected to the salaries tax assessment for the year of assessment 2002/03 raised on him. The Taxpayer claims that a sum of HK\$115,380 paid to him by his employer was compensation for loss of employment and should not be assessable to salaries tax.

2. By a memorandum dated 9 February 2001 ('the Memorandum'), the Taxpayer was offered by Legal Firm B the position of associate with effect from 9 May 2001 or such earlier date as mutually determined. The Memorandum contains, inter alia, the following clauses:

' II. Compensation and Benefits

Your salary shall be the associate level for the class (year of qualification) of 1996, equal to HK\$100,000.00 per month, i.e. HK\$1.2 million per annum

Please also note that your position does not have a fixed term, as it is an "at will" arrangement which can be terminated by either party with or without cause, upon forty-five days prior notice

The Taxpayer accepted the offer.

3. By a letter dated 19 February 2002 ('the First Letter'), Legal Firm B informed the Taxpayer that his employment was to be terminated with effect from 1 May 2002.

4. By another letter also dated 19 February 2002 ('the Second Letter'), the Taxpayer was notified by Legal Firm B of the payment of a separation payment to him, in the following terms:

' We refer to [the First Letter], by which we gave you 70 days' notice of termination of your contract of employment, which notice will expire on April 30, 2002.

In recognition of your efforts in the course of your employment and to assist you in the period in which you are seeking alternative employment, we are offering you a

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

separation payment equal to five weeks of base pay provided that you continue to be employed by the firm for the entire notice period.

Our above offer is subject to and conditional upon you signing the duplicate copy of this letter, to signify your agreement that:

- a. you have no claims against [Legal Firm B] arising out of or in relation to your contract of employment, or its termination; and
- b. you hereby unconditionally waive, abandon and discharge [Legal Firm B] from all and any claim(s) that you have, may have or consider you have arising out of or in relation to your contract of employment or its termination.

.....’

The Taxpayer accepted the terms of the Second Letter on 19 February 2002.

5. Upon the Taxpayer’s termination of his employment with Legal Firm B, Legal Firm B reported to the Inland Revenue Department, inter alia, the payment to the Taxpayer of a sum of HK\$115,385 (‘the Sum’) as back pay, terminal awards and gratuities, etc.

6. The Taxpayer contends that the Sum is not chargeable to salaries tax in that the Sum was paid to him because of the termination of the employment and not because of the services rendered by him under his contract of employment with Legal Firm B.

7. Thus the issue for our determination is whether or not the Sum is chargeable to salaries tax.

8. Before we proceed to consider the issue, there is also the preliminary issue of the late appeal filed by the Taxpayer. By virtue of section 66(1) of the Inland Revenue Ordinance (‘IRO’), no notice of appeal shall be entertained unless it is given within one month after the transmission to the taxpayer the Commissioner’s written determination. By virtue of section 66(1A) of the IRO, the Board may extend the time for filing the notice of appeal if it is satisfied that the appellant was prevented by illness or absence from Hong Kong or other reasonable cause from giving notice of appeal. The Deputy Commissioner’s determination in this case was dated 30 December 2004 and was sent by the Revenue to the Taxpayer by registered post on 30 December 2004. The Taxpayer’s notice of appeal was dated 31 January 2005 and was only received by the Revenue on 3 February 2005. The Taxpayer’s notice of appeal was apparently filed out of time. However there is the record from the Postmaster General that the Deputy Commissioner’s determination was collected over the post office on 5 January 2005. In view of the postal delivery record of the Postmaster General, the Revenue did not oppose the hearing of the appeal. The Revenue has fairly not opposed to the hearing of the appeal. We so extend time for the Taxpayer.

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

9. On the substantive issue, the following statutory provisions apply:

a. 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 from the following sources-

(a) any office or employment of profit;’

b. Section 9(1) of the IRO states 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,’

c. Section 68(4) of the IRO provides that:

‘The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.’

d. Section 6 of the Employment Ordinance [‘EO’] provides that:

‘(1) Subject to, either party to a contract of employment may at any time terminate the contract by giving to the other party notice, orally or in writing, of his intention to do so.

(2) The Length of notice required to terminate a contract of employment shall be –

(a)

(b) in the case of a contract which is deemed by virtue of the provisions of section 5 to be a contract for 1 month renewable from month to month and which makes provision for the length of notice required to terminate the contract, the agreed period, but not less than 7 days;

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

(c) in every other case, the agreed period, but not less than 7 days in the case of a continuous contract.'

e. Section 31B(1) of the EO provides that:

'Where an employee who has been employed under a continuous contract for a period not less than 24 months ending with the relevant date –

a. is dismissed by his employer by reason of redundancy; or

b. is laid off within the meaning of section 31E,

the employer shall, subject to this Part and Part VC, be liable to pay to the employee a severance payment calculated in accordance with section 31G.' (emphasis added)

10. The Taxpayer attended the hearing. There is no dispute between the parties on the facts leading to the payment of the Sum by Legal Firm B to the Taxpayer. The dispute is on the nature of the payment. The Taxpayer contends that the payment of the Sum was a separation payment or a severance payment, that the payment was made because his contract of employment with Legal Firm B was terminated after a short duration, that the Sum was to assist him in the period in which he was to seek alternative employment and that the payment was also to secure from him a waiver of all his claims against Legal Firm B. On the other hand, the Revenue contends that the Sum was not intended to be a compensation to the Taxpayer for loss of his employment but the Sum was for securing the Taxpayer's services during the entire notice period and should therefore be assessable to salaries tax.

