

Case No. D34/06

Salaries tax – severance pay or special retention bonus – concession to exempt statutory severance payments – section 8(1) of the Inland Revenue Ordinance ('IRO') – section 31G(1) of the Employment Ordinance.

Panel: Jat Sew Tong SC (chairman), Eric T M Kwok SC and Dieter Yih.

Date of hearing: 21 February 2006.

Date of decision: 6 July 2006.

The employer of the taxpayer, the Hong Kong branch of a Japanese bank, decided to close the Branch and, in order to urge its employees to stay with the Branch until its closure, offered to its then employees, including the taxpayer, a special retention bonus. Before concluding the terms of the special retention bonus, the Assistant General Manager of the Branch enquired with the IRD as to whether the IRD would accept as non-taxable 'severance payments' equal to one month's salary per year of employment without set-off against the employer's portion of provident fund entitlement under the Provident Fund Scheme of which the taxpayer was a member. The AGM was told by an officer of the IRD that there would be 'no problem' with such payments.

In the notice of the taxpayer's cessation of employment filed by the Branch it was declared that the taxpayer received 'severance pay' in the Sum A. The taxpayer in her tax returns did not declare Sum A as she was under the belief that the same was not taxable income. The 'Calculation of Severance Pay to Employee' prepared by the Branch stated that Sum A had been paid to the taxpayer due to closure of the Branch. Further, in a letter from the Bank providing information to the IRD, Sum A was described as 'severance pay compensating [the ex-staff's] loss of employment'.

The assessor followed D73/04 and assessed 6/10 of Sum A as the taxpayer's taxable income. The Commissioner upheld the determination and the taxpayer appealed contending that Sum A was in the nature of 'severance pay' and thus not taxable. She also raised an argument that the IRD had not treated her case fairly and was forced to accept a settlement with the IRD on fear of costs consequences and also due to the stress of litigation. The Commissioner contended that under the IRO there is no exemption for 'severance payment' paid in accordance with the provisions of section 31G(1)(a) of the Employment Ordinance but as a matter of concession, the Revenue would exempt statutory severance payments from salaries tax, any amount in excess of the statutory severance payment would be taxable. The main point at issue was whether Sum A

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received by the taxpayer upon termination of her employment is assessable income for the purpose of salaries tax under section 8(1) of the IRO.

Held:

1. This Board was of the view that the principles to be applied in determining whether a payment received by an employee upon termination of service is taxable under section 8(1)(a) of the IRO are those summarised in D80/00. Applying those principles, and having considered all the evidence in the round, the Board came to the conclusion that the true nature of Sum A was compensation paid to the taxpayer for the loss of her employment and non-taxable. The label ‘special retention bonus’ rather than ‘severance pay’ used was not determinative. It was very clear that the common intention of both the employer and the employees was that the employees should receive ‘severance pay’ of one month per year of service, without set-off against the employer’s contribution to the Scheme.
2. The Board observed that the ‘concession’ as contended by the Commissioner, that is, that the IRD would only treat the statutory amount of severance pay as non-taxable, did not appear to have been consistently applied.
3. The Board did not consider it necessary to consider the taxpayer’s ‘fairness’ argument.

Appeal allowed.

Cases referred to:

B/R 94/02 (reported D107/02, IRBRD, vol 18, 32)
D126/02, IRBRD, vol 18, 188
D80/00, IRBRD, vol 15, 715
D73/04, IRBRD, vol 19, 571
D24/97, IRBRD, vol 12, 195
D37/05, IRBRD, vol 20, 563

Taxpayer in person.

Wong Kai Cheong for the Commissioner of Inland Revenue.

Decision:

Introduction

1. The Appellant Taxpayer appeals against the determination dated 23 August 2005 ('the Determination') whereby the Commissioner upheld an additional salaries tax assessment for the year of assessment 1999/2000 raised on the Taxpayer.
2. The main point at issue in this appeal is whether a sum of \$451,684.93 received by the Taxpayer upon termination of her employment is assessable income for the purpose of salaries tax under section 8(1) of the Inland Revenue Ordinance ('IRO').
3. This appeal is of some interest because there have been four previous appeals to the Board arising from essentially the same factual background. The Board in the first two of these appeals held in favour of the taxpayer, but the subsequent panels held in favour of the Commissioner.

