INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D24/97

Salaries tax – sum payable as per contract on termination of employment – amount of sum payable based on compromise between the parties – whether assessable to salaries tax.

Panel: Audrey Eu Yuet Mee SC (chairman), Michael Choy Wah Ying and John Lee Luen Wai.

Date of hearing: 8 April 1997.
Date of decision: 15 April 1997.

Appeal dismissed.

Cases referred to:

Mairs v Haughey [1993] 3 WLR 393
Hochstrasser v Mayes [1960] AC 376
D13/89, IRBRD, vol 4, 242
D19/92, IRBRD, vol 7, 156
D43/93, IRBRD, vol 8, 323
D90/96, IRBRD, vol 11, 727
D24/88, IRBRD, vol 3, 289
D15/93, IRBRD, vol 8, 350
D32/95, IRBRD, vol 10, 195
David Hardy Glynn v CIR 3 HKTC 245

Yim Kwok Cheong for the Commissioner of Inland Revenue.
Jefferson Vanderwolk of Messrs Deloitte Touche Tohmatsu for the taxpayer.

Decision:

THE APPEAL

1. The Taxpayer objects to the salaries tax assessment for the year of assessment 1993/94. He claims that s um of $1,923,809 ('the Relevant Sum') paid to him on the termination of his employment should not be assessable to salaries tax.

THE FACTS

2. The relevant facts are not in dispute and we find the facts in this section proved.

3. The Taxpayer was initially employed by Bank A, Hong Kong Branch. Clause 3.1 of the terms of employment, a copy of which was provided to us by the Taxpayer, stipulated that Bank A could terminate the employment by giving to the employee one calendar month's notice in writing or on payment of a sum equal to the amount of basic salary which would have accrued to the employee during the period of notice required.

4. In 1991, Bank A was in financial difficulties and was cutting down its operations. Bank B decided to take over Bank A.

5. By a letter dated 3 June 1991 signed by both banks and addressed to the Taxpayer, it was proposed that the Taxpayer's employment be transferred. The employment with Bank A would be terminated on 3 months' notice and Bank B would offer employment on exactly the same terms and conditions (except for one change referred to below) as from 3 September 1991. if the offer was accepted, the Taxpayer's rights would be protected in the same way as if the Taxpayer had continued as an employee of Bank A and the prior service would be treated as service with Bank B for the purposes of calculating his entitlements as an employee with Bank B.

6. The letter went on to say that in addition, without prejudice to any other rights the Taxpayer might have, in the event of him ever being dismissed for any reason other than those set out in section 3.3 in Bank A's terms of employment (summary dismissal for cause), the Taxpayer would be entitled to a payment equal to the sum of his last full month's salary and benefits multiplied by the greater of:

(a) twelve;

(b) the number of years employment under a continuous contract (prior service with Bank A being counted for this purpose and part of a year being taken into account pro rata)

(c) (if the dismissal occurs before 3 September 1993), the number of full month's (sic) from the date of dismissal to 3 September 1993.

We shall call this the relevant clause. Payment under the relevant clause was on top of any entitlement to payment in lieu of notice.

7. The Taxpayer indicated his acceptance by signing and returning a copy of the letter. It became the letter of employment.

8. By a letter dated 9 November 1993, Bank B informed the Taxpayer that, as a result of the re-definition of its operations in Hong Kong, it was no longer in a position to employ him. Accordingly Bank B gave him notice commencing from 9 November (the date of the letter) and expiring on 28 February 1994 in accordance with Clause 3.1 of the

conditions of employment with Bank B. That was probably a reference to clause 3.1 of Bank A's terms of employment providing for termination on one month's notice.

9. Paragraph 3 of the letter of termination says that in addition to the salary payable and entitlement to benefits in respect of the notice period, Bank B would make a severance payment in accordance with the letter of employment dated 3 June 1991. A statement of the severance payment giving details of its computation would be given in due course to the Taxpayer.

