Case No. D58/08

Salaries tax – payment on termination of employment – whether assessable to salaries tax – sections 8(1) and 9(1)(a) of the Inland Revenue Ordinance ('IRO').

Panel: Kenneth Kwok Hing Wai SC (chairman), Wendy O Chan and Jessica Young Yee Kit.

Date of hearing: 6 February 2009.
Date of decision: 6 March 2009.

The appellant claimed that a sum paid to him by his former employer upon termination of employment ('the Sum') was 'a compensation for service termination' and should not be chargeable to salaries tax for the year of assessment 2005/06.

Held:

1. The question is whether the Sum was in consideration of the surrender by the appellant of his rights in respect of the office.

2. The appellant has received all his contractual entitlements and the former employer was not in breach of his employment contract upon termination.

3. The appellant has also received all his statutory entitlements and the former employer was not in breach of his statutory duty under the Employment Ordinance, Chapter 57.

4. The appellant thus surrendered no rights. The Sum was not compensation for loss of employment. It was a gratuitous payment made for the appellant's having acted as employee for 9 years hence it is caught by the word 'gratuity' under section 9(1)(a).

5. The appellant seemed to suggest yet the Board do not think that the Sum was an inducement to appellant's becoming an employee of the new employer as:

    5.1 The Sum was not conditional upon the appellant's taking up of employment by the new employer; and

5.2 The appellant admitted that the Sum would still have been paid even if he had not taken up employment by the new employer.

Appeal dismissed.

Cases referred to:

CIR v Humphrey [1970] HKLR 447
Hochstrasser (Inspector of Taxes) v Mayes [1960] AC 376
Shilton v Wilmshurst (Inspector of Taxes) [1991] 1 AC 684
Humphrey, Wing Tai Development Co Ltd v Commissioner of Inland Revenue [1979] 642
Commissioner of Inland Revenue v Yung Tse Kwong [2004] 3 HKLRD 192
Fuchs, Walter Alfred Heinx v Commissioner of Inland Revenue, HCIA 1/2008
Commissioner of Inland Revenue v Elliott [2007] 1 HKLRD 297

Taxpayer in person.
Chan Tak Hong and Yip Chi Chuen for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal against the Determination of the Deputy Commissioner of Inland Revenue dated 19 September 2008 whereby the salaries tax assessment for the year of assessment 2005/06 under charge number X-XXXXXXX-XX-X, dated 23 August 2006, showing net chargeable income of $498,029 with tax payable thereon of $88,805 was confirmed.

2. The issue in this appeal is whether an *ex gratia* payment of $85,500 paid by the appellant's former employer to the appellant upon the termination of his employment was chargeable to salaries tax under section 8(1) of the Inland Revenue Ordinance, Chapter 112 ('the Ordinance').

The agreed facts

3. The appellant agreed the following facts in the section 'Facts upon which the Determination was arrived at' in the Determination and we find them as facts.

4. The appellant has objected to the salaries tax assessment for the year of assessment 2005/06 raised on him. The appellant claimed that a sum paid to him by his former employer upon termination of employment should not be chargeable to salaries tax.

5. The appellant commenced his employment with the former employer on 8 May 1997.

6. By letter dated 8 December 2005 ('the Termination Letter'), the appellant was notified that his employment with the former employer would be terminated and his last employment date was 11 December 2005. The Termination Letter provided for the calculation of the appellant's terminal benefits as follows:

		$
(a)	Salaries up to and including 11 December 2005	15,968
(b)	Payment for outstanding annual leave of 6.5 days	9,436
(c)	Payment in lieu of notice (1 month) for service termination	45,000
(d)	Severance payment – after offset by Provident Fund Company's contribution	0
(e)	*Ex gratia* payment	85,500
(f)	Discretionary bonus 2005	108,000
	Total	263,904

7. The former employer filed an employer's Return in respect of the appellant and reported, among other things, the following:

(a)	Capacity in which employed	Asst Mgr – Systems Development	
(b)	Period of employment	01/04/2005 to 11/12/2005	
(c)	Particulars of income		
	Salary	375,968	
	Leave pay	9,436	
	Back pay, Terminal awards, and Gratuities, etc.	85,500	('the Sum')
	Bonus	108,000	
	Total	578,904	

8. In his tax return for the year of assessment 2005/06, the appellant declared, among other things, the following income particulars:

Employer	Period	Amount ($)
The former employer	01/04/2005 – 11/12/2005	578,904
The new employer	12/12/2005 – 31/03/2006	164,032
		742,936

9. The assessor raised on the appellant the following salaries tax assessment for the year of assessment 2005/06 in accordance with his tax return:

