Case No. D24/88

Salaries tax – severance payment – whether taxable – s 9(1)(a) of the Inland Revenue Ordinance.

Salaries tax – sum paid on termination of employment – whether a taxable gratuity or a tax-free severance payment – s 9(1)(a) of the Inland Revenue Ordinance.

Panel: Henry Litton QC (chairman), Robert G Kotewall and P G Willoughby.

Date of hearing: 4 July 1988.
Date of decision: 13 July 1988.

Upon cessation of his employment, the taxpayer received a lump sum of $80,000 from his employer. Of this, $26,667 was attributable to severance pay calculated under the Employment Ordinance, and it was accepted by the IRD that this was not subject to salaries tax.

The IRD assessed the taxpayer on the remaining $53,333 on the basis that this amount constituted gratuities and allowances from his employment which were taxable.

The taxpayer argued that the $53,333 was paid to him as part of a severance package, pursuant to a promise which had been made to him by a director of the employer company when he had commenced his employment eight years earlier. The promise was to the effect that, in calculating his future severance pay, the taxpayer's previous employment of eight years with another company would be taken into account.

Held:

The $53,333 was not subject to salaries tax. It was not income from the taxpayer's employment.

(a) The payment represented a discharge of the director's personal obligation to the taxpayer. The employer had simply made the payment on the director's behalf.

(b) It was unlikely that, in rewarding the taxpayer for his services to the employer over and above the requirements of the Employment Ordinance, the employer would have arrived at an odd figure like $53,333. The $80,000 appeared to have been calculated at the rate of one month's salary ($5,000)

for each of the taxpayer's 16 years of employment with his current and previous employers. It was therefore likely that the $53,333 was paid in respect of the taxpayer's service with his previous employer.

(c) Because the payment was made in discharge of the director's personal obligation to the employee, it was not a payment for services.

Appeal allowed.

Jennifer Chan for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. This appeal concerns the charge to salaries tax on a sum of $80,000 which the Taxpayer received from his employer, Company A, in 1985. This was paid to him upon the cessation of his employment with Company A as its sales manager.

2. In Company A's return to the Inland Revenue Department, made under section 52(5) of the Inland Revenue Ordinance, the sum of $80,000 received by the Taxpayer came under the printed particulars as:

'(f) Back Pay, Terminal Awards, and Gratuities, etc'.

3. In his 1985/86 salaries tax return, the Taxpayer similarly declared the receipt of $80,000 under the heading of 'Back Pay, Terminal Awards, Gratuities, etc'.

4. Not surprisingly, the assessor raised an assessment, in 1986, on the basis that the whole of the $80,000 was chargeable to salaries tax. On the face of the information before the assessor, the $80,000 received by the Taxpayer would appear to be income from his employment as sales manager with Company A, and came within the charge to tax under section 9(1)(a) of the Inland Revenue Ordinance.

5. After the Taxpayer had objected to the assessment, further enquiries were made by the assessor concerning the $80,000. In 1987, the assessor received a letter from Company A to the following effect:

Severance pay	$26,667
Gratuities and allowance	$53,333
Total	$80,000

The letter from Company A went on to say that the $26,667 was computed in accordance with the Employment Ordinance, on the basis of two thirds of his last full month's pay ($5,000), multiplied by the 8 years of his employment with Company A. This letter went on to say that the 'gratuities and allowances' were paid 'at the directors' discretion'.

6. With this information in hand, the assessor proposed to re-assess the Taxpayer's liability by conceding that the 'severance payment' of $26,667 was not subject to tax, and to assess the Taxpayer in respect of the 'gratuities and allowances' of $53,333 by spreading it over a number of years, commencing 1 April 1982.

7. The Taxpayer did not accept the assessor's proposal. The Commissioner determined his objection by adopting the assessor's proposal, and revised the assessment accordingly. It is against this assessment, as revised by the Commissioner's determination, that the Taxpayer now appeals to the Board of Review.

The case for the Taxpayer

8. Ever since he objected to the assessment made in October 1986, the Taxpayer has advanced arguments (in lengthy and sometimes passionate letters) to the Inland Revenue Department to the following effect:

(i) Although his employment as sales manager with Company A was for about 8 years, the $80,000 received by him was in truth a severance payment for 16 years of service. The figure of $80,000 was computed on the basis of his last full month's pay ($5,000) multiplied by 16.