10. By a letter dated 26 January 1994 from Bank B to the Taxpayer, a statement of final payment was enclosed. The Taxpayer had worked for 15 years and 5 months, this worked out to a factor of 15.4167. The last month and benefits were set out and the total severance pay was said to come to $1,728,325.72. The Taxpayer and Bank B could not agree on the sum. There was no dispute on the factor of 15.4167. There was also no dispute over the last month's salary. Essentially the dispute was what would or would not be counted as the last month's benefits which would have to be multiplied by the agreed factor representing his length of service.

11. There were several rounds of correspondence between the solicitors on both sides. By a letter dated 3 March 1994 from Solicitors C, for the Taxpayer, to Solicitors D, for Bank B, it was stated that the Taxpayer was prepared to accept the severance payment of $1,923,809 as what he was clearly entitled under the terms and conditions of his employment. He would sign a statement setting out all payments to him and acknowledging that he had no further claims against Bank B in respect of severance payment. In reply, by a letter dated 14 March 1994 from Solicitors D to Solicitors C, the sum of $1,923,809 was paid in full and final settlement of all or any rights or claims the Taxpayer had or might have in respect of his former employment with Bank B. In accepting the sum, the Taxpayer expressly waived any such claim or rights or released Bank B, its directors and employees from all or any liability in that regard. Bank B made clear that it admitted no liability to pay the sum and that the proposal was accepted not as acceptance of the Taxpayer's interpretation of his rights but as an amicable compromise of those issues in dispute.

12. Eventually, Bank B filed a notification to the Inland Revenue declaring the $1,923,809 as severance payment made to the Taxpayer.

13. The Taxpayer says that the Relevant Sum of $1,923,809 is not chargeable to salaries tax.

THE EVIDENCE

14. The Taxpayer gave evidence. He said that he was not induced to enter into employment with Bank B because of the relevant clause for extra payment on termination. At the time, the Bank A's staff looked upon Bank B as the white knight. It was strongly capitalized and they were looking forward to better bonus based on performance. He also explained that the Relevant Sum did not represent his full entitlement under the relevant clause. There were still a number of elements in his benefits which were not fully reflected

in the calculation. He accepted a lesser amount because of the legal fees, the time and the pressure that it would entail if he had to go on fighting to the end. He needed to get on with his life. However, if Bank B did not offer to compromise, he would have sued. He agreed that the Relevant Sum stemmed from the letter of employment. His evidence was not challenged.

THE DETERMINATION

15. The Commissioner of Inland Revenue found that section 8(1)(a) of the Inland Revenue Ordinance (chapter 112)(the IRO) does not restrict income from employment to that for services rendered. He had regard to the fact that the termination clause was agreed in the letter of employment. The Taxpayer was paid according to that clause, he lost no rights. In the circumstances, the assessment was upheld.

THE TAXPAYER'S CASE

16. Mr Vanderwolk for the Taxpayer argues that:

(a) the relevant clause did not induce the Taxpayer to enter into the contract of employment;

(b) the Relevant Sum was not paid under a term in the contract but was paid in return for the Taxpayer's agreement to waive any and all claims he had or might have had against Bank B;

(c) even if the Relevant Sum was paid under contract, it was not income from employment under the principles applied by the House of Lords in Mairs v Haughey [1993] 3 WLR 393.

THE REVENUE'S CASE

17. The Revenue says that the label of a payment is inconclusive, the only question is whether the payment was or was not income from employment. Income was widely defined and includes a lump sum.

18. The Revenue says that 'breach of contract' or 'compensation' has no relevance to this case. The Taxpayer's employment was discharged by proper notice. The Taxpayer did not suffer a loss which entitled him to compensation. The Relevant Sum was paid pursuant to the employment contract. Bank B's unilateral disclaimer of liability in paying the Relevant Sum could not change the real nature of the sum determined by the overall objective circumstances. Such objective circumstances showed that the Relevant Sum was paid to the Taxpayer as an employee. It was not a gift or compensation for loss.