Relevant facts

4. The Taxpayer gave evidence under oath. She also called one factual witness, Mr L, who also gave evidence under oath. The Board finds the Taxpayer and Mr L to be truthful witnesses and has no hesitation in accepting their evidence.
5. The material facts as found by the Board are as follows.
6. The Taxpayer commenced her employment with the Hong Kong branch ('the Branch') of a Japanese bank ('the Bank') on 14 January 1987. The Branch operated a defined contribution Provident Fund Scheme ('the Scheme') and the Taxpayer was a member of the Scheme.
7. By letter dated 2 November 1998 ('the 1st Letter'), the Branch announced to its employees that its head office had decided to close the Branch not later than June 1999. In the letter, the Branch urged its employees to stay with the Branch until the closure and in turn offered the following incentive to the employees:
 - 7.1. Under paragraph 2a: 'Severance pay' equivalent to the employee's monthly salary x length of service x 2/3, which amount was to be set off by the Branch's portion of the employee's entitlement under the Scheme;
 - 7.2. Under paragraph 2b: Payment in lieu of notice corresponding to the employee's rank (two months for the Taxpayer); and
 - 7.3. Under paragraph 2c: A further sum equivalent to 50% of the total salary (including basic salary and position allowance but excluding bonus or overtime

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allowance) to be paid to the employee from 1 November 1998 to the last day of employment.

8. The 1st Letter further provided that if the employee resigned, for whatever reason, before the closure of the Branch, he/she would only be entitled to the 'severance pay' under paragraph 2a and only half of the further sum under paragraph 2c.

9. After the issue of the 1st Letter, there was a feeling of discontent among the Branch's staff. In particular, the effect of the 'severance pay' offered was that the longer an employee was employed, the less the employee would receive by way of 'severance pay' because the amount to be set-off against the employee's portion of provident fund entitlement under the Scheme would be proportionately larger.

10. The Taxpayer was not satisfied with the offer contained in the 1st Letter because due to her length of service she would receive nothing by way of the proposed 'severance pay'. She learnt that many of her colleagues were similarly dissatisfied with the proposal. Eventually, a number of staff meetings were convened to discuss the feasibility of seeking better severance pay from the Branch.

11. Mr L was the Assistant General Manager of the Branch at the time. He actively participated in the discussions between the staff and the senior management in relation to the severance package. He made a number of enquiries with people from other Japanese banks which were also closing down at around that time, and found out that the amount of 'severance pay' offered by other banks to their employees ranged from one month's salary per year of employment to three months per year of employment.

12. Mr L also made enquiries with the Inland Revenue Department ('IRD') as to whether the IRD would accept as non-taxable 'severance payments' equal to one month's salary per year of employment without set-off against the employer's portion of provident fund entitlement under the Scheme. He was told over the phone by an officer of the IRD, who said that she was handling the Branch's case, that there would be 'no problem' with such payments. It is pertinent to note that this evidence is not challenged by the Commissioner.

13. Based on the information obtained from his enquiries, Mr L on behalf of the staff put forward a revised proposal to the senior management of the Branch asking for 'severance pay' of one month's salary per year of service without set-off against the employer's portion of provident fund entitlement under the Scheme.

14. The management was receptive to the proposal as is evidenced by an Approval/Record Form dated 1 March 1999.

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15. Mr L then prepared a further letter to the staff dated 10 March 1999 ('the 2nd Letter'), which was signed by the General Manager, setting out the revised incentive scheme.

16. The material parts of the 2nd Letter provided as follows:

'Re: Branch Closure – Special Retention Bonus

Further to my letter of November 2, 1998 to all of you concerning the closure of HK Branch and related transit arrangements ...

