INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D37/99

Salaries Tax – whether payment in lieu of notice constituting income.

Panel: Ronny Wong Fook Hum SC (chairman), Gregory Robert Scott Crichton and Ho Chung Ping.

Date of hearing: 26 April 1999.
Date of decision: 23 July 1999.

The taxpayer commenced employment with Company A in July 1987. In January 1996, he was employed as 'group circulation manager'. The terms of employment provide, inter alia, that the employment 'shall be terminable by the giving by either party of three months' notice in writing.' In March 1996, Company A sought to terminate the taxpayer's employment with immediate effect. He was given, inter alia, 3 months' salary in lieu of notice. The taxpayer responded by proposing an imicable parting by offering various terms including, inter alia, an ex gratia payment of $940,5000. Shortly after, Company A counter offered to him a package which included, inter alia, an ex gratia payment of $500,000 in full and final settlement. The counter offer was accepted by the taxpayer. The Commissioner assessed on the taxpayer for the sum of $500,000.

Held:

The payment was only taxable if it was to the taxpayer for services but not as compensation for loss of employment.

Company A wanted the taxpayer to leave forthwith. The taxpayer did not accept the validity of the termination. There was no express provisions permitting the payment of salary in lieu of notice. Without the three months' prior notice, Company A might or might not have been legally entitled to ask the taxpayer to leave forthwith. The taxpayer agreed to leave only on the settlement package.

The Board found the payment in question was consideration given in settlement of any disputes between the parties that would prevent the taxpayer's immediate departure. It was the sweetener to remove the taxpayer's resistance and thus not taxable. (Henley v Murray applied, D55/93 followed, D19/92, D24/97 considered)

Appeal allowed.

Cases referred to:

D24/97, IRBRD, vol 12, 195
D19/92, IRBRD, vol 7, 156
Henley v Murray 31 TC 351
D55/93, IRBRD, vol 8, 395

Ma Wai Fong for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

Background

1. The Taxpayer commenced employment with Company A, a publishing company, in July 1987.

2. By letter dated 24 May 1995 ['the Employment Letter'], Company A offered the Taxpayer fresh terms of employment coming into effect as from 1 January 1996. The Taxpayer was to be employed as 'group circulation manager'. The Taxpayer's employment 'shall be terminable by the giving by either party of three months' notice in writing.' The Taxpayer accepted these terms of employment on 30 May 1995.

3. The Taxpayer was warmly applauded by Company A in July 1995 for his performance. His salary was increased on 24 July 1995 by $9,500 effective 1 July 1995. On 15 December 1995, the Taxpayer was paid a bonus of $313,500.

4. The harmony between the Taxpayer and Company A did not last long. By letter dated 8 March 1996 ['the Termination Letter'], Company A sought to terminate the Taxpayer's employment with immediate effect. Company A pointed out that 'it has become increasingly obvious in the past months that your temperament and character is unsuited to the requirements of harmony and necessary team spirit that is fundamental to this Company.' The Taxpayer was given 3 months' salary in lieu of notice. Company A further indicated readiness to afford the Taxpayer his other entitlements under the Employment Letter.

5. The Taxpayer responded immediately to the Termination Letter. In a hand-written note dated 8 March 1996 ['the Taxpayer's Note'], he said this:

> ‘ Your letter of dismissal came as a great shock after 9 very successful years as circulation manager of Company A. The terms of your dismissal letter are even greater shock after 9 very successful years.
>
> I have carefully considered the implications to both myself and my wife and I should like to propose an amicable parting as follows:’

The Taxpayer then outlined various terms that he sought including an ‘ex-gratia payment’ of $940,500 calculated on the basis of 1 month’s salary for each year of service. The terms proposed by the Taxpayer entailed substantial benefits to the Taxpayer over and above his entitlements under the Employment Letter.

6. Company A was equally swift in their reply. By letter dated 8 March 1996, Company A counter offered a package [‘the Package’] to the Taxpayer ‘in full and final settlement’. The Package included an ‘ex-gratia payment’ of $500,000 and terms less generous than those outlined in the Taxpayer’s Note but more favourable than those embodied in the Termination Letter and the Employment Letter. This Package was accepted by the Taxpayer.