19. It was not very clear to us what position the Revenue was adopting in relation to the House of Lords decision of Mairs v Haughey. The hearing was adjourned to enable both parties to put in further written submissions. Such further submissions were received

from both parties. The Revenue submits that on the facts, the nature of the Relevant Sum is very different from the nature of the redundancy payment as analysed by Lord Woolf in Mairs v Haughey. On the law, the provisions are also different in both jurisdictions. Thus the English case should not be applied in determining whether the Relevant Sum should be chargeable to salaries tax.

THE LAW

20. Section 8(1) of the IRO (chapter 112) provides:

> *'(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 the following sources-*
>
> *(a) any office or employment of profit; and*
>
> *(b) any pension.'*

The key is whether the Relevant Sum was or was not 'income arising in or derived from employment'.

21. 'Income from any office or employment' is very widely defined in section 9. It is also important to point out that the definition is not exhaustive. Income *includes* but is not limited to what is stated in section 9.

22. In Hochstrasser v Mayes [1960] AC 376, the House of Lords was faced with a housing scheme whereby employees who had to be transferred would be compensated for their capital loss on the sale of their house. It was held that in order to be taxable, a payment must be made with reference to services the employee rendered by virtue of his office, and it must be something in the nature of a reward for services past, present or future. Although the fact of employment was the causa sine qua non, it was not the causa causens of the payment. Thus the payment did not raise therefrom and was not taxable.

23. In D13/89, IRBRD, vol 4, 242 the Board of Review in referring to the Hong Kong charging provisions said this:

> *'These words are very wide, and in construing section 8(1) effect have to be given to them. There is in our view no room for reading into section 9(1) some implied limitation such as 'provided that the income is received by him in the nature of a reward for services past, present or future' or 'provided that the payment is made in reference to the services the employee renders by virtue of his office' (these are the words of qualification quoted in the judgment of Upjohn J in the **Hochstrasser** case). To do so is to read into the statute words which are simply not there.'*

In that case, the taxpayer received a removal allowance. The Board found that the taxpayer *'received the allowance because he was entitled to do so under the terms of his employment. Whilst the removal had nothing to do with his services qua employee, the allowance was nevertheless paid with reference to his position as employee and had the effect of enhancing the package of remuneration he received from his employer'.*

24. In D19/92, IRBRD, vol 7, 156, the Board of Review said section 9 was not an exhaustive definition but merely a list of items which are included. Whether or not a sum falls within one of those items does not answer the question whether or not its source was the employment. That is what section 8 says it must be if it is to come within the charge of salaries tax. It went on to say that the *source* of something is a matter of fact and not of law. In that case, the payment was an inducement to enter into the contract and a relocation allowance. The *source* was the employment contract and the payment was thus correctly assessed to salaries tax.

25. In D43/93, IRBRD, vol 8, 323, the employer wanted to terminate the employment contract without waiting for the requisite 9 months and then giving 3 months' notice. So a termination package was negotiated and this included a severance payment. The Board distinguished D19/92, IRBRD, vol 7, 156 and found that the real nature of the payment was compensation for loss of office. It was a payment which the employer agreed to make as compensation to the taxpayer in order to bring his employment to a premature end. The distinction was explained as follows:

> *'This appeal is significantly different from D19/92 because this payment neither arose out of the employment contract of the Taxpayer nor was it in return for services rendered by the Taxpayer to his employer. It was the opposite. It was a payment made to terminate the contractual obligations of the employer and to compensate the Taxpayer for what would otherwise have been a breach of contract. In such circumstances the severance payment is not assessable to salaries tax.'*

26. In D90/96, IRBRD, vol 11, 727 the employment contract provided that in the event of the taxpayer's position becoming redundant, the company would offer the option of either payment equivalent to one year earnings or a transfer to a suitable position elsewhere in the corporation subject to a suitable position being available. The Board found that the redundancy provision was inserted in return for the taxpayer acting as employee for the employer. The entire provision was designed as an inducement to the taxpayer to leave her original employment and join the employer. It was in the nature of a reward for services to be rendered in future. It was a perquisite and taxable as such.

