

**Case No. D28/05**

**Salaries tax** – gratuity payment – severance payment – section 31B(1) and (2), 31D, 31I, 31IA and 31Q of the Employment Ordinance(‘EO’) – sections 8(1) and 9(1) of the Inland Revenue Ordinance (‘IRO’).

Panel: Patrick Fung Pak Tung SC (chairman), Peter Sit Kien Ping and David Wu Chung Shing.

Date of hearing: 9 May 2005.

Date of decision: 29 June 2005.

The taxpayer appealed and argued that the gratuity sums he received upon completion of his First Contract (First Gratuity) and termination of his Second (a renewal of the First) Contract (Second Gratuity) qualified as ‘severance payments’ to which he was entitled under the Employment Ordinance and hence should have been exempt from tax.

**Held:**

1. The adopted labels ‘gratuity’ or ‘severance payment’ are not conclusive. It is the true nature of such payment, determined by looking at the terms of the contract and the character of the payment made under it that is relevant.
2. As there had been contract renewal, i.e. the Second Contract, which took immediate effect upon the ending of the First Contract, the First Gratuity was not a severance payment but a gratuity to which the taxpayer was entitled under the First Contract (section 31B(1) and (2), 31Q and 31D of EO).
3. The aggregate of the First Gratuity and the Second Gratuity effectively reduced, by the operation of section 31I of EO, the severance payment entitled of by the taxpayer, at the end of his employment under the Second Contract on 31 March 2001 to nil. Hence the Second Gratuity was also not a severance payment.
4. Section 31IA of EO is not applicable to the present case.

**Appeal dismissed.**

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Cases referred to:

D90/96, IRBRD, vol 11, 727  
D24/97, IRBRD, vol 12, 195  
To Kin Wah v Shiu Hing Co Ltd [1985] 1 HKC 239  
Wan Hung Shu v Li Chun Yam [1993] 2 HKC 714  
Tsang Sau Yue and Another v Lucci Creation Ltd (DCCJ 379 of 2003, unreported decision of DJ Marlene Ng dated 16 March 2004)  
D81/01, IRBRD, vol 16, 671  
D131/00, IRBRD, vol 16, 1  
D151/00, IRBRD, vol 16, 101  
D51/01, IRBRD, vol 16, 451  
D10/04, IRBRD, vol 19, 116  
D110/03, IRBRD, vol 19, 44

Taxpayer in person.

Tang Hing Kwan and Yeung Siu Fai for the Commissioner of Inland Revenue.

**Decision:**

**The appeal**

1. This is an appeal by the Taxpayer against two notices of assessment and demand for salaries tax and additional salaries tax for the year of assessment 2000/01 issued by the Respondent ('the Commissioner'). An objection was lodged by the Taxpayer. By a letter dated 21 February 2005, the Commissioner acting by her deputy made a determination ('the Determination') whereby she:

- (i) confirmed the salaries tax assessment dated 25 September 2001 showing net chargeable income of \$1,353,295 with tax payable thereon in the sum of \$219,560 and
- (ii) revised the additional salaries tax assessment dated 11 April 2002 downwards to additional net chargeable income of \$35,871 with tax payable thereon in the sum of \$6,098.

The Taxpayer has brought this appeal against the Determination.

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2. The basic facts of the case are set out in detail in the Determination and are not in dispute. We will not repeat the same save as to set out below those facts which are directly relevant to this decision.

**The relevant facts**

3. By a letter dated 23 January 1998 ('the First Contract'), Company A offered the Taxpayer an appointment as Resident Engineer for a term of 36 months commencing on 2 February 1998. Clause 3 of the First Contract provided for the payment of gratuity in the following terms:

'3. Gratuity On satisfactory completion of the full period of engagement required by this letter, or if your service is terminated under paragraph 12.1 of this letter and for reasons other than misconduct, you will receive a gratuity for the period of service including vacation leave taken within the agreement. Such gratuity will be payable at the rate of 25% of total basic salary drawn during the engagement period.'

The Taxpayer accepted the offer on 6 February 1998.

4. On 6 February 2001, Company A paid a gratuity of \$659,272.50 ('the First Gratuity') to the Taxpayer in respect of the First Contract.

