Case No. D43/98

Salaries tax – retirement benefits under a company's internal pension scheme upon restructuring of the company's pension scheme – immediate re-employment on different terms – whether taxable –section 8 of the Inland Revenue Ordinance, Chapter 112 – section 31R(2)(a), section 31Y(2). Section 31T(2) of the Employment Ordinance, Chapter 57

Panel: Ronny Wong Fook Hum SC (chairman), Mathew Ho Chi Ming and Larry Kwok Lam Kwong.

Date of hearing: 30 December 1997.
Date of decision: 10 June 1998.

The taxpayer was an employee of a company which had an internal pension scheme. By notice dated 20 September 1995, the company announced that by virtue of the implementation of the Occupational Retirement Schemes Ordinance, the company decided to terminate the company's internal pension scheme. Various terms were laid down in order to compensate the entitlements of its workers under the company's internal pension scheme: (a) all employees were to be treated as having notionally retired on 30 September 1995 (b) an employee whose entitlement under the company's internal pension scheme is greater than his theoretical entitlement to long service pay would be paid a lump sum by the end of 1995 by way of compensation.

The taxpayer who had been working for the company for over 5 years opted for retirement on 30 September 1995 so as to receive his retirement benefits under the company's internal pension scheme. He was then re-engaged on same pay but his period of service was measured as from 1 October 1995.

The taxpayer got a compensation of $61,187 by way of "pension" or "long service fund". The issue is whether the said sum is taxable as part of the taxpayer's emolument for the period between 1 April 1995 to 30 September 1995.

Held:

1. Given that there was no loss of employment, the sum in question in this case is clearly not long service payment within the meaning of the Employment Ordinance, Chapter 57 as to attract the extra statutory concession by the Commissioner. (D26/94, IRBRD, vol 9, 189 applied; D38/94, IRBRD, vol 9, 264 considered)

2. However, since the sum constitutes damages for breach of contract, the same was not taxable. (Hochstrasser v Mayes [1960] AC 376; Du Cros v Ryall 19 TC 444; Henley v Murray 31 TC 351 applied; D26/94 distinguished.)

Appeal allowed.

Cases referred to:

D26/94, IRBRD, vol 9, 189
D38/94, IRBRD, vol 9, 264
Hochstrasser v Mayes [1960] AC 376
Du Cros v Ryall 19 TC 444
Henley v Murray 31 TC 351

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

Decision:

Background of this case

1. With effect from 1 July 1977, Company X had in place a staff pension temporary regulation scheme ('Company X's Internal Scheme') for its monthly workers.

2. The Taxpayer commenced employment with Company X on 22 September 1986.

3. By notice dated 20 September 1995, Company X announced that by virtue of the implementation of the Occupational Retirement Schemes Ordinance, the company decided to terminate Company X's Internal Scheme as from 30 September 1995. Various terms were laid down in order to compensate the entitlements of its workers under Company X's Internal Scheme:

a. All employees were to be treated as having notionally retired on 30 September 1995.

b. A comparison was to be made between each employee's entitlement under Company X's Internal Scheme and his theoretical entitlement to long service pay under the Employment Ordinance consequential upon such notional retirement. No compensation will be made to an employee whose entitlement under Company X's Internal Scheme is less than his theoretical entitlement to long service pay. An employee whose entitlement under Company X's

Internal Scheme is greater than his theoretical entitlement to long service pay would be paid a lump sum by the end of 1995 by way of compensation.

c. An employee who had been with the company for over 5 years may instead opt for retirement on 30 September 1995 so as to receive his retirement benefits under Company X's Internal Scheme. The employee would then be re-engaged on same pay but his period of service would be measured as from 1 October 1995.

4. The Taxpayer availed himself to the option referred to in paragraph 3c above.

5. On 26 April 1996, Company X filed two employer's returns in respect of the Taxpayer's earnings as 'assistant sales manager' for the year of assessment 1995/96. The first return was for the period between 1 April 1995 to 30 September 1995 with the Taxpayer earning a total of $128,987 including a sum of $61,187 by way of 'pension'. The second return was for the period between 1 April 1995 to 31 March 1996. The Taxpayer's earnings for this period was said to be $110,140.