In recognition of your loyalty and support to [the Bank], and also as a means to further smoothening our operations for the months to come, I have had a series of conversations with Head Office and it is my pleasure to announce here today that following incentive payments will be added to employees who satisfied our requirements as follows:

1. Special Retention Bonus

Subject to (2) below, in addition to the packages mentioned in our letters dated November 2, 1998 to respective employees, following payments will be added:

- a. A sum equivalent to your **monthly salary x length of service x 1/3**, plus
- b. A further sum equivalent to **employer's portion of your Provident Fund** [entitlement under the Scheme].

2. Conditions/Restrictions

In principle, the above payments applied to all employees However, to be eligible to the additional payments, employees **must also** satisfy [the Bank] with the following points:

- a. Employees must continue to work for [the Branch] through the very last day until [the Branch] takes the initiative to terminate their services.
- b. Employees must continue to perform their duties to our satisfaction up to end of their services. **Their performance will be evaluated by respective superiors**, which will be taken into consideration when determining one's entitlement of bonus mentioned in (1) above, which may result in reduction of the above payments.

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- c. Employees must continue to attend their duties punctually. As a measure to keep this morale, your special payment as determined in (1) above will be deducted by a sum derived from the following formula:

$$(S+L\div 2) \times \text{monthly salary} \times 1/20$$

where S = no. of sick leave & L = no. of lateness, counted from 11/3/1999 until your last date of employment

- d. This special retention bonus was approved separately by the Head Office taking into account of the unique situation of HK Branch. To ensure its smoothness, **no information contained in this letter shall be divulged** to unrelated parties including, but not limited to ex-[Bank] staff and other overseas branch/subsidiaries of [the Bank]. Any breaches of that will not only lead to non-payment of the above, but may also affect other benefits they are entitled.' (original emphasis)

17. The 2nd Letter did not refer to 'severance pay' but to 'Special Retention Bonus'. But the combined effect of paragraph 2a of the 1st Letter and paragraph 1 of the 2nd Letter is that the staff would get an amount equal to one month's salary per year of service on top of their entitlement under the Scheme.

18. In relation to the added 'conditions' set out in the 2nd Letter, Mr L's evidence is that by the time of the 2nd Letter, the staff morale was low and while the management wanted to improve the severance pay, it also wanted to add some terms so as to encourage the staff to work harder in the remaining months, such as arriving punctually to work, not leaving early and not applying for sick leave unnecessarily, etc.

19. Also, although the 2nd Letter referred to a 'Special Retention Bonus' as a means to 'further smoothening' the Branch's operations prior to its closing, the Taxpayer was on maternity leave during the relevant period. Hence the incentive did not apply to her anyway.

20. On 28 June 1999, the Branch filed a notification regarding the Taxpayer's cessation of employment. In the notification, the Branch declared that the Taxpayer received 'severance pay' of \$451,684.93, made up as follows:

$$\$36,250 (\text{last month salary}) \times 12^{168/365} (\text{year of service}) \times 1 = 451,684.93 \text{ ['Sum A']}$$

21. The Taxpayer in her tax returns for the assessment year 1999/2000 did not declare Sum A as she was under the belief that the same was not taxable income. It is not necessary to go into the details of the subsequent correspondence between the Taxpayer and the IRD. Suffice to say that by a letter dated 11 October 2001, the Assessor proposed to revise the assessment raised

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on the Taxpayer to assess one-third of Sum A as taxable income. This assessment was eventually revised to 6/10 of Sum A on 6 May 2005 after the assessor had considered the decision of the Board in D73/04, IRBRD, vol 19, 571. It will be necessary to return to this and other relevant decisions of the Board later on in this Decision.

22. Two documents require specific mention. The first is a 'Calculation of Severance Pay to Employee' dated 26 June 1999 prepared by the Branch. It stated that:

'DUE TO CLOSURE OF THIS BRANCH, THE FOLLOWING PACKAGE HAS BEEN PAID TO THE [TAXPAYER] AS SEVERANCE PAY:

(1) SEVERANCE PAY ACCORDING TO YEARS OF SERVICE (NOTE 1)

EQUIVALENT TO ONE MONTH' S SALARY FOR EACH YEAR OF SERVICE

HK\$36,250.00 X 12.4603 (YEARS) X 1 451,684.93

(NOTE 1): THIS COMPANY WILL WITHDRAW ITS BUSINESS FROM HK AND HAD ANNOUNCED ITS CLOSURE ON 1/11/98. ACCORDINGLY, ALL EMPLOYEES HAVE BEEN ARRANGED TO BE LAID OFF ON VARIOUS STAGES DEPENDS ON SCHEDULE OF EACH DEPARTMENT.

