INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D43/93

Salaries tax – payment on termination of employment – whether subject to salaries tax – sections 8 and 9 of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), Lester Kwok Chi Hang and Ambrose Lau Hon Chuen.

Date of hearing: 19 August 1993.
Date of decision: 3 December 1993.

The taxpayer was employed on an ongoing employment contract. The employer informed the taxpayer that it intended to terminate his service and a termination package was negotiated and agreed between the employer and the taxpayer. The termination package included a severance payment which the Commissioner considered to be a gratuity subject to salaries tax. The taxpayer appealed to the Board of Review.

Held:

On the facts it was clear that the severance payment was a payment made as compensation for the loss of employment. If the payment had not been made the taxpayer would have been entitled to claim damages for wrongful dismissal.

Appeal allowed.

Cases referred to:

D19/92, IRBRD, vol 7, 156
D79/88, IRBRD, vol 4, 160

Pauline Lee for the Commissioner of Inland Revenue.
Michael R Eyles of Messrs Fan, Mitchell & Co for the taxpayer.

Decision:

This is an appeal against a salaries tax assessment wherein the assessor assessed to salaries tax a payment received by the Taxpayer on the termination of his employment. The facts of the case are as follows:

1. The Taxpayer was employed by a company in Hong Kong ('the employer's) as the manager of a department.

2. The terms of his employment were set out in an employment agreement in late 1984. This agreement provided that the employment of the Taxpayer would be upon the standard terms and conditions of service of the employer as the same might be in force from time to time.

3. The Taxpayer was employed upon expatriate staff terms and conditions of service which provided, inter alia, the following provisions:

> 'Employee will be granted six weeks' home leave within each calendar year. This must be taken annually, and will not be cumulative, unless the exigencies of the company's business make this unavoidable. This period includes travel time.'
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> 'Normally employees are expected to spend their leave in a different climate, but subject to prior approval of the company, leave may be taken locally in either one period of six weeks or two periods of three weeks each.'
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> 'The employer will retire at the end of the month in which his fifty-fifth birthday falls. In exceptional circumstances the company may wish the employee to serve after age 55 and in which case the company will notify him twelve months before his fifty-fifth birthday.'
>
> 'The company without being required to give any reason for so doing and without payment of any compensation whatsoever (save and except as is hereinafter specifically mentioned) may terminate the employee's employment hereunder as follows:
>
> i) During the first three years of the employee's employment with the company the company may at any time after the expiration of the first year of such employment forthwith determine the employee's employment by giving to him written notice to that effect and by paying to him a sum equivalent to three months' basic salary.
>
> ii) After satisfactory completion by the employee of three years from the date of his employment with the company, the company may terminate the employment of the employee forthwith by giving to him written notice to that effect and by paying to him three calendar months' basic salary such notice however not to be given:

(a) While the employee is on home leave; or

(b) while the employee is taking any local leave in lieu of home leave; or

(c) within nine calendar months from the date of the return of the employee to his place of employment with the company from the full period of home leave and in case of home leave being taken in split periods from the date of the return of the employee to his place of employment with the company from the first split period of such home leave; or

(d) within nine calendar months from the date of the return of the employee to his place of employment with the company from local leave taken in lieu of home leave and in case of local leave in lieu of home leave being taken in split periods from the date of the return of the employee to his place of employment with the company from the first split period of such local leave.

An employee whose employment is terminated under the provisions of this clause will also be entitled to the benefits of clause 19(e) if he leaves the far east and returns to his place of engagement within three months from the date of written notice of termination.'

4. In addition, the terms and conditions of service included many of the usual provisions relating to provision of accommodation, a general bonus, provident fund etc. Provision was also made for the employer to provide to the employee air passages for himself and his family, baggage allowances etc.

5. In 1992 the Taxpayer proceeded on home leave and returned to work in August 1992. On his return from leave he continued to perform his duties as before for a period of approximately one week. In September 1992 the managing director of the employer saw the Taxpayer and informed him that because of adverse business circumstances it had been decided to close down the department which the Taxpayer managed. Consequent upon this decision the services of the Taxpayer would be terminated. This decision came as a shock to the Taxpayer who had expected to continue to be employed even if the department which he managed was closed. The managing director informed the Taxpayer of proposed terms of termination. The Taxpayer was informed by the managing director that he should consider what the managing director had told him and met again.

6. After one or two days the Taxpayer again saw the managing director and informed the managing director of what were his requirements in the event of his employment being abruptly terminated as had been decided by the employer. By letter

dated 2 September 1992 addressed to the managing director the Taxpayer placed on record that at the meeting the previous day the managing director had requested the termination of his services and as compensation had offered him a gratuity of one year's salary. In answer the Taxpayer proposed that he should receive in addition three months' notice, pro rata bonuses and thirteen months' salary and an adequate container allowance to enable his personal effects to be shipped to his home country. He also requested the right to remain in the accommodation provided by his employer until the end of the three months' notice period.