6. Company X subsequently filed two 'amended' returns dated 13 November 1996. The first of such return reported the Taxpayer's income as 'assistant sales manager' for the period between 1 April 1995 to 30 September 1995 amounting in total to $128,978 made up of $67,800 by way of salary and $61,187 by way of 'long service fund'. 'Dismissal' was given by Company X as the reason for the cessation of the Taxpayer's employment. The second 13 November 1996 return was in respect of the Taxpayer's income as 'assistant sales manager' for the period between 1 October 1995 to 31 March 1996 amounting in total to $110,140 made up of $67,840 by way of salary; $31,000 by way of bonus and $11,300 by way of other 'rewards, allowances or perquisites'.

7. The Taxpayer was stationed in the office of Company X in District Y prior to 30 September 1995. Upon re-engagement on 1 October 1995, the Taxpayer was posted in a godown in District Z. The nature of the Taxpayer's job changed from that of a business manager to that of warehouse operations supervisor.

8. The Taxpayer left the employment of Company X on 7 August 1996. 'Resignation' was given as the reason for cessation of employment in Company X's return of 30 April 1997.

9. The issue before us is whether the sum of $61,187 referred to respectively as 'pension' and 'long service fund' in Company X's 26 April 1996 and 13 November 1996 returns is taxable as part of the Taxpayer's emolument.

Contentions and evidence of the Taxpayer

10. The Taxpayer maintains that the sum of $61,187 is not taxable. He places heavy reliance on the designation 'long service fund' in Company X's 13 November 1996 return.

11. The Taxpayer explained to us in evidence that his duties and entitlements before 30 September 1995 were wholly different from those applicable after his re-engagement on 1 October 1995. His poor relationship with his new supervisor in the godown led to his eventual departure from Company X.

The authorities

12. The issue was considered in D26/94, IRBRD, vol 9, 189. The taxpayer in that case was employed by her employer since February 1987. In September 1991 the employer sold some machinery and equipment in order to reorganise its operations. Some employees left the employer on their own accord with effect from 1 November 1991 and lump sum payments termed 'long service payments' were made to those employees for their past services. Other employees, including the taxpayer in that case, knew about the lump sum payments and requested early termination of service in order to get the 'long service payment'. After negotiations between the employers and employees, it was agreed that their employment under the existing employment contract would be terminated and that 'long service payments' calculated up to 31 March 1992 would be paid to the employees who would then each be employed under a new employment contract with effect from 1 April 1992. Pursuant to that agreement, the employer paid the taxpayer a sum calculated in accordance with the formula provided by the Employment Ordinance ['the EO'] for the calculation of long service payments.

a. The Board referred to the practice of the Revenue not to tax severance payments and long service payments that are within the provisions of the EO. It further recognised that compensation for loss of employment is not taxable because it is not income from employment within the meaning of section 8 of the Inland Revenue Ordinance.

b. There Board was inclined to the view that there was no entitlement to severance payment as there was no redundancy within the meaning of section 31B(2) of the EO. There was also no dismissal for the purpose of section 31D(2) of the EO.

c. The Board was of the view that there was no entitlement to long service payment under section 31R(2)(a) of the EO as the taxpayer was immediately re-engaged under a new contract of employment. There was therefore no 'dismissal' as defined by section 31Y(2) of EO.

d. Given that there was no loss of employment, the Board further concluded that no question of compensation for such loss arose.

13. The issue was further considered in D38/94, IRBRD, vol 9, 264. The taxpayer in that case reached his retirement age for service with his employer in 1992. By notice dated 22 February 1993, the employer gave notice to the taxpayer informing him that his retirement would become effective on 1 March 1993 and he would be entitled to retirement

benefits of $107,750. The taxpayer's employment was terminated on 28 February 1993. Pursuant to an agreement reached prior to 28 February 1993, the taxpayer was re-employed in a different capacity and on different terms by the same employer. The Revenue there submitted that the entire payment made to the taxpayer was in respect of his past services and arose out of his employment. The issue before the Board was whether such payment amounted to long service benefit in accordance with the terms of the EO as to fall within the extra statutory concession which the Commissioner extended to salary taxpayers in practice. The Board indicated that although it had not yet reached a decision it was likely that it would find that:

a. as a matter of contractual law, the original employment of the taxpayer had been terminated and a new employment had commenced.

b. section 31T(2) of the EO had no application to contractual or taxation law because the subsection stated that an employee shall not be taken 'for the purposes of this part' to be dismissed etc.