27. In England, tax shall be charged in respect of any office or employment on emoluments therefrom and emoluments shall include all salaries, fees, wages, perquisites and profits. In Mairs v Haughey, the taxpayer was employed by a publicly owned firm and enjoyed contingent rights in a non statutory enhanced redundancy scheme. When agreement was reached for the privatisation of the firm, the employees were to be transferred to a new company. Under the new terms, the employees would give up their

rights under the enhanced redundancy scheme in return for certain payments. The House of Lords accepted that the payments were paid in consideration of the employee's acceptance of the new terms and the termination of the enhanced redundancy scheme and not as an inducement to them to become or remain employed by the new company. Redundancy payment was not emolument from employment but compensation to the employee for his no longer receiving emoluments from the employment. A payment made in satisfaction of a contingent right to a payment took its character from the nature of the payment that it replaced and that the sum paid to the taxpayer in lieu of his right to receive a redundancy payment was not chargeable to tax.

28. It is also pertinent to point out that the Commissioner of Inland Revenue accepts that redundancy payments and long service payments made under the terms of the Employment Ordinance are not taxable, see D24/88, IRBRD, vol 3, 289, D15/93, IRBRD, vol 8, 350 and D32/95, IRBRD, vol 10, 195.

29. Mr Vanderwolk for the Taxpayer also cited to us articles written by Mr A J Halkyard, one of the Deputy Chairmen of the Board of Review, in the New Gazette. Mr Halkyard commented that many recent Board of Review cases have taken a very tough line on the liability to salaries tax of pre-retirement and redundancy gratuities. The key to liability is the nature of payment and whether it is made in return for acting as or being an employee. Many types of termination and retirement payments would not satisfy this condition. He appeared to be dealing with gratuitous rather than contractual termination benefits.

THE DECISION

30. We have carefully considered all the oral and written evidence and submissions urged upon us. We shall deal with the three main submissions of the Taxpayer.

31. Although the Taxpayer gave evidence claiming that he was not induced to enter into the employment on account of the relevant clause for extra payment on termination, we do not feel able to rely on such evidence. That is not to say we disbelieve him. We do not feel it open to this tribunal to go into the subjective view of the parties to any contract. There are bound to be differences of opinion between different employees and it would be impossible to judge, after the event, as to which clause induced which employee. Such varying subjective feelings cannot make a difference to the nature of the payment or the legal result. The reality is that the clause was part of the contractual package and, save in the case of clear objective circumstances to the contrary, must be deemed to have induced the employee. Payment under the relevant clause was without prejudice to other rights of the employee. Limb (c) of the relevant clause ensured that if the Taxpayer was dismissed shortly after the transfer, he would have received a payment based on the number of months from the dismissal to 3 September 1993. The earlier he was dismissed, the more he would have received until a time when the factor under limb (b) would exceed the factor under limb (c). Thereafter the longer he worked, the greater would be the multiplier. In the premises, we find that the relevant clause was an inducement to the Taxpayer to enter into employment with Bank B and to stay in that employment.

32. It is true that the determination did not mention the waiver and the compromise. However, it is clear that the Relevant Sum was paid under the relevant clause in the letter of employment. That set out a formula for payment. Mr Vanderwolk for the Taxpayer accepted that if the clause had specified an amount and his client was paid the specified amount, it would have been a contractual payment. But he argued that if the clause set out a formula for payment and there was disagreement over the amount payable under the formula, a compromise on the amount payable under the formula would have made a difference. That cannot be right. This is not a waiver or a compromise on a breach of agreement or a claim for wrongful dismissal. Bank B was entitled to terminate the Taxpayer's employment on the basis of the relevant clause. It is clear that the termination was under that clause and payment was due under that clause. The dispute as to the amount cannot change the nature of the payment. If the original entitlement under the contract is taxable, it does not become non taxable because the parties reached a settlement on the amount payable.