7. The matter was then referred to the financial general manager of the employer who by letter dated 4 September 1992 together with its enclosure set out in detail the proposed termination package which had been negotiated with the Taxpayer and which the Taxpayer accepted in writing on 17 September 1992. The detailed termination package was set out as follows:

	$	$
Salary for 1-11-92 – 30-11-92	61,455.00	
Less: 10% Retirement Grant	(6,145.50)	
Family health contribution	(35.00)	
Family health contribution	(105.00)	55,169.50
for 3 months		
Ex-Gratia payment: General Bonus		87,954.00
Termination Gratuity:		
(Compensation for loss of office)		
12 Months' Salary	737,460.00	
13th Months' Salary	61,455.00	
Special Bonus	61,455.00	860,370.00

Retirement grant benefit:

Date joined: 5-10-84

Service to 30-11-92 = 8.16 years

Average Salary = $783,405.00/12 = $65,283.75

Fraction		Average Salary		Completed Years of Service		
2.39	×	65,283.75	×	8.16	=	1,273,189.80
						2,276,683.30

Deductions:

Retention of deposit for settlement of any incidentals which may have occurred	(3,000.00)
Housing loan repayment	(177,776.18)
Housing loan interest	(388.60)
	2,095,518.52

8. The Taxpayer continued in the employment of the employer until 30 November 1992 when according to the agreement which he had reached with the employer his employment terminated.

9. The assessor issued a salaries tax assessment to the Taxpayer for the year of assessment 1992/93 showing total assessable income of $1,487,111 with tax payable thereon of $223,066. The assessable income included the sum of $737,460 being the twelve months' salary which the employer had agreed to pay.

10. By letter dated 24 November 1992 the Taxpayer objected to this salaries tax assessment on the ground that the lump sum received amounting to $737,460 should not be subject to salaries tax.

11. By his determination dated 24 February 1993 the Deputy Commissioner of Inland Revenue decided that the sum of $737,460 had been correctly assessed to salaries tax and furthermore increased the total assessable income of the Taxpayer from $1,487,111 to $1,613,154 with tax payable thereon of $241,973. The increase determined by the Deputy Commissioner of Inland Revenue was to bring the assessment into line with the actual income of the Taxpayer as returned by him in his salaries tax return and by the employer. Apparently this had been incorrectly stated by the assessor when he had issued the salaries tax assessment for the year of assessment 1992/93 referred to above.

12. By letter dated 22 March 1993 the Taxpayer appealed to the Board of Review against the determination of the Deputy Commissioner on the ground that the lump sum payment of $737,460 should not have been assessed to salaries tax.

At the hearing of the appeal the Taxpayer was represented by his tax representative. The Taxpayer himself also appeared and gave evidence having travelled to Hong Kong for this purpose.

We accept the evidence given by the Taxpayer which was clear and concise.

The representative for the Taxpayer submitted that the sum of $737,460 (which for the sake of convenience we will refer to as 'the severance payment') did not arise from the employment of the Taxpayer but from the termination of that employment. He pointed out that the employer had no right to terminate the employment of the Taxpayer which was of a continuous nature. Under the contractual provisions which we have set out in the facts

above the employment of the Taxpayer could not have been terminated other than by the giving of three calendar months' notice which could not be given until after the expiry of nine calendar months from the date on which the employee had returned from leave, that is a period of twelve months.

The representative for the Commissioner drew our attention to sections 8 and 9 of the Inland Revenue Ordinance. In particular he referred to the word 'gratuity' appearing in section 9(l)(a). He said that there is nothing in sections 8 or 9 of the Inland Revenue Ordinance which limits taxable payments to remuneration for services rendered or to be rendered and cited to us D19/92, IRBRD, vol 7, 156. He cited to us the following words appearing at page 164:

> '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 some time 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 sections 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 employment. It arose directly from the employment which the HK employer offered to the Taxpayer and which the Taxpayer accepted. Accordingly it is assessable to salaries tax.'

He went on to submit that in considering whether a sum is assessable to salaries tax it is necessary to ascertain the nature of the sum and he said that if it is of an income nature and arises directly from the office or employment it is assessable to salaries tax. However he went on to point out that the Commissioner accepts that there are certain payments which are not subject to salaries tax namely:

> ' ii A gift given due to the personal qualities of the employee,
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> ii a payment made as compensation for the loss of employment and
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> iii a payment made in settlement of a claim for damages for wrongful dismissal.'