		$	$
Income (paragraph 8)			742,936
Less:	Charitable donations	600	
	Home loan interest	30,507	
	Retirement scheme contributions	3,800	34,907
			708,029
Less:	Basic allowance	100,000	
	Child allowance	80,000	
	Dependant parent allowance	30,000	210,000
Net chargeable income			498,029
Tax payable thereon			88,805

10. The appellant objected against the above assessment on the ground that the Sum was 'a compensation for service termination'. He asserted the following:

> 'My ground is based on the fact that [the Sum] is a compensation for [loss] of employment, a form of severance payment. If I was not retrenched, I won't be granted with this compensation and in fact this job has been ceased to exist in [the former employer]. Moreover, some of my colleagues were granted exclusion of the ex-gratia payment from the assessment. They had the same situation as me.'

11. In response to the assessor's enquiries, the former employer provided the following information:

(a) The Sum was paid to the appellant as he was made redundant by the company.

(b) The Sum was paid at the discretion of the company. It was paid on top of the contractual and legal requirement induced by the appellant's separation.

(c) The appellant had not been deprived of any rights in receiving the Sum.

The appellant's case

12. The appellant's case was that his remuneration package under his employment by the new employer was inferior to that of the former employer and that the *ex gratia* payment was to compensate him for loss of employment by the former employer. He testified that the reason for the compensation package was that the former employer outsourced certain work to the new employer and that the former employer needed the staff whose employment had been terminated to

continue to provide, as employees of the new employer, the same services to the former employer. He acknowledged that he had not given up any rights. He also admitted under cross-examination that there was no breach of contract by the former employer, that there was no strings attached to the *ex gratia* payment and that he would still have received it had he not joined the new employer. He told us that the former employer used the same formula in computing the amounts of *ex gratia* payments to him and his ex colleagues, i.e. basic monthly salary ÷ 4 x number of years of service rounded up to the nearest number.

The Board' s decision

13. Section 68(4) of the Ordinance provides that the onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.

14. Section 8(1) of the Ordinance provides that:

> '*(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 or employment of profit; and*
>
> *(b) any pension.'*

15. Section 9(1)(a) of the Ordinance provides that:

> '*(1) Income from any office or employment includes ... any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others ...'*

16. Judgments handed down by the Hong Kong courts and the English cases on the corresponding English provisions establish that to come within the section 8(1) charge:

(a) the Sum was income arising in or derived from Hong Kong from the source – the appellant' s employment;

(b) the Sum was paid in return for having acted as employee;

(c) the payment arose from the employment and not from 'something else';

(d) the employment was the *causa causans* and not merely the *causa sine qua non* of the receipt of the Sum.

Compensation for loss of employment is thus not within the charge. The question here is whether the Sum was in consideration of the surrender by the appellant of his rights in respect of the office.

(1) In CIR v Humphrey [1970] HKLR 447 at page 452, CA, Blair-Kerr J said that the following are the corresponding English provisions of our sections 8(1) and 9(1):

'*The corresponding English statutory provisions are s. 156 of the Income Tax Act 1952 and rule 1 of the Rules applicable to Schedule E (9th Schedule to the Act). These provisions read as follows:-*

"s. 156..... Schedule E

1. Tax under this Schedule shall be charged in respect of every public office or employment of profit.....".

"r. 1. Tax under Schedule E. shall be annually charged on every person having or exercising an office or employment of profit mentioned in Schedule E..... in respect of all salaries, fees, wages, perquisites or profits whatsoever therefrom ....."'.

(2) In Hochstrasser (Inspector of Taxes) v Mayes [1960] AC 376 at pages 387-388, Viscount Simonds cited section 156 of the 1952 Act and commented on Upjohn J's summary of the law:

'It is by section 156 of the Income Tax Act, 1952, provided as follows:

"The Schedule referred to in this Act as Schedule E is as follows-

Schedule E

1. Tax under this Schedule shall be charged in respect of every public office or employment of profit. ...

2. Tax under this Schedule shall also be charged in respect of any office employment or pension, the profits or gains arising or accruing from which would be chargeable to tax under Schedule D but for the proviso to paragraph 1 of that Schedule. ...

5. The provisions set out in Schedule IX to this Act shall apply in relation to the tax to be charged under this Schedule."

Schedule IX, so far as relevant, was as follows:

"Rules Applicable To Schedule E

1. Tax under Schedule E shall be annually charged on every person having or exercising an office or employment of profit mentioned in Schedule E, or to whom any annuity, pension or stipend chargeable under that Schedule is payable, in respect of all salaries, fees, wages, perquisites or profits whatsoever therefrom for the year of assessment, after deducting the amount of duties or other sums payable or chargeable on the same by virtue of any Act of Parliament, where the same have been really and bona fide paid and borne by the party to be charged."