5. By a memorandum dated 9 March 2001 ('the Memorandum'), Company A reminded the Taxpayer of his employment position in the following terms:

'Up to todate, we still have not received your signed copy of our appointment offer letter Ref. [xxxxxxxxxxx] dated 29 January 2001 to extend your contract end date to 1 June 2001.

...

I would like to remind you that you are still working in the captioned project and receiving salary payment and other benefits after the contract completion date on 1 February 2001, it implies that you are undertaking our extension offer even you did not return your signed letter to us. ...'

Shortly after the Memorandum and upon review, Company A informed the Taxpayer that it would offer to extend his employment under the First Contract to 31 March 2001 instead of the previously planned extension to 1 June 2001.

6. By a letter dated 19 March 2001 ('the Second Contract'), Company A offered to extend the Taxpayer's employment under the First Contract to 31 March 2001 on the same terms

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and conditions of the Taxpayer's employment under the First Contract, except that Clause 3 of the Second Contract was in the following terms:

- '3. Gratuity      On satisfactory completion of the full period of engagement required by this letter, or if your service is terminated under paragraph 12.1 of your appointment letter and for reasons other than misconduct, you will receive a gratuity for the period of service.

Such gratuity will be payable at a rate of 25% of the total basic salary drawn from the first day of the engagement period up to a date immediately before section 7A of the Mandatory Provident Fund (MPF) Scheme Ordinance (Cap. 485), as amended by the Provident Fund Schemes Legislation (Amendment Ordinance) 1998 ("Amendment Ordinance"), comes into effect, or the end of this agreement, whichever is earlier.

Starting from the commencement date of section 7A of the Ordinance, as amended by the Amendment Ordinance, [Company A] will make a monthly contribution in respect of you to a scheme registered under the MPF Schemes Ordinance for the remainder of this agreement at the statutory contribution rate (i.e. 5% of your monthly relevant income or \$1,000 whichever is the less).

The gratuity payable for the remainder of this agreement will be the sum which, when added to [Company A's] contribution to the said MPF Scheme, equals 25% of the total basic salary drawn during that period.'

The Taxpayer accepted the offer on 26 March 2001.

7.            Upon completion of the Second Contract on 31 March 2001, the Taxpayer ceased employment with Company A.

8.            On 25 May 2001, Company A paid a gratuity of \$35,248.44 ('the Second Gratuity') to the Taxpayer in respect of the Second Contract.

**The issue**

9.            The issue in this case is whether the First Gratuity and the Second Gratuity qualify as 'severance payments' and are therefore exempt from tax.

**The law**

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10. Section 8 (1) of the Inland Revenue Ordinance ('the IRO') provides as follows:
- '(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 from the following sources –*
- (a) any office or employment of profit and*
- (b) any pension.'*
11. The relevant part of section 9(1) of the IRO provides as follows:
- '(1) 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 ...'*

12. It is settled law that labels such as 'gratuity' or 'severance payment' are not conclusive. One must look at the terms of the contract and the character of a payment made under it in order to determine the true nature of such payment. See decisions of the Board in D90/96, IRBRD, vol 11, 727 and D24/97, IRBRD, vol 12, 195.

13. The Commissioner has however made a concession in interpreting the various statutory provisions and as a result severance payments and long service payments are expressly declared to be not subject to tax ('the Concession'). On the Inland Revenue Department website, the following passage appears under the heading 'The Scope of the Charge' in relation to salaries tax:

**'The Scope of the Charge**

This tax is imposed on all income arising in or derived from Hong Kong from an office or employment or any pension.

"Income arising in or derived from Hong Kong", without in any way limiting the meaning of the expression, includes all income derived from services rendered in Hong Kong.

Special provisions apply to seamen, airmen and other persons who visit Hong Kong for short periods and also to those who have paid tax of substantially the same nature as Hong Kong Salaries Tax in any territory outside Hong Kong.