11. The Taxpayer produced the following authorities in support of his case:

- (a) Hochstrasser v Mayes [1960] AC 376
- (b) Henley v Murray [1950] 1 All ER 908; 31 TC 351
- (c) Mairs v Haughey [1994] 1 AC 303
- (d) D16/95, IRBRD, vol 10, 144

12. The Revenue produced the following authorities in support of its case:

Boards of Review decisions

- (a) D90/96, IRBRD, vol 11, 727
- (b) D24/97, IRBRD, vol 12, 195
- (c) D167/98, IRBRD, vol 14, 25
- (d) D2/99, IRBRD, vol 14, 84
- (e) D80/00, IRBRD, vol 15, 715

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

(f) D87/01, IRBRD, vol 16, 725

Tax Case

Richardson v Delaney [2001] 74 TC 167

13. The relevant legal principles from the above authorities are as follows:
- a. A payment made on account of compensation for loss of employment or a payment in lieu of or on account of severance pay is not taxable.
 - b. It is not the label, but the real nature of the payment, that is important.
 - c. A finding of a breach of contract must be one which is sustainable on the facts.
14. By the Memorandum, the Taxpayer was offered an employment with Legal Firm B without a fixed term, either party might terminate the employment upon forty-five days prior notice, and the Taxpayer was offered HK\$100,000 per month and a discretionary annual bonus of up to HK\$100,000. The Taxpayer was not entitled to other payments under the Memorandum.
15. By the First Letter, the Taxpayer was given 70 days' notice of termination. By the Second Letter, the Taxpayer was offered a payment equal to five weeks of base pay which Legal Firm B named as a 'separation payment', subject to the conditions that the Taxpayer should continue to work for Legal Firm B for the entire notice period and that he should also waive all claims against Legal Firm B.
16. How Legal Firm B labelled the payment is not a decisive factor but the nature of the payment is.
17. To be eligible for a severance payment, an employee must have been employed by the employer for a period of not less than 24 months. In this instance, the Taxpayer was employed by Legal Firm B for less than 24 months from 9 April 2001 to 30 April 2002. He was not entitled to a severance payment under the law. Thus the Sum was not a severance payment.
18. During the investigation and at the hearing, the Taxpayer admitted that he did not have any claims against Legal Firm B. Consequently, although one of the conditions for the payment of the Sum was described as for waiver of claims, this payment could not be a payment of damages or compensation consequent on a breach of contract on the part of Legal Firm B. The Taxpayer said that it was his expectation to serve Legal Firm B for a long period of time, but Legal Firm B could not be held responsible for a loss of expectation. There could not be a breach of contract on the part of Legal Firm B for not fulfilling the Taxpayer's expectation. As to the other condition that the Taxpayer should continue to work for the entire notice period, Legal Firm B had acted within its rights under the Memorandum to give notice of termination. Although the period of notice was

(2005-06) VOLUME 20 INLAND REVENUE BOARD OF REVIEW DECISIONS

longer than required under the Memorandum, a longer notice given cannot be construed as a breach of the contract on the part of Legal Firm B. Legal Firm B offered the Taxpayer the Sum for him to continue to be employed by Legal Firm B for the entire notice period. The offer was accepted by the Taxpayer. Legal Firm B was acting lawfully by making an offer and coming to an agreement with the Taxpayer. Again Legal Firm B's act in this regard cannot be held as a breach of contract on their part. The sum was paid pursuant to the agreement reached between the Taxpayer and Legal Firm B.

19. For a sum to be compensation for the loss of right under a contract, the breach of the contract must be identified (see Richardson v Delaney). There is absolutely no basis in the evidence for us to come to the conclusion that Legal Firm B was in breach of the contract of employment with the Taxpayer. Consequently there was no loss of rights of the Taxpayer under his contract of employment with Legal Firm B, and the Sum was not paid in the nature of compensation for any loss of the Taxpayer. We are of the view that the payment of the Sum was an additional payment to the Taxpayer for his services until the expiration of the 70 days' notice of termination as contended by the Revenue. The Sum was an income from the Taxpayer's employment with Legal Firm B and is therefore taxable.

20. For the aforesaid reasons, the Taxpayer's appeal is dismissed and the assessment confirmed.