7. The Taxpayer was paid on 8 March 1996 in accordance with the Package. He acknowledged the ‘ex-gratia payment’ of $500,000 and the other payments under the Package ‘in full and final settlement of all claims arising out of or in connection with my employment with you.’

8. The Taxpayer’s departure was announced in Company A the following morning. The Taxpayer was said to have ‘tendered his resignation yesterday to pursue other interests.’ His replacement commenced work the following Monday (11 March 1996).

9. On 18 March 1996, Company A reported to the Revenue the following ‘emoluments’ of the Taxpayer from 1 April 1995 to the cessation of his employment on 8 March 1996:

Particulars	**Amount**
	$
Salary/Wages	1,148,000
Leave pay	209,000
Bonus	313,500
Payment in lieu of notice	313,500
Ex-gratia payment	500,000

10. In response to enquiries from the Revenue, Company A informed the Revenue that the sum of $500,000 ‘was neither contractual nor under any statutory requirement but

was paid to [the Taxpayer] at the sole discretion of the senior management of the Company, having regard to the performance and length of service of the staff concerned.'

11. By his determination dated 25 November 1998, the Commissioner confirmed an assessment on the Taxpayer in respect of the sum of $500,000. The Taxpayer appealed. In his notice of appeal dated 9 December 1998, the Taxpayer asserted that the sum in question was 'in the form of a gift' given to him by Company A 'to maintain future contact and not a recognition of past services.'

The hearing before us

12. The Taxpayer told us that he was shocked to receive the Termination Letter. He asked for compensation in respect of the 'instant dismissal'. He maintained that his 'dismissal' was 'unfair' and he should be compensated for the same.

13. The Taxpayer further maintained that the sum was a gratuity and a voluntary payment made by Company A. He accepted the payment in order to settle matter.

The relevant statutory provisions

14. Section 8 of the Inland Revenue Ordinance ['the IRO'] 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 from the following sources –*
>
> *(a) any office of employment of profits; and*
>
> *(b) any pension.'*

15. Section 9 of the IRO provides a non-exhaustive definition of 'income from employment'. It states that:

> *'(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 ...'*

16. The issue is this : is the sum of $500,000 income arising in or derived from Hong Kong from the Taxpayer's employment with Company A?

The case law

17. The state of the authorities was summarised by the Board in D24/97, IRBRD, vol 12, 195. The Board pointed out that two approaches can be found in the decided cases:

(a) The wider approach under which if 'the payment was sourced from the employment', it is taxable.

(b) The narrower approach under which one has 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.'

18. The wider approach was adopted in D19/92, IRBRD, vol 7, 156. The Board had to decide whether a lump sum payment made by the employer to the taxpayer on his joining the employer was taxable. The Board stated:

> *' The source of something is a matter of fact and not of law. A careful analysis of the facts before us leads us to the conclusion that the source of the lump sum payment was the employment of the Taxpayer with the HK employer. Indeed it could be nothing else. It was not a payment made to the Taxpayer unrelated to his employment and it certainly was not a gift. It was not a payment made sometime before his employment and unrelated to his employment. It was a front end payment but was an integral part of his employment and indeed part of his employment contract. There is nothing in section 8 or 9 of the Inland Revenue Ordinance which limit taxable payments to remuneration for services rendered or to be rendered. Section 8 relates to income from a source namely the employment. This lump sum payment was part and parcel of the employment of the Taxpayer with the HK employer.'*

19. Henley v Murray 31 TC 351 is an example of the narrow approach. The taxpayer was the managing director of a property company. His employment under his service contract was to continue until 31 March 1944. At the request of the company, he agreed to resign on terms including payment of a sum calculated from the date of his resignation to the date of termination of his service agreement. The Court of Appeal held that the sum was paid to him as compensation for the surrender of his rights to future remuneration under the service agreement. Jenkins L J pointed out that:

> *'The question in each case is whether, on the facts of the case, the lump sum paid is in the nature of remuneration or profits in respect of the office or is in the nature of a sum paid in consideration of the surrender by the recipient of his rights in respect of the office.'*

20. The Taxpayer placed heavy reliance on D55/93, IRBRD, vol 8, 395. The taxpayer there was a senior employee of a school. He was employed by yearly contracts. The relevant contract commenced from 1 September 1989 to 31 August 1990 was concluded in May 1989. The taxpayer did not see eye to eye with the principal of the school. After a heated argument in July 1989, the principal asked the taxpayer to retire effective 1

September 1989. The taxpayer did not wish to retire from service and asked if he could be paid a pension of 2 years' salary in order to tide him over. The school management committee eventually agreed to pay the taxpayer salary for the period between 1 September 1989 to 31 August 1990 on the basis that the taxpayer was not required to take up any duty at the school; his provident fund was closed and the monthly payments would be stopped if the taxpayer acted contrary to the school's interests. The Board held that 'given the school's intention to terminate the employment contract prematurely and given the taxpayer's reluctance to agree to the termination, we are impelled to the view that the twelve monthly payments were intended to compensate the taxpayer for the loss of his employment rather than present him with a gift on account of his past services.'

Our decision

21. Miss Ma for the Commissioner laid considerable emphasis on the express provision in the Employment Letter permitting termination by either side giving 3 months' notice. She submitted that the Termination Letter was an attempt by Company A to sever the parties' relationship in accordance with the express terms of the Employment Letter. No question of compensation arose as the Taxpayer was given his full contractual entitlements. Miss Ma argued that this distinguishes the Taxpayer's case from the position of the taxpayer in D55/93.

22. It should however be noted that the Employment Letter only permits termination by 'three months' notice in writing.' There is no express provision permitting the payment of salary in lieu of notice. Paragraph 37-114 of Chitty on Contracts Chapter 37 states that:

> '*Contracts of employment are frequently in practice terminated by payment in lieu of notice. There is some doubt as to the contractual status of a payment in lieu of notice. One view is that in the absence of express provision to the contrary in the original contract of employment, the payment is normally to be regarded as liquidated damages for breach of contract consisting in the refusal to allow the employee to work out his notice. Some payments in lieu of notice can be viewed as an ordinary giving of notice accompanied by a waiver of services by the employer which is accepted by the employee. Another view might be that a right to terminate by payment in lieu of notice can be viewed as a normally implied corollary of a contractual right on the part of an employer to terminate by notice, unless it is clear that the employee has some special interest in being allowed to work out his notice.*'

This passage indicates that entitlement of Company A to pay wages in lieu of notice in the absence of express provision in the Employment Letter is not a matter that is free from doubt.

23. We are of the view that the issue whether the payment constitutes compensation for breach must be ascertained by reference to objective facts. There are two important features in this case. First, Company A clearly wanted the Taxpayer to leave forthwith.

Secondly, the Taxpayer did not accept the validity of the Termination Letter. He regarded the same as a 'letter of dismissal'. He was shocked by the terms embodied in the terms of that 'dismissal letter'.

24. The reality of the situation is that without any prior warning Company A wanted the Taxpayer to leave forthwith. They may or may not have been legally entitled so to do. The Taxpayer was shocked. He was only prepared to part amicably on negotiated terms. The Employment Letter did not contain any formula to give guidance on the ambit of those terms. His refusal to leave instantaneously may or may not have been justified in law. Commercial pragmatism was adopted by both sides to avoid the impasse.

25. In these circumstances, we are of the view that the sum in question was consideration given in settlement of any dispute between the parties that would prevent the Taxpayer's immediate departure. It was the sweetener to remove the Taxpayer's resistance. We are of the view that the case is within the principle in Henley v Murray and indistinguishable from D55/93.

26. We would like to record our sincere appreciation for the immense assistance given to us by Miss Ma for the Commissioner. This is a difficult case. We regret that we do not agree with her thorough submissions.