Case No. D58/98

Salaries tax – whether payment under voluntary retirement scheme damages for breach of contract or income from employment.

Panel: Ronny Wong Fook Hum SC (chairman), Anthony So Chun Kun and Andrew Wang Wei Hung.

Date of hearing: 9 May 1998.
Date of decision: 9 July 1998.

The taxpayer started working with Company X in 1965. In 1977, Company X introduced a retirement scheme conferring various benefits to its employees on their retirement at 60 years of age. This retirement scheme is not a recognised occupational retirement scheme for the purpose of the Inland Revenue Ordinance.

In September 1995, Company X notified its employees that it would abolish its retirement scheme on 1 October 1995. All its employees were given a choice of either retaining their years of service and accepting a special subsidy in consideration of termination of their entitlements under the retirement scheme or retiring on 30 September 1995 and obtaining their benefits under the retirement scheme pursuant to such retirement. The taxpayer selected the latter and obtained payment of a sum of $210,000 (the Payment). The taxpayer was immediately re-employed in the same job by Company X and left the Company in August 1997.

Held:

Company X's retirement scheme was part of the taxpayer's contractual entitlements. In seeking to terminate that scheme by its notice in September 1995, Company X was committing an anticipatory breach of the contract of employment. The notice offered the taxpayer compensation terms (including the Payment) to remedy that breach. The whole package was designed by Company X to absolve itself from liabilities for its breach of the then subsisting contract. The payment thus constitutes damages for breach of contract only and is not income from employment within the meaning of section 8 of the IRO (D26/94 distinguished; D38/94, Hochstrasser v Mayes, Du Cros v Ryall, Henley v Murray considered).

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

Yim Kwok Cheong for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

Background

1. Company X commenced business on about 15 October 1965. The Taxpayer started working with them on 1 November 1965.

2. With effect from 1 July 1977, Company X introduced a retirement scheme conferring various benefits to its employees on their retirement at 60 years of age. The benefits were to be computed on the basis of the years of service of the employee in question. This retirement scheme is not a recognised occupational retirement scheme for the purpose of the Inland Revenue Ordinance ['the IRO'].

3. By notice dated 20 September 1995, Company X notified its employees that it would abolish its retirement scheme on 1 October 1995. All its employees were given a choice of either retaining their years of service and accepting a special subsidy in consideration of termination of their entitlements under the retirement scheme **or** retiring on 30 September 1995 and obtaining their benefits under the retirement scheme pursuant to such retirement. The Taxpayer selected the latter and obtained payment of a sum of $210,000 described as 'long service payment'.

4. The Taxpayer's retirement from Company X was merely notional. He was immediately re-employed in the same job by Company X. He left that company on 1 August 1997.

5. The question before us is the taxability of the sum of $210,000 referred to in paragraph 3 above.

The statutory provisions

6. Section 8 of the IRO provides that salaries tax shall be charged on every person in respect of his income arising in or derived from Hong Kong from any office or employment of profit.

7. According to section 9(1)(aa) of the IRO, income from any office or employment includes any amount received by an employee before or after his employment ceases from a pension or provident fund as representing the employer's contributions to that fund. Exemption from the tax net is only conferred on amounts received from 'a recognised occupational retirement scheme'. Given the fact that Company X's retirement scheme is not a recognised occupational retirement scheme, the exemption is not available to the Taxpayer.

The authorities

8. Similar issue was considered by this Board 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 IRO.

b. The 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.

9. The issue was also 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'.

10. 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.'

11. We are of the view that for the purpose of the extra statutory concession of the Commissioner, the issue is whether there was a dismissal within the meaning of the EO as to confer entitlement to long service payment. Given the re-engagement, there was no 'dismissal' by virtue to section 31T(2) of the EO. It follows that there was no entitlement to long service payment **under the EO** and the case does not fall within the extra statutory concession of the Commissioner.

12. What remains to be considered is whether the payment constitutes damages for breach of contract. 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'.*

13. 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.

14. 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.'

15. 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

16. We are of the view that Company X's retirement scheme was part of the Taxpayer's contractual entitlements. 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.

17. 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 by Company X to absolve itself from liabilities for its breach of the then subsisting contract.

18. 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.

19. For these reasons, we hold that the Taxpayer is not liable to salaries tax in respect of the sum of $210,000. We discharge the assessment accordingly.