(ii) How this 16 years of service came about was this. His former employer was Company B of which one Mr X was the manager. The Taxpayer first started working for Company B in 1969. Mr X and his wife were both directors and shareholders of Company B and the Taxpayer looked to Mr X as his employer. When Mr X 'resigned from office' and formed Company A, Mr X verbally promised the Taxpayer that his previous nine years' service with Company B would still be 'valid' and would be 'computed' together with his years of service with Company A. Thus, in truth, the $80,000 should be regarded as severance pay and be tax-free.

The hearing

9. At the hearing, the Taxpayer (who was unrepresented) elected to give evidence before us. He substantiated in his testimony the gist of what he stated in his letters of objection to the Inland Revenue Department and elaborated upon his case as follows:

(i) In the jewellery business, the question of personal trust is very important.

(ii) Although his former employer was Company B, he regarded Mr X (the manager) as the 'boss'.

(iii) When, in 1978, Mr X disposed of his shares in Company B and set up Company A, he promised the Taxpayer that his former service with Company B would be taken into account. Mr X wanted the Taxpayer to help him in his new business.

(iv) The Taxpayer relied on Mr X's oral promise and did not seek a termination payment from Company B when he left its employment.

(v) The $80,000 which he received in September 1985, on his cessation of employment with Company A, was simply the redemption of Mr X's oral pledge given to him in 1978.

10. The Taxpayer was not cross-examined upon his testimony, and we accept the truth of his statements. The position as we see it is as follows:

(a) Quite apart from the formal legal relationship which the Taxpayer had with Company A, his employer for the period March 1978 to 30 September 1985, he also had a personal relationship with Mr X. This was based upon mutual trust and confidence.

(b) When, in 1978, Mr X asked the Taxpayer to help him in his new business and promised that his previous service with Company B would be taken into account, this was accepted as a promise binding between man and man. The Taxpayer did not understand Mr X to be formally giving an undertaking on behalf of Company A. The parties were content to leave the matter upon a personal basis. There was nothing in writing which bound Company A, and it is unlikely that the Taxpayer could have brought legal proceedings to enforce such an undertaking against Company A. (No evidence was adduced as to when Company A was incorporated, and we do not know whether it was in existence as a company when the promise was given.)

(c) As far as the Taxpayer was concerned, Mr X did in fact honour his undertaking and the 16 years' service which the Taxpayer had with Mr X was fully taken into account.

11. The crucial issue as we see it in this case is this: was the sum of $53,333 income from employment, within the meaning of section 9(1)(a)? The Commissioner's representative says yes because it was in the nature of gratuities and allowances paid by the Taxpayer's employer Company A, as stated both in the Inland Revenue return and in Company A's letter of 7 April 1987. The Taxpayer says no because the payment made by Company A was simply to discharge Mr X's personal obligation to him, a promise made upon the termination of his service with Company B.

12. A fact which we find of some importance is this: the figure of $80,000 is not a matter of coincidence. It was computed with reference to the Taxpayer's 16 years of service, less than 8 of which were with Company A. If Company A wanted to reward the Taxpayer for his services as sales manager, over and above Company A's legal liability under the Employment Ordinance for severance pay, it was most unlikely that such reward should have come out at the odd figure of $53,333. This goes some way to corroborate the Taxpayer's testimony that it was in recognition of his past service with Company B. One view of the matter may be that, technically speaking, it was ultra vires the powers of Company A to pay to the Taxpayer $53,333 when such payment was unconnected with the Taxpayer's employment with Company A or any services rendered to Company A. In this event, the only way such payment could be properly dealt with in the books of Company A is to account for it as a payment on behalf of its own shareholder, in discharge not of Company A's liability but of Mr X's liability to the Taxpayer.

Conclusion

13. In our view, the sum of $53,333 was not a payment made by Company A on account of the Taxpayer's employment by Company A. It was not income from the Taxpayer's employment with Company A. It was, in the exceptional circumstances of this case, a payment made by the company in discharge of Mr X's personal obligation: in other words, it was not a reward for services.

14. This appeal is therefore allowed, and the assessment of 20 October 1986 is revised by the deduction of the sum of $80,000 from the assessable income.