Case No. D37/05

Salaries tax – special retention bonus – payment on top of severance payment under Employment Ordinance (Chapter 57) – sections 8(1) and 9(1)(a) of the Inland Revenue Ordinance (Chapter 112)('IRO').

Panel: Ronny Wong Fook Hum SC (chairman), Simon Ho Shun Man and Peter Ngai Kwok Hung.

Date of hearing: 17 December 2002.
Date of decision: 9 August 2005.

The appellant appealed and argued that the 'special retention bonus' (for her remaining with the employer, the Bank, until the very last day of the Bank's closure) on top of her statutorily entitled severance pay should not be taxable as it was part and parcel of her severance pay and constituted compensation for her loss of office.

The appellant also claimed that she had been unfairly treated as, contrary to treatments afforded to other employees of the Bank, the Revenue unreasonably refused to accept her offer to return 1/3 of her total severance pay to tax.

Held:

1. The issue is whether the sum in question, the 'special retention bonus', constitutes income arising in or derived from Hong Kong from the appellant's employment with the Bank.

2. The Board is of the view that several factors prompted the Bank's promise and payment of 'special retention bonus', the weight of which should be apportioned as follows:

2.1	Alleviation of potential hardship when economic situation was gloomy.	3/10
2.2	Acknowledgement of past services rendered.	3/10
2.3	Inducement to continue rendering services till the Bank's final closure.	3/10

2.4 Acceptance of the Non-disclosure Clause. 1/10

The appeal is thus allowed to the extent of 4/10 of the sum in question.

3. In respect of the appellant's unfairness point, the Board agrees with the conclusion in Decision D126/02, IRBRD, vol 18, 188.

Appeal allowed in part.

Cases referred to:

D12/92, IRBRD, vol 7, 122
D24/97, IRBRD, vol 12, 195
D80/00, IRBRD, vol 15, 715
D43/93, IRBRD, vol 8, 323
B/R 125/02 (decision number D126/02, IRBRD, vol 18, 188)

Taxpayer in person.
Wong Kai Cheong and Ngan Man Kuen for the Commissioner of Inland Revenue.

Decision:

1. The Appellant commenced her employment with Bank A ['the Bank'] in August 1991. According to her letter of employment dated 6 July 1991, 'either party may terminate the employment by giving the other party not less than one calendar month prior notice in writing, or by paying to the ether party one month salary ... in lieu of notices'.

2. In about the final quarter of 1998, the Bank decided to close its Hong Kong office.

3. By letter dated 2 November 1998 ['the 1st letter'], the Bank offered to the Appellant 'employment arrangement' which provided, inter alia, that in the event of the Appellant remaining with the Bank until the very last day of closure the Bank would pay the Appellant the following sums:

(a) 'Severance pay'

(i) This is to be computed on the basis of:

Length of service ×? of monthly salary

(ii) This is to be set off by the Bank's portion of the Appellant's Provident Fund entitlement.

(b) 'Payment in lieu of notice'.

(c) A further sum equivalent to 50% of the Appellant's total salary (including basic salary and position allowance but excluding bonus and overtime allowance) for the period between 1 November 1998 and the closure of the Bank.

The Appellant accepted the terms so offered.

4. By letter dated 10 March 1999 ['the 2nd Letter'], the General Manager of the Bank informed the Appellant that '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', the Bank would pay on top of the sums outlined in the 1st letter additional 'incentive payments' designated as 'Special Retention Bonus'.

(a) The sum is to be computed on the basis of:

(Length of service ×? of monthly salary) + Bank's portion of her provident fund

(b) Payment of this Special Retention Bonus is subject to the following conditions:

(i) 'Employees must continue to work for [the Bank] through the very last day until [the Bank] takes the initiative to terminate their services.'

(ii) 'Employees must continue to perform their duties to our satisfaction up to end of their services. **Their performance will be evaluated by respective superiors …**'.

(iii) 'Employees must continue to attend their duties punctually'. Payment under this head will be reduced by the sick leave by and late attendance on the part of the Appellant.

(c) '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 … Any breaches of that will not only lead to non-payment of

> the above, but may also affect other benefits they are entitled' ['Non-disclosure Clause'].

The Appellant accepted the terms of this 2nd letter.

5. Severance pay to the Appellant computed in accordance with the terms of the 1st Letter amounted to $17,575. This is also the sum which the Bank was required to pay to the Appellant in accordance with the provisions of the Employment Ordinance (Chapter 57). The assessor has accepted that this sum is not assessable to salaries tax.

6. The dispute between the parties relates to the taxability or otherwise of the Special Retention Bonus of $140,726 computed in accordance with the terms of the 2nd Letter.

7. The Appellant's contentions may be summarised as follows:

(a) The Special Retention Bonus was in truth part and parcel of her severance pay. Employees of the Bank were dissatisfied with the terms offered in the 1st Letter as compared with the terms offered by other Country B banks who closed their offices in Hong Kong. The Special Retention Bonus was really the top up of her severance pay. Implicit in this argument is the contention that the payment in question is not taxable as it constitutes compensation for loss of office.

(b) On or about 16 November 2001, she offered ? of her total severance pay to tax. Contrary to treatments afforded to other employees of the Bank, the Revenue unreasonably refused to accept her offer ['the Unfairness Point'].

8. The Appellant called two of her colleagues to support her contentions. Mr C was the Deputy General Manager of the Bank. He told us that the 1st letter was prompted by the following considerations on the part of the Bank:

> ' On one hand, the management couldn't tolerate any trouble which might be created before it returned its bank license to Hong Kong Monetary Authority: on the other hand, [the Bank] wished to compensate its staff members according to market practice'.

