

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D55/93

Salaries tax – premature termination of employment – periodic payment – whether subject to salaries tax.

Panel: Robert Wei Wen Nam QC (chairman), Philip Fu Yuen Ko and Peter F Rhodes.

Date of hearing: 14 December 1993.

Date of decision: 1 February 1994.

The taxpayer was a senior employee of a school who was employed under an employment contract. The employer terminated the services of the taxpayer and agreed to make monthly payments to the taxpayer as compensation for terminating the employment contract. The assessor assessed the periodic payments to salaries tax. The taxpayer appealed on the ground that the payments were not assessable to salaries tax.

Held:

The periodic payments were compensation for the loss of employment and accordingly were not subject to salary.

Appeal allowed.

Wong Cheung Pik Har, Amy for the Commissioner of Inland Revenue.

Taxpayer in person.

Decision:

1. This is an appeal by an individual (the Taxpayer) against the salaries tax assessments raised on him for the years of assessment 1989/90 and 1990/91 as revised by the Commissioner of Inland Revenue. The question for the Board is whether the twelve monthly sums paid to him by his employer, a school, on account of his leaving the employment, was assessable to salaries tax.

2. The Taxpayer appeared in person and was the only witness. From his evidence and the documents produced before us, we have found certain facts which are stated below.

3. The Taxpayer was a senior employee of a school. His employment with the school commenced in mid-1977. In 1988/89, at the suggestion and cost of the school, the

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Taxpayer undertook a part-time degree course in Country X; promotion was promised upon successful completion of the course. The Taxpayer was popular and influential with the teachers.

4. The Taxpayer and the principal did not see eye to eye over a number of matters concerning the administration of the school; from time to time there were disagreements between the two at administrative meetings, although otherwise they were civil to each other.

5. The Taxpayer was employed by yearly contracts. The contract for the period from 1 September 1989 to 31 August 1990 was made in May 1989 and contained, so far as they were relevant, the following terms:

‘We have great pleasure to offer you re-appointment to the same post ... in our school, commencing September 1989.

Your monthly salary will be HK\$[21,435].

Your duties are to assist the Supervisor and Principal to manage the school, and you are required to act in accordance with the instructions given to you by them or their deputies. This re-appointment will expire on 31 August 1990, and a three months’ notice or three months’ salary in lieu of notice will be required if either party decides to terminate the contract on/before its expiration.’

6. In July 1989, the Taxpayer had a heated argument with the principal about a teacher’s qualification and pay; the Taxpayer had introduced the teacher to the principal; during the argument the principal accused the Taxpayer of deceiving the school, and said he would continue the discussion the next day.

7. On the next day, the principal wrote to the Taxpayer as follows:

‘Please be informed that it is the decision of the School Management Committee to ask you to retire, effective 1 September 1989.

You are allowed to take leave from 10 July 1989. Kindly hand over all matters of the school to the undersigned before you take leave.

In appreciation of your long service, the School Management Committee has decided to give you a bonus of \$128,610 (that is \$21,435 × 6) on 1 September 1989, on condition that you have handled all matters satisfactorily before you leave. This arrangement supersedes the contract of service are (sic) offered you for the school year 1989/90.’

8. On 13 July 1989 the Taxpayer wrote in reply as follows:

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‘I am writing to acknowledge receipt of and refer to your letter dated 5 July 1989, I am presently considering my position. As you must be aware, I shall be away from Hong Kong from mid-July 1989 to mid-August 1989 for my degree examination. I shall contact you upon my return to discuss arrangements relating to the decision of the School Management Committee.’

9. In July 1989 the Taxpayer left for Country X; sometime after late August 1989 he returned to Hong Kong, having successfully passed the examination and been awarded a Bachelor degree.

10. In late August 1989 the Taxpayer wrote a letter in Chinese to the principal; a translation prepared by the Revenue for use for the purposes of this appeal was as follows:

‘I signed an employment contract with the school for the school year 1989/90 but you later suggested that I retire prematurely and explained to me the various advantages of rescinding the contract. Thinking that it was for my interest as well as the school’s I decided to do as I was told.