THE AMOUNT INDICATES ON ITEM (1) IS A SEVERANCE PAY BASED ON YEARS OF SERVICE OF EMPLOYEE CONCERNED.'

23. Further, in a letter dated 6 December 2001, the Bank provided information to the IRD on 'severance pay' paid to ex-employees of the Branch. The letter described the additional payment under paragraph 1 of the 2nd Letter as 'severance pay compensating [the ex-staff' s] loss of employment'.

24. On 23 August 2005, the Deputy Commissioner affirmed the 6 May 2005 assessment, hence this appeal.

Previous decisions of the Board

25. There are four previous appeals to the Board arising from the termination of employment of the Branch' s employees.

(1) B/R 94/02

26. Mr L himself was the appellant in the first case, B/R 94/02 dated 9 January 2003, a decision of the Board chaired by Mr Patrick Fung Pak-tung SC, with members Mrs Daisy Tong Yeung Wai-lan and Mr Stephen Yam Chi-ming.

26.1. In that case, the Commissioner accepted that although the 'severance pay' paid to the taxpayer under the 1st Letter was larger than the severance pay

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which the taxpayer would have been entitled to under section 31G(1) of the Employment Ordinance, the entirety of that sum would not be taxable.

- 26.2. The Commissioner contended that the amount payable to the taxpayer under the 2nd Letter was taxable because it was not in the nature of a true 'severance pay'. The Commissioner mainly relied on the wording of the 1st and 2nd Letters in support of that contention.
- 26.3. The Board concluded that the amount in question was in nature 'severance pay' and the same was not taxable. The appeal was accordingly allowed.

(2) D126/02

27. The second case is an appeal by another employee of the Branch, Mr A, in B/R 125/02 dated 11 March 2003, a decision of Mr Benjamin Yu SC (chairman), with members Mr Dennis Law JP and Ms Agnes Ng.

- 27.1. The facts of the case are materially indistinguishable from the facts of the instant appeal. Mr L was also called as a witness in that appeal and his evidence was essentially the same as that he gave to this Board. The Board in that case accepted his evidence in all material respects.
- 27.2. The Board referred to D80/00, IRBRD, vol 15, 715, in which the Board reviewed a number of previous decisions and formulated the following principles in determining whether a payment received by an employee upon termination of employment is taxable under section 8(1) of the IRO:
- (a) A payment would be taxable if it is in the nature of a gift on account of past services. The word 'gratuity' connotes a gift or present usually given on account of past services.
 - (b) 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.
 - (c) It is not the label, but the real nature of the payment, that is important.
 - (d) The way in which the sum in question was arrived at is a material factor in determination the real nature of the payment.
- 27.3. The Board, applying those principles to the evidence, found that the true nature of the payment was compensation to the taxpayer for the loss of his employment. The Board also held that both the taxpayer and the employer

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regarded the payment as severance pay for the reasons set out in paragraph 19 of the decision.

27.4. In so holding, the Board rejected the Commissioner's arguments which are largely the same arguments advanced before this Board in the instance appeal: see paragraphs 18 and 20-21 of the decision.

28. The IRD appealed against both decisions by way of Case Stated. Eventually, the IRD reached settlement with Mr L and Mr A after the Board's decision in D73/04, IRBRD, vol 19, 571. This Board is not informed of the terms of those settlements.

(3) D73/04

29. In this case the Board (chaired by Mr Ronny Wong Fook-hum SC, with members Mr Arthur Chan Ka Pui and Mr Michael Seto Chak-wah) heard the appeal in January 2003 but by agreement of the parties delivery of decision was deferred pending the appeals by way of Case Stated in the two previous appeals. The Board eventually delivered its decision dated 21 January 2005 when no decision had yet been delivered by the Court of First Instance.