He went on to describe to us the dissatisfaction which led to the 2nd Letter. He also produced management records of the Bank indicating that the Bank viewed the sum in question as part of 'Severance Pay'.

9. Mr D is the other witness of the Appellant. His position is the same as that of the Appellant and he is having similar dispute with the Revenue.

The applicable statutory provisions in the Inland Revenue Ordinance (Chapter 112) ['IRO']

10. 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 ….'*

11. Section 8(2)(c)(i) of the IRO provides that in computing the income of any person for the purpose of subsection 8(1), subject to subsection 8(4), there shall be excluded any sum received by way of commutation of pension under a recognized occupational retirement scheme upon termination of service.

12. Section 9(1)(a) of the IRO provides that 'Income from any office or employment includes any wages, salary, … gratuity, perquisite, or allowance'.

Cases decided by this Board

13. The taxability or otherwise of payments made to employees on cessation of the employer's business was considered by this Board in D12/92, IRBRD, vol 7, 122. The Board expressed the following sentiments:

> *'The Board has total sympathy for the Taxpayer. Retirement benefits are a major subject of debate and discussion by our government, our legislators and pressure groups. There is a major debate taking place about whether or not the so-called 'sandwiched' middle class should be subject to salaries tax and whether the tax threshold should be substantially increased. Arguments are put forward that employers should be responsible and take care of their employees in their old age. It is pointed out that if statutory arrangements are not made the burden will eventually fall on the government and public revenue. It seems inconceivable in the light of all of this that our taxation law should require that when an employer goes out of business leaving behind an employee with some forty years of loyal service, and a comparatively modest ex-gratia payment of $500,000 is made, that payment to be subject to tax only because the employer did not establish an approved provident fund or retirement scheme. Unfortunately for the Taxpayer that is the state of our laws and neither the Commissioner nor this Board has any discretion in the matter. We are not allowed to investigate to see whether or not the payment is*

in fact reasonable and whether or not it would have been capable of approval if the employer had sought to establish an approved retirement scheme'.

14. The issue is whether the sum in question constitutes income arising in or derived from Hong Kong from the Appellant's employment with the Bank within the meaning of section 8 of the IRO. In D24/97, IRBRD, vol 12, 195 the Board reviewed the relevant English and local authorities and came to the view that two different approaches have been adopted in determining whether a payment falls within the tax net or not:

(a) The wider approach: According to this approach, it is not necessary to demonstrate that the income was received by the employee 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 employment or a reward for services rendered in the past or as an inducement to continue with the services during the employment. Indeed it could be a combination of one or more of those reasons. All we need to know is that the payment was sourced from the employment'.

(b) The narrower 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.'*

15. In D80/00, IRBRD, vol 15, 715 the Board formulated the following propositions on the basis of the previous decisions of this Board:

(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 determining the real nature of the payment.

Our decision

16. We are of the view that the stance of the Appellant is attributable to a misunderstanding of the second of the four propositions in D80/00. The Appellant appears to labour under the assumption that she was entitled to job security and the payment in question is not taxable as the same constitutes compensation for loss of that security.

17. In D43/93, IRBRD, vol 8, 323, the taxpayer was employed on terms that his employment was not terminable within nine calendar months from the date of his return from home leave. The employer sought to terminate the taxpayer's employment shortly after his return from home leave. The taxpayer was paid a lump sum in return for such premature termination. The Board held the sum not taxable:

> *'The real nature of the payment in this case before us 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.'*

18. In this case, the Appellant was employed on terms that her employment was terminable by service of one calendar month's notice or payment in lieu. That was the extent of her job security. The 1st letter made provision for payment in lieu of notice. She therefore did not lose any right which calls for compensation.

19. As far as severance pay is concerned, that was provided for in the 1st Letter. She obtained her statutory entitlements under the Employment Ordinance. The Revenue has not sought to tax her on her entitlement under the 1st Letter.

20. What we are concerned with is payment under the 2nd Letter. We are of the view that several factors prompted the payment promised under the 2nd Letter:

(a) The letter was issued at the time when the economic situation was gloomy. Comparable positions were few. The Bank was minded to alleviate the difficulties confronting its employees.

(b) The 'incentive payments' were expressed to be 'In recognition of your loyalty and support to The Bank'. The payments were prompted in part by the Bank's desire to acknowledge the past services rendered by the relevant employees in favour of the Bank.

(c) The 'incentive payments' were also 'a means to further smoothening our operations for the months to come'. The Bank was closing down its operation. Its employees were informed of such closure. The Bank was concerned to retain suitable number of staff till its final closure. The 'incentive payments'

were therefore inducements to the relevant employees to continue rendering services in favour of the Bank.

(d) The acceptance of the Non-disclosure Clause was also part of the consideration for the 'incentive payments'. As opposed to the three factors which we outlined above (recognition of past services, alleviation of potential hardship and inducement for continued services), we are of the view that this clause was not the major cause that prompted the payments.

(e) We would apportion the sum in question as follows:

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

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

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

(iv) 1/10 thereof for other consideration including the Non-disclosure Clause.

21. For these reasons, we allow the appeal to the extent of 4/10 of the sum in question. We dismiss the remaining part of the appeal.

The unfairness point

22. As far as the unfairness point is concerned, this point was discussed at length in a decision of this Board in B/R 125/02 (Decision D126/02, IRBRD, vol 18, 188). We agree with the conclusion in that decision.