Income includes, inter alia, the value of **quarters** provided rent free by an employer or the excess of this value over the rent actually paid by the employee to his employer for the quarters. The value of quarters to be included in assessment is 10% [8% and 4% for not more than 2 bedrooms and 1 bedroom respectively in a hotel, hostel or boarding house] on total income (after deducting outgoings, depreciation, etc.) from the employer or any person associated with the employer. Where an employer refunds all or part of the rent paid by an employee, the place of residence is deemed to have been provided by the employer either rent free or for an amount equal to the difference between the rent paid and the amount refunded.

Income also includes, inter alia, any gain realized by the exercise of, or by the assignment or release of, **a right to acquire shares**, whether the shares are in the employing company or another.

**Severance payments and long service payments** that are required to be paid under the Employment Ordinance are not assessable to Salaries Tax, as they are not payments for services rendered but for termination of the employment. Any payment in excess of the amount computed in accordance with the Employment Ordinance may be subject to Salaries Tax.

As from 1 April 2003 onwards, any amount paid by an employer in connection with a holiday is taxable. For details, please click [here](#).

### **The case of the Taxpayer**

14. The Taxpayer argues that the First Gratuity and the Second Gratuity are in fact severance payments to which he was entitled under the Employment Ordinance ('the EO') and that he is exempt from tax liability in respect of the same by reason of the Concession.

### **Our finding**

15. We have come to the conclusion that the First Gratuity and the Second Gratuity do not qualify as 'severance payments'. We set out our reasons below.

16. Section 31B(1) and (2) of the EO provide as follows:

#### ***'31B. General provisions as to right to severance payment***

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

(a) *is dismissed by his employer 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.*

(2) *For the purposes of this Part an employee who is dismissed shall be taken to be dismissed by reason of redundancy if the dismissal is attributable wholly or mainly to the fact that –*

(a) *his employer has ceased, or intends to cease, to carry on the business –*

(i) *for the purposes of which the employee was employed by him; or*

(ii) *in the place where the employee was so employed; or*

(b) *the requirements of that business for employees to carry out work of a particular kind, or for employees to carry out work of a particular kind in the place where the employee was so employed, have ceased or diminished or are expected to cease or diminish.’*

17. Section 31Q of the EO provides as follows:

***‘31Q. Presumption***

*For the purposes of this Part an employee who has been dismissed by his employer shall, unless the contrary is proved, be presumed to have been so dismissed by reason of redundancy.’*

18. There is no definition as such of the word ‘redundancy’ in the EO. The authorities are, however, clear that ‘dismissal by reason of redundancy’ means that it is not ‘dismissal for cause’. See, for example, the cases of To Kin Wah v Shiu Hing Co Ltd [1985] 1 HKC 239, Wan Hung Shu v Li Chun Yam [1993] 2 HKC 714 and Tsang Sau Yue and Another v Lucci Creation Ltd (DCCJ 379 of 2003, unreported decision of DJ Marlene Ng dated 16 March 2004).

19. Section 31D of the EO provides as follows:

*31D. Dismissal by employer*

- (1) *For the purposes of and subject to this Part, an employee shall be taken to be dismissed by his employer if, but only if—*
  - (a) *the contract under which he is employed is terminated by the employer with or without notice or payment in lieu thereof other than in accordance with section 9;*
  - (b) *where under that contract he is employed for a fixed term, that term expires without being renewed under the same contract; or*
  - (c) *the employee terminates that contract with or without notice or payment in lieu, in circumstances such that he is entitled to terminate it without notice or payment in lieu in accordance with section 10 by reason of the employer's conduct.*
- (2) *An employee shall not be taken for the purposes of this Part to be dismissed by his employer if—*
  - (a) *his contract of employment is renewed, or he is re-engaged by the same employer under a new contract of employment; and*
  - (b) *the renewal or re-engagement takes effect immediately on the ending of his employment under the previous contract.'*

20. It is clear therefore that, at the time the First Gratuity was paid, that is, 6 February 2001, the Taxpayer was not entitled to any severance payment because his contract of employment was renewed and such renewal took effect immediately on the ending of his employment under the previous contract. Hence, the First Gratuity represented a gratuity to which the Taxpayer was entitled under the First Contract but did not include any severance payment.