29.1. The Board observed that Mr L who testified in B/R 94/02 and D126/02, IRBRD, vol 18, 188 was not called to give evidence in that case, so that those decisions were not strictly binding on the Board.

29.2. The Board referred to D24/97, IRBRD, vol 12, 195 and D80/00, IRBRD, vol 15, 715 but expressed reservations on the general exclusion of compensation for loss of employment and severance pay from the tax net.

29.3. The Board stated the issue thus: 'were Sum A ... paid in consideration of services, past, present or future or were they paid for a consideration wholly unrelated to the Appellant's service/employment or were they paid for mixed considerations?'

29.4. On the facts, the Board came to the view that a number of factors prompted the payments promised under the 2nd Letter. The Board then apportioned Sum A as follows:

(a) 3/10 thereof as payment in recognition for past services.

(b) 3/10 thereof as inducement for future services.

(c) 3/10 thereof as payment for the alleviation of the difficulties arising from the then economic climate experienced by the appellant.

- (d) 1/10 thereof for other consideration including the Non-disclosure clause in the 2nd Letter.

29.5. The Board therefore allowed the appeal to the extent of 4/10 of Sum A, that is, affirming that 6/10 thereof was taxable.

(4) D37/05

30. Finally, in D37/05, IRBRD, vol 20, 563 a decision dated 9 August 2005, Mr Ronny Wong Fook-hum SC again chaired the Board, with members Professor Simon Ho Shun-man and Mr Peter Ngai Kwok-hung. The Board basically followed the decision on this issue in D73/04.

Taxpayer's contentions in this appeal

31. The Taxpayer, who acted in person, put her case primarily on the basis that the entire Sum A was in the nature of 'severance pay' and thus not taxable.

32. In any case, she relies on the fact that Mr L had been advised by the IRD that the IRD would accept as non-taxable severance pay of up to one month's salary per year of service without set-off against the employer's contribution under the Scheme.

33. The Taxpayer also raised an argument that the IRD had not treated her case fairly. Her argument is, in essence, that the IRD should follow the decisions of this Board in Mr L's and Mr A's cases, or pursue the appeals to the High Court for a decision at its own costs. Instead, she complains, the taxpayer is forced to accept a settlement with the IRD on fear of costs consequences and also due to the stress of litigation, while the IRD is able to rely on decisions favourable to it and leaving the burden on the taxpayer to challenge the correctness of the decisions so relied upon.

The Commissioner's contentions

34. Mr Wong, on behalf of the Commissioner, argued that Sum A was 'income' within the meaning of section 9(1) of the IRO received by the Taxpayer from her employment in Hong Kong and hence taxable under section 8(1) of the IRO. He understandably placed heavy reliance on D73/04 and D37/05. It has already been noted above that in coming to the assessment in this case, the assessor had followed D73/04 in assessing 6/10 of Sum A as the Taxpayer's taxable income.

35. Secondly, Mr Wong pointed out that under the IRO there is no exemption for 'severance payment' paid in accordance with the provisions of section 31G(1)(a) of the Employment Ordinance but as a matter of concession, the Revenue would exempt statutory

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severance payments from salaries tax. Any amount in excess of the statutory severance payment would be taxable.

36. For these and other reasons advanced by Mr Wong in his helpful written submissions, it is contended that this Board should follow the decisions in D73/04 and D37/05, and uphold the Determination.

Issues for determination

37. The main issue for determination is the true nature of Sum A: whether it is in nature ‘severance pay’ or compensation for loss of employment. [**Issue 1: True nature of Sum A**]

38. There is a secondary issue arising if Sum A is found to be ‘severance pay’: in so far as Sum A exceeds the statutory amount of severance pay under section 31G of the Employment Ordinance, whether the ‘excess’ part is liable to salaries tax. [**Issue 2: the concession point**]

39. This Board does not consider it necessary to consider the Taxpayer’s ‘fairness’ argument.

Issue 1: True nature of Sum A

40. This Board is of the view that the principles to be applied in determining whether a payment received by an employee upon termination of service is taxable under section 8(1)(a) of the IRO are those summarised in D80/00.