...

Upjohn J., before whom the matter first came, after a review of the relevant case law, expressed himself thus in a passage which appears to me to sum up the law in a manner which cannot be improved upon. "In my judgment," he said, "the authorities show this, that it is a question to be answered in the light of the particular facts of every case whether or not a particular payment is or is not a profit arising from the employment. Disregarding entirely contracts for full consideration in money or money' s worth and personal presents, in my judgment not every payment made to an employee is necessarily made to him as a profit arising from his employment. Indeed, in my judgment, the authorities show that to be a profit arising from the employment the payment must be made in reference to the services the employee renders by virtue of his office, and it must be something in the nature of a reward for services past, present or future." In this passage the single word "past" may be open to question, but apart from that it appears to me to be entirely accurate.'

Lord Radcliffe (at pages 391-392) thought that the test was whether a payment was made in return for acting as or being an employee:

'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.'

Lord Cohen (at pages 394-395) said that the court must be satisfied that the service agreement was the *causa causans* and not merely the *causa sine qua non* of the receipt of the profit:

> *'My Lords, I am prepared to accept that statement of the law but it is, I think, clear from the final conclusion of Morris L.J. in the case last cited, and from the decisions cited by Jenkins L.J. in his judgment in the present case (see especially Beak v. Robson, per Lord Simon, and Cowan v. Seymour, per Younger L.J.) that it is not enough for the Crown to establish that the employee would not have received the sum on which tax is claimed had he not been an employee. The court must be satisfied that the service agreement was the causa causans and not merely the causa sine qua non of the receipt of the profit.'*

(3) Shilton v Wilmshurst (Inspector of Taxes) [1991] 1 AC 684 was a case where Nottingham Forest Football Club paid the taxpayer, a world famous goalkeeper, a lump sum of £75,000 in consideration of his agreement to sign a contract with Southampton Football Club. Thereafter the taxpayer entered into a new contract of employment with Southampton. The taxpayer was assessed to income tax under Schedule E for 1982-83 *on the basis that the £75,000 was an emolument of his employment with Southampton*. The tax dispute went all the way to the House of Lords. Lord Templeman, delivering the leading judgment in the House of Lords, cited sections 181 and 183 of the English Income and Corporation Taxes Act 1970, and stated what emolument 'from employment' or 'from the employment' meant (at pages 688 & 689):

> *'Section 183 of the Act of 1970, now replaced by section 131 of the Income and Corporation Taxes Act 1988, provided that:*
>
> *"(1) Tax under Case I, II or III of Schedule E shall … be chargeable on the full amount of the emoluments falling under that Case . . . and the expression 'emoluments' shall include all salaries, fees, wages, perquisites and profits whatsoever."*
>
> *It is common ground that the sum of £75,000 paid by Nottingham Forest to Mr. Shilton was an emolument as defined by section 183.*
>
> *Section 181(1) of the Act of 1970, as amended and now replaced, so far as material, by section 19(1) of the Act of 1988, provided that tax under Schedule E:*

> *"shall be charged in respect of any office or employment on emoluments therefrom which fall under . . . Case I: where the person holding the office or employment is resident and ordinarily resident in the United Kingdom . . ."*
>
> *...*
>
> *... Section 181 is not confined to "emoluments from the employer" but embraces all "emoluments from employment"; the section must therefore [comprehend] an emolument provided by a third party, a person who is not the employer. Section 181 is not limited to emoluments provided in the course of employment; the section must therefore apply first to an emolument which is paid as a reward for past services and as an inducement to continue to perform services and, secondly, to an emolument which is paid as an inducement to enter into a contract of employment and to perform services in the future. The result is that an emolument "from employment" means an emolument "from being or becoming an employee." The authorities are consistent with this analysis and are concerned to distinguish in each case between an emolument which is derived "from being or becoming an employee" on the one hand, and an emolument which is attributable to something else on the other hand, for example, to a desire on the part of the provider of the emolument to relieve distress or to provide assistance to a home buyer. If an emolument is not paid as a reward for past services or as an inducement to enter into employment and provide future services but is paid for some other reason, then the emolument is not received "from the employment".'*

(4) *Hochstrasser* and *Shilton* had been cited and applied by our Courts, e.g. Humphrey, Wing Tai Development Co Ltd v Commissioner of Inland Revenue [1979] 642, Commissioner of Inland Revenue v Yung Tse Kwong [2004] 3 HKLRD 192 and Fuchs, Walter Alfred Heinx v Commissioner of Inland Revenue, HCIA 1/2008, Burrell J, 26 June 2008.