21. At the end of his employment under the Second Contract on 31 March 2001, the Taxpayer was entitled to be paid a severance payment pursuant to section 31B(1) of the EO for the period between 2 February 1998 and 31 March 2001 to be calculated in accordance with the formula set out in section 31G of the EO as follows:

$$\$22,500 \times \frac{2}{3} \times \frac{358}{365} = \$47,383.56$$



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22. Section 31I of the EO provides as follows:

***‘31I. Severance payment to be reduced by amount of gratuities and benefits in certain cases***

*If an employee becomes entitled to payment of a severance payment under this Part and –*

*(a) because of the operation of the employee’s contract of employment, one or more gratuities based on length of service of one or more relevant occupational retirement scheme benefits have been paid to the employee; or*

*(b) a relevant mandatory provident fund scheme benefit is being held in a mandatory provident fund scheme in respect of the employee, or has been paid to or in respect of the employee,*

*the severance payment is to be reduced by the total amount of all of the gratuities and benefits to or in respect of the employee to the extent that they relate to the employee’s years of service for which the severance payment is payable.’*

23. The First Gratuity and the Second Gratuity add up to a total of \$694,520.94. The severance payment to which the Taxpayer would have been entitled to was \$47,383.56. By the operation of section 31I of the EO, the latter had been reduced to nil.

24. Our conclusion on the facts is in accordance with the factual situation as shown by the contemporaneous record, including the following:

- (i) a calculation sheet by Company A relating to the First Gratuity;
- (ii) a bank pay-in slip relating to the payment of the First Gratuity;
- (iii) a memo by Company A to the Taxpayer dated 9 March 2001;
- (iv) the Second Contract;
- (v) a calculation sheet by Company A relating to the Second Gratuity;
- (vi) a bank pay-in slip relating to the payment of the Second Gratuity and

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(vii) a letter from Company A to the Labour Department dated 23 June 2004.

25. Our decision on the law, in particular, regarding the application of section 31I of the EO is in accordance with a line of well-established authorities in previous decisions by the Board (which were variously constituted), including the following: Cases Nos D81/01, IRBRD, vol 16, 671, D131/00, IRBRD, vol 16, 1, D151/00, IRBRD, vol 16, 101, D51/01, IRBRD, vol 16, 451, D10/04, IRBRD, vol 19, 116, D110/03, IRBRD, vol 19, 44.

26. We wish to emphasise that, as was made clear in the said previous decisions, each case must be decided on its own facts, especially the terms of the employment contracts involved in each particular case.

27. In the present case, an application of section 31I of the EO to the facts logically produces the result we have arrived at.

28. Our attention has been drawn to section 31IA(1) of the EO which provides as follows:

**‘31IA. *Gratuity or benefit to be reduced by amount of severance payment in certain cases***

*(1) If—*

*(a) because of the operation of the employee’s contract of employment, an employee has become entitled to payment of a gratuity based on length of service, or to payment of a relevant occupational retirement scheme benefit; or*

*(b) a relevant mandatory provident fund scheme benefit is being held in a mandatory provident fund scheme in respect of the employee,*

*and the employee has been paid a severance payment under this Part, the gratuity or benefit is, to the extent that it is attributable to the same years of service as those for which the severance payment is payable, to be reduced by the whole amount of the severance payment.’*

The subsection seems to deal with the reverse situation from that dealt with by section 31I. It was expressly addressed by Mr David Wu Chung Shing, the dissentient member of the Board which decided Case No D51/01 and a member of the Board hearing the present appeal.

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29. We have decided that on the facts of the present case, section 31I of the EO applies but not section 31IA. We feel that we should not express any opinion **obiter** as to under what circumstances section 31IA would apply. We prefer to leave it to another Board to deal with it should other factual situations arise making it appropriate to consider the application of section 31IA.

30. In view of the number of similar cases which have arisen on appeal to the Board of Review, we also raise the question as to whether the Commissioner might feel that it would be of benefit to the public for the explanation about exemption from tax of severance payments and long service payments to be elaborated upon on the Inland Revenue Department website.

**Conclusion**

31. In the result, we dismiss the Taxpayer's appeal and confirm the Determination by the Commissioner.