33. Before we turn to the last question, whether non statutory severance payment is taxable or not, we should first point out that the clause in the letter of employment is not limited to dismissal on account of redundancy. Subsequent labelling of the Relevant Sum as severance payment cannot change the nature of the payment. Bank B could dismiss the Taxpayer without cause by giving the requisite notice (be it 1 or 3 months) and by paying the amount under the formula. The Taxpayer had a contingent right. Nothing would be payable under the clause if the Taxpayer was summarily dismissed for cause, resigned or retired or died without being dismissed. But the longer he worked, the greater would be the chance of a larger payment under the clause. The monthly salary and the benefits would have increased and the number of years of employment under a continuous employment would also have increased.

34. **Mairs** is highly persuasive authority. The United Kingdom statutes on salaries tax are not the same as the Hong Kong provisions. In D13/89, the Board said that we have to be careful in applying case-law from overseas such as Hochstrasser v Mayes which deals with a different statutory scheme. In D19/92, we were again reminded that United Kingdom tax law was very significantly different from that of Hong Kong. The United Kingdom has a more comprehensive system of taxation. Though it may be possible to draw threads of principle from the United Kingdom cases, it is necessary very carefully to analyse each and every one to see whether or not the threads of principle are based upon United Kingdom tax concepts which are foreign to our system of tax law. In David Hardy Glynn v CIR 3 HKTC 245 Lord Templeman referred to the Court of Appeal's inhibition in applying United Kingdom authorities to the Hong Kong definitions of 'salary' and 'perquisite' and said:

> *'That statement does not however prevent the application of the logical and sensible principle that expressions employed in British legislation and authorities on the meaning of such expressions are of assistance in construing identical expressions in Hong Kong legislation concerned with the same subject matter.'*

It is argued by the Taxpayer that **Mairs**, a case on non statutory redundancy payment, is on the same subject matter. **David Hardy Glynn** turned on the meaning of terms which appear in the Hong Kong Ordinance as well as the Income Tax Act. We are concerned with a different problem.

35. There appears to us to be two different approaches. The wider approach is that adopted by the Board of Review in D13/89 as referred to in paragraph 23 above. We should not read into the legislation implied limitation such as '*provided that the income is received by him in the nature of a reward for services past, present or future*'. We do not need to know if the payment might have been for compensation for loss of the employment or a reward for services rendered in the past or as an inducement to continue with the service during the employment. Indeed it could be for a combination of one or more of those reasons. All we need to know is that the payment was *sourced* from the employment. It was not gratuitous. It arose from a clause in the letter of employment. It was contractual. It was without prejudice to any other rights of the employee. **Mairs**, which dealt with whether a redundancy payment was an emolument from employment, a term which does not appear in our legislation, does not assist on the facts of this case. If we adopt the wider approach, there can be no doubt that the Relevant Sum derived in or arose from the employment and was taxable.

36. The narrower approach is that adopted in **Hochstrasser** or **Mairs**. Adopting this approach, we have to examine the reason for the payment and be satisfied that the payment was to the employee for services and not as compensation for loss of employment. There is some support from section 8(1A) of the IRO which defines income arising in or derived from Hong Kong as income derived from *services* rendered in Hong Kong. This does suggest that income ought to be referable to services past, present or future, although the opening words do provide that this is without limiting the meaning of the general expression.

37. If we adopt the narrower approach, we find that the relevant clause was an inducement for the Taxpayer to enter into the employment and to continue in that employment. Under section 68(4) of the IRO the onus is on the Taxpayer to persuade us that the assessment is incorrect. The Taxpayer has failed to discharge that onus.

CONCLUSION

38. For reasons given, we dismiss the appeal accordingly.