The Board refrained from reaching a final decision as the Commissioner indicated that he 'would be prepared to grant to the taxpayer the benefit of the extra statutory concession in so far as the amount that he received was within the spirit of [the EO] even though it was not strictly paid thereunder'.

14. This Board shares the sentiment expressed by the Board in D38/94. It was there pointed out that:

> *'… the matter was highly technical because if the employment had terminated on one day and the new employment had commenced 24 hours later there would have been a technical break within the meaning of [the EO] and the Taxpayer would then have been entitled to the benefit of the extra statutory concession'.*

It was further recognised in that case that the remedy for such technical situation might not lie in this Board and consideration 'should be given to regularizing the position and to encourage the provision of long service benefits which are intended to help citizens of Hong Kong to provide for their retirement and old age.'

15. In the light of these authorities, the sum in question in this case is clearly not long service payment within the meaning of the EO as to attract the extra statutory concession by the Commissioner. What remains to be considered is whether the payment constitutes damages for breach of contract.

16. The starting point is the speech of Lord Radcliffe in Hochstrasser v Mayes [1960] AC 376

> *'For my part, I think that their meaning is adequately conveyed by saying that, while it is not sufficient to render a payment assessable that an employee would*

not have received it unless he had been an employee, it is assessable if it has been paid to him in return for acting as or being an employee'.

17. In Du Cros v Ryall 19 TC 444 the taxpayer was employed under an agreement as general manager of a company for 15 years. His employment was terminated prior to expiration of the 15 years period. He sued his employer for wrongful repudiation. The suit was compromised and a sum was agreed as damages. Findlay J took the view that the amount so agreed was merely damages payable in respect of the repudiation of the agreement and as the price for the cancellation of the agreement. He held that the same was not taxable.

18. In Henley v Murray 31 TC 351 the taxpayer was the managing director of a property company. He was entitled to various benefits under his service agreement. The company experienced financial difficulties. Assistance would only be forthcoming if the taxpayer were to sever his relationship with the company, the taxpayer 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 not taxable.

a. According to Lord Evershed, two classes of cases have to be distinguished.

   i. The first class of case is where the employers remain liable under the contract for the renumeration they had contracted to pay though they gave up their right to call upon the employee to perform the duties under the contract which he was bound to perform.

   ii. The other class is where 'the contract goes altogether and some sum becomes payable for the total abandonment of all the contractual rights which the other party had under the contract'. In this latter class of cases, the receipt is not taxable [page 363].

b. Jenkins LJ put the matter succinctly thus:

   '…the question in each case is whether, on the facts of the case, the lump sum paid is in the nature of renumeration 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 his office'.

19. These principles were obviously in the mind of the Board in D26/94, as the Board pointed out that:

> 'there is no question [of the sum in question] being compensation or damages for breach of contract on the part of the employer because the previous employment contract was terminated as a result of the employees' request for early termination of service.'

Our decision

20. We are of the view that Company X's Internal Scheme was part of the Taxpayer's contractual entitlements as assistant sales manager of Company X. That scheme was only voluntary in the sense that the same was not formed pursuant to any statutory compulsion. The scheme once formed was part of the terms and conditions regulating the Taxpayer's employment with Company X. Company X was not entitled unilaterally to terminate that scheme.

21. In seeking to put an end to that scheme by its notice dated 20 September 1995, Company X was committing an anticipatory breach of the contract of employment. The 20 September 1995 notice offered the Taxpayer compensation terms to remedy that breach. Those terms entailed payment to the Taxpayer of the sum in question; termination of the Taxpayer's subsisting contract and agreement to re-engage the Taxpayer under a new employment contract. The whole package was designed to absolve Company X from liabilities for breach of the then subsisting contract.

22. The case is distinguishable from D26/94. There was no question of breach in that case since it was the employees who initiated the move to secure the payment in question.

23. For these reasons, we hold that the Taxpayer is not liable to salaries tax in respect of the sum of $61,187. We discharge the assessment accordingly.