Although I have reached the age of retirement, I have no intention to retire from my service. I have made no plans for my livelihood either. In view of these, I hesitate to make such a move in haste.

It is understood that the school has always been generous towards its leaving staff. I wonder if you would approach the authority on my behalf for a pension in the sum of my two years’ salary so that I can be tided over the difficulty. I am ashamed I was no perfect staff during my service in [the school] and it is indeed bold of me to make such a proposal. Nevertheless I hope the authority would be considerate and take into account my long service in the school and fulfil my wish. I would be most grateful if you convey this message for me. Sorry for any inconvenience caused.’

11. On 2 September 1989 the principal wrote in reply as follows:

‘
Re: Retirement

I have been directed by the School Management Committee to reply to your letter of late August 1989 to request for financial assistance after your retirement.

We have the pleasure to inform you of the decision of the School Management Committee as follows:

1. You will be paid a monthly amount of \$21,435, from 1 September 1989 to 31 August 1990.

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2. During the period of 1 September 1989 to 31 August 1990, you are not required to take up any duty in school.
3. The provident fund on your account will stop on 31 August 1989, and any balance thereof including your contribution and the employer's contribution, will be paid to you in full, when the statement is available.
4. If at any time it is found that you have acted in any way we consider as against the interest of the school, we will serve you notice to stop the monthly payment.
5. You have to sign to agree that the aforesaid arrangements supersede any of our offer to you concerning your retirement.

You also agree that you will have no further claim or request for compensation of any kind relating to your service on retirement from service in our school.'

The Taxpayer signed the above letter and accepted the terms stated therein.

12. The twelve monthly sums mentioned in paragraph 1 of the 2 September 1989 letter were duly paid. The question is whether they were assessable to salaries tax: if, as the Taxpayer contended, the sums were in the nature of compensation for the termination of his employment, they were not assessable, whereas if, as Mrs WONG the representative of the Commissioner of Inland Revenue contended, they were in the nature of a gratuity, they were.

13. From the facts found in paragraphs 3 to 11 above, we infer that prior to July 1989, relations between the Taxpayer and the principal had been strained, and that the last straw was the argument in July 1989 which led to negotiations for the termination of the Taxpayer's employment, commencing with a proposition from the principal representing the school that the Taxpayer retire as from 1 September 1989 and take leave as from 10 July 1989 and that he be paid a bonus equal to six month' pay on 1 September 1989 (see paragraph 7 above). The negotiations progressed to a counter-offer by the Taxpayer to retire with a pension equal to two years' pay (see paragraph 10 above), and culminated in the agreement of 2 September 1989, whereby: (1) the Taxpayer was to be paid twelve equal monthly sums (each equivalent to one month's pay) during the period from 1 September 1989 to 31 August 1990; (2) during the same period the Taxpayer was not required to take up any duty at the school; (3) the Taxpayer's provident fund account was closed as from 31 August 1989 (from which we infer that the Taxpayer's employment was terminated on that day); and (4) the monthly payments were liable to be stopped if at any time the Taxpayer had acted in any way which the school considered as being against its interests (see paragraph 11 above).

14. One thing that was conspicuous by its total absence from the negotiations and the resultant agreement of 2 September 1989 was the provision in the employment contract

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which gave the school the right to terminate the employment contract by giving a three months' notice or paying three months' salary in lieu of notice (see paragraph 5 above). We agree with the view that the three months' pay in lieu of notice was in truth agreed compensation for any premature termination of the one-year employment contract. However, the parties did not apply that yardstick; instead they agreed on 2 September 1989 quite different terms on which to compensate the termination of the contract; in our view they were entitled to do so.