He clarified the first of these exceptions as meaning gifts such as on marriage etc.

He then cited to us D79/88, IRBRD, vol 4, 160.

The representative for the Commissioner then went on to submit that the label given to a payment by the parties was not the governing factor. He said that the expression 'compensation for loss of office' was not a binding statement because it is the substance of the matter viewed in the light of the evidence that must decide what in truth was the real bargain between the parties. He then submitted that on the evidence before us the payment was not really a payment for premature termination of employment. He said that the Taxpayer was inconsistent because he had first argued that the payment was compensation for surrendering his future rights but had subsequently said that it was paid for breach of contract. He then submitted that the sum was not compensation for breach of contract, was not damages for wrongful dismissal, was not compensation for the surrender of future rights, was not compensation for deprivation of rights and was not compensation for premature termination of the employment contract. In such circumstances the payment was a gratuity which was specifically included in income from any office or employment by virtual of section 9(l)(a) of the Inland Revenue Ordinance.

In finding the facts of this case we have not made reference to a number of letters which were issued by the employer subsequent to the events either to the Taxpayer himself or to the Commissioner in answer to enquiries from the assessor. It appears to us that what is said ex-post facto is of little value in this case when we have the direct evidence from the Taxpayer of what happened at the time and the contemporaneous agreement which was prepared by the employer and accepted in writing by the employee. However insofar as the statements made by the employer were concerned we note that they indicate that the sum of $737,460 was stated to be a capital sum paid in full settlement and in lieu of all rights which the Taxpayer would have had if his employment contract had continued and was in full compensation for the premature termination of his current employment.

We find it difficult to understand the case for the Commissioner in this appeal. The Commissioner's representative informed us that the Commissioner accepts that payments made as compensation for the loss of employment or in settlement of a claim for damages for wrongful dismissal are not assessable to salaries tax. In this case the employer decided to terminate the employment of the Taxpayer. To do this according to the contract between the employer and the Taxpayer it was necessary for the employer to wait for a period of nine months and then to give three months' notice of termination. No doubt to follow such a procedure would have caused difficulties. It had been decided to close down the department which the Taxpayer managed with immediate effect. It was not possible to relocate the Taxpayer within the structure of the employer. The employer would then have been in the position of continuing to employ a person with no doubt have been considerable and indeed might have led to claims for damages from the Taxpayer. In such circumstances it is customary for the employer to negotiate an amicable settlement with the employee. The question of damages for breach of contract does not arise because there had not as yet been any such breach. Clearly the Taxpayer had valuable contractual rights which the employer wished to extinguish. Terms of settlement were agreed between the employer and the Taxpayer which included the sum of $737,460 being compensation for the loss of employment. According to the Commissioner's own guidelines a payment made as compensation for the loss of employment and a payment made in settlement of a claim for damages for wrongful dismissal are not assessable to salaries tax. It is quite clear to us on

the evidence and facts before us that the sum of $737,460 which we have described as a severance payment was a payment made to terminate the employment of the Taxpayer and compensate him for the loss of his employment. If the payment had not been made the Taxpayer would have been entitled to claim damages for wrongful dismissal and it appears clear to us that he was entitled to a minimum of twelve months employment and/or notice of termination.

Perhaps the assessor and indeed the Deputy Commissioner have been confused because the employer and the Taxpayer used the word 'gratuity' when referring to the payment. By dictionary definition a gratuity is something to which a person has no legal entitlement. It is also a word used in section 9 of the Inland Revenue Ordinance. However the representative for the Commissioner quite rightly pointed out to us that the label which the parties give to a payment is not the governing factor. What one must do is to look at the real nature of the payment. 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.

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 this 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.

The only doubt which we have in this case is whether or not certain other sums included in the settlement were also payments as compensation for the loss of employment. We mention this because we would not like this decision to be taken as authority for what payments do and do not come within the designation of compensation for the loss of employment. The Taxpayer has only appealed in relation to the sum of $737,460. We assume that the ex-gratia payment of a general bonus, the thirteen months' salary, and the special bonus are accepted by the Taxpayer as being payments made to him in respect of his past services. Each case depends upon its own facts and only the Taxpayer and the managing director of the employer know what they negotiated and agreed.

For the reasons given we find in favour of the Taxpayer and direct that the assessment against which the Taxpayer has appealed should be referred back to the Commissioner to be amended in accordance with the determination of the Deputy Commissioner dated 24 February 1993 save and except that the sum of $737,460 should be deducted therefrom as not being subject to assessment to salaries tax and that consequent thereto any other necessary amendments be made to the assessment, that is the computation of the rental value of the quarters provided by the employer.