40.1. First, it should be noted that previous decisions of the Board are not binding on this Board.

40.2. Secondly, this Board has carefully considered the principles summarised in D80/00 and agrees that they correctly summarise the law. This Board has also carefully considered the reservations expressed in D73/04 over D80/00 (and D24/97). However, such reservations do not persuade this Board that the principles as summarised in D80/00 are incorrect.

40.3. Thirdly, in the instant appeal, the Commissioner’s written submissions in fact referred to and relied on the principles summarised in D80/00 without dissent. Certainly no argument was advanced before this Board as to why and to what extent those principles summarised in D80/00 are incorrect.

40.4. For these reasons, this Board proposes to apply the principles summarised in D80/00.

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41. Applying those principles, and having considered all the evidence in the round, this Board comes to the conclusion that the true nature of Sum A was compensation paid to the Taxpayer for the loss of her employment and non-taxable.

41.1. Although the 2nd Letter described the payment under paragraph 1 as ‘Special Retention Bonus’ rather than ‘severance pay’, the label used is not determinative. This Board entertains no doubt that the intended effect of the ‘Special Retention Bonus’ under the 2nd Letter was to alleviate the staff’s dissatisfaction over the original proposal for ‘severance pay’ under paragraph 2a of the 1st Letter. Accordingly, the 1st and 2nd Letters should be read together, and due regard must be given to the statements made and notification filed by the employer as well as the ‘Calculation of Severance Pay to Employee’ dated 26 June 1999 prepared by the Branch in relation to the purpose of the payment.

41.2. Once the matter is looked at in this way, it is very clear that the common intention of both the employer and the employees was that the employees should receive ‘severance pay’ of one month per year of service, without set-off against the employer’s contribution to the Scheme.

41.3. This Board, while attaching proper weight to the wording used in the 1st and 2nd Letters, declines to adopt a literal approach. In this connection, the different evidence adduced before the Board in D73/04 may explain why in that case the Board adopted a more literal approach and attached considerable weight, probably predominant weight, to the wording used. In any case, it seems to this Board that the Board in D73/04 probably read far too much into the labels used.

42. It is unnecessary to address each of the arguments advanced by the Commissioner, most of which have been advanced and rejected in D126/02. This Board respectfully adopts the decision of the Board in that case where appropriate.

43. Finally on this issue, this Board wishes to mention that it does not find the apportionment of Sum A in D73/04 convincing. It seems to this Board that the apportionment exercise is subjective and rather arbitrary. However, it is not necessary to express an opinion on the correctness of that exercise in this decision.

Issue 2: the concession point

44. Given this Board’s conclusion on the true nature of Sum A, it is strictly speaking not necessary to determine the concession point.

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45. Nevertheless, this Board would observe that the ‘concession’ as contended by the Commissioner, that is, that the IRD would only treat the statutory amount of severance pay as non-taxable, does not appear to have been consistently applied.

45.1. It has already been noted that in B/R 94/02, the Commissioner had accepted that the entire amount of ‘severance pay’ under the 1st Letter was not taxable although it was larger than the statutory amount. If there had been a consistent concession as contended by the Commissioner before this Board (and apparently accepted by the Board in D73/04: see paragraph 23 of that decision), the Commissioner’s position in B/R 94/02 is difficult to understand.

45.2. Further and in any case, the clear unchallenged evidence of Mr L to this Board is that he had been advised by the IRD that the IRD would accept as non-taxable severance payment up to one month per year of service. We observe that Mr L gave similar evidence in D126/02 which was also accepted by the Board. Such evidence is contrary to the existence of a consistent concession as claimed by the Commissioner.

Conclusion

46. For these reasons, the appeal is allowed. It only leaves us to thank the Taxpayer and Mr Wong for the Commissioner for their very helpful assistance.