15. Mrs WONG contended that the twelve monthly payments were in the nature of a gratuity; we disagree. From the deterioration in the relationship between the Taxpayer and the principal which led up to the letter of July 1989 from the principal to the Taxpayer, and from the terms of that letter (see paragraph 7 above), it is clear that the school's intention was that the Taxpayer should leave the school as soon as possible and that the 1989/90 employment contract should be terminated on 1 September 1989, that is, the day on which it was to have come into force. The principal used the word 'retire' in the letter in early July 1989 and the word 'retirement' repeatedly in the letter of 2 September 1989 (see paragraph 11 above); those words were misleading: they meant nothing more or less than termination of the employment contract by the school. As the Taxpayer pointed out, he had no intention to retire, but the school insisted that he should; that is borne out by his letter dated late August 1989 to the principal (see paragraph 10 above). In the circumstances, 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 past services (see D78/88, IRBRD, vol 4, 160). Mrs WONG did not submit alternatively that the monthly payments were partly compensation and partly gratuity; we think she was right not to do so, because such a view cannot in our opinion be sustained on the facts. Likewise, the words 'retire' and 'retirement' in the Taxpayer's letter dated late August 1989 should be construed in the same way as where they appear in the principal's letters; and the word 'pension' in the Taxpayer's letter of that date should be construed to mean compensation.

16. Moving on to the agreement of 2 September 1989, the closing of the Taxpayer's provident fund account as from 31 August 1989 and the payment in full of the balance including the Taxpayer's and the school's contributions as provided by clause 3 of the agreement pointed clearly to the termination of the Taxpayer's employment as from 1 September 1989. Clause 2 provided that the Taxpayer would not be required to take up any duty. Looked at in isolation, it could mean that the school was waiving a contractual right to call upon the Taxpayer to take up duties. But in the context of clause 3, there is no room for such a construction, for it would mean that, subject to the waiver, the Taxpayer's employment would have continued and that he would have continued to draw his salary, whereas clause 3 was in our view a clear indication that the Taxpayer's employment was terminated as from 1 September 1989. Clause 2 should therefore be construed strictly, that is, without the implication of a waiver. Clause 4 was understandable in the circumstances of the case: in monetary terms the compensation provided by clause 1 was much larger in amount than the three months' pay in lieu of notice under the employment contract, while clause 4 afforded the school the advantage of imposing a degree of restraint during the year

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on the Taxpayer's conduct in relation to the school, bearing in mind that the Taxpayer was popular and influential with the teachers. As for clause 5, the Taxpayer submitted that the word 'compensation' as it was used in that clause showed that the intention of the agreement was to give the Taxpayer compensation; we accept that. In our view, the twelve monthly payments were part of a package deal with the object of which was to compensate the Taxpayer in respect of the premature termination of the employment contract for the year of assessment 1989/90, and were in the nature of compensation for loss of employment.

17. On clause 4 of the agreement, Mrs WONG submitted that the fact that the monthly payments could be stopped by the school unilaterally if it was of the view that the Taxpayer had done something against the interests of the school suggested that the Taxpayer had no legal entitlement to the payments which therefore could not be compensation for loss of employment. We disagree. Clause 4 was one of the terms on which the Taxpayer was to be compensated; it had the effect of making the payments less secure than they might otherwise have been, but it cannot be said that he had no legal entitlement to the payments: for instance, if he kept his hands off the affairs of the school, he would certainly be entitled to the payments; if he was to take some action, he might or might not be putting his entitlement in jeopardy and he would have been well advised to be very careful, but that does not mean that he had no title to the payments.

18. Mrs WONG referred to a letter dated in mid-November 1991 from the chief accountant of the school in answer to queries made by the Commissioner of Inland Revenue in which the writer confirmed that the monthly payments were made in appreciation of the Taxpayer's twelve years of service with the school and to enable him to have a good living while looking for a new job. We do not attach any weight to the confirmation because: (1) the writer was not called to give evidence, and (2) it cannot be ruled out that the writer was influenced by the fact that the school through the principal had all along been using the word 'retirement' (wrongly in our view) to describe the premature termination of the Taxpayer's employment contract at the school's insistence.

19. It follows that this appeal is allowed. The case is hereby remitted to the Commissioner for the assessments in question to be revised on the basis that the twelve monthly payments made pursuant to the agreement dated 2 September 1989 were not assessable to salaries tax.