(5) In Commissioner of Inland Revenue v Elliott [2007] 1 HKLRD 297 at paragraph 28, Le Pichon JA[1] said that question is whether the lump sum paid was in consideration of the surrender by the recipient of his rights in respect of the office:

[1] Rogers VP and Stone J agreed with the judgment of Le Pichon JA.

'In Henley, Sir Raymond Evershed, MR (at page 363) contrasted the case in which "the contract persists", where the employers remain liable under the contract for the remuneration they had contracted to pay though they gave up their right to call upon the employee to perform the duties under the contract with another class of case where the bargain was of an essentially different character, where "the contract itself goes altogether and some sum becomes payable for the consideration of the total abandonment of all the contractual rights which the other party had under the contract". The critical distinction was the continued existence or otherwise of the contract of employment. As Jenkins LJ remarked (at page 367), "the question in each case is whether, on the facts of the case, the lump sum paid is in the nature of remuneration of profits in respect of the office or is in the nature of the sum paid in consideration of the surrender by the recipient of his rights in respect of the office." In the present case, the Agreement unquestionably came to an end.'

(6) In Yung Tse Kwong, Tang J (as he then was) stated that the crux of the matter was whether the sum in dispute was paid solely or partly as an inducement to enter into employment and, if it was, it was taxable, and that it did not matter whether it was paid before, during or on termination of employment.

'... Mairs v. Haughey is clear authority that payment made as an inducement to enter into employment is taxable, and that it does not matter whether it was paid before, during or on termination of the employment'. (at paragraph 30)

'[The above cited] authorities confirm my view that the crux of the matter is whether Sum A was paid solely or partly as an inducement to enter into employment'. (at paragraph 40)

17. The first question is whether the Sum was compensation for loss of employment.

18. Under the terms of the appellant's employment by the former employer, the former employer was entitled to terminate the appellant's employment by 'payment of one month's Basic Salary together with Non-Pensionable Salary'[2]. His basic salary was $38,000 per month and non-pensionable salary was $7,000 per month, totalling $45,000 per month. The sum of $45,000 which formed part of his terminal benefits[3] was not included[4] in the former employer's return referred to in paragraph 7 above. The Revenue has not sought to tax this amount. The appellant

[2] Clause 16 of the former employer's letter dated 1 August 2001.
[3] See paragraph 6 above.
[4] The former employer reported salary income of $375,968. This is equal to 8 months' salary at $45,000 per month for April to November 2005 and $15,968 as salary for 1 – 11 December 2005 referred to in paragraph 6 above.

has thus received all his contractual entitlements and the former employer was not in breach of his employment contract.

19. So far as the appellant's entitlement to severance payment under the Employment Ordinance, Chapter 57, is concerned, he has not disputed the former employer's assertion that this was offset by contributions by the former employer to its provident fund. The Revenue has not sought to tax the appellant's benefits under the provident fund. The appellant has thus received all his statutory entitlements and the former employer was not in breach of his statutory duty to make severance payment.

20. The appellant surrendered no rights. To his credit, he admitted that he had not given up any rights. We conclude that the Sum was not compensation for loss of employment. It was a gratuitous payment made for the appellant for having acted as employee for 9 years[5] and, as such, it was caught by the word 'gratuity' in section 9(1)(a).

21. The appellant seemed to suggest that the Sum was an inducement to become an employee of the new employer.

22. On the facts of this case, we do not think it was an inducement. It is clear from the Termination Letter that the Sum was not conditional upon the appellant taking up employment by the new employer. Again, to his credit, he admitted that the Sum would still have been paid even if he had not taken up employment by the new employer.

23. Further and in any event, even if it was, the Sum was still chargeable to tax as an emolument of his employment with the new employer[6]. Treating the Sum as an emolument of his employment with the new employer instead of the former employee has no effect on the correct amount of chargeable income.

24. The appellant felt a sense of grievance that his case was treated differently from those of some of his former colleagues. Our jurisdiction is limited to the assessment appealed against in this case and the issue is whether the Sum is caught by the charge under section 8(1). We should add that it appears from the correspondence and notes of a meeting between the assessors and the former employer's human resources officers that the Revenue was looking into similar cases and giving advance notice to the former employer of further enquiries in those cases.

Conclusion and disposition

25. We have carefully considered all the points raised by the appellant in correspondence and at the hearing. In our view, the Sum was income arising in or derived from Hong Kong from the source – the appellant's employment by the former employer. The Sum was paid in return for having acted as employee; the payment arose from the employment and not from 'something else'

[5] After rounding up.

[6] See Hochstrasser and Yung Tse Kwong.

and the employment was the *causa causans* and not merely the *causa sine qua non* of the receipt of the Sum.

26. The appeal fails. We dismiss the appeal and confirm the assessment appealed against as confirmed by the Deputy Commissioner.