Case No. D59/98

Salaries tax – retirement scheme – pension on termination of employment – statutory concession – whether there was a dismissal within the meaning of section 31T(2) of the Employment Ordinance – re-engagement – whether compensation to breach.

Panel: Ronny Wong Fook Hum SC (chairman), Walter Chan Kar Lok and Ho Chung Ping.

Date of hearing: 22 April 1998.
Date of decision: 16 July 1998.

The taxpayer commenced employment with Company X as a clerk on 1 August 1989. Company X operated a retirement scheme ('Company X Internal Scheme') for the benefit of its employees. As from 1 October 1995, by notice dated 20 September 1995, employees of Company X were informed that Company X had decided against registration of Company X Internal Scheme under the Occupational Retirement Schemes Ordinance and thereafter Company X's employees would be entitled to long service payment upon their retirement in the future.

The taxpayer opted to retire on 30 September 1995 and received her entitlements under Company X Internal Scheme. The taxpayer was re-employed on the same salary as from 1 October 1995 and her year of service under long service payment would be computed as from 1 October 1995. A sum of $20,227 was paid in her favour. The taxpayer declared this sum of $20,227 as her pension. The issue is on the taxability of this sum of $20,227.

Held:

(1) For the purpose of the extra statutory concession of the Commissioner, the issue is whether there was a dismissal within the meaning of the Employment Ordinance as to confer entitlement to long service payment. Given the re-engagement, there was no 'dismissal' by virtue of section 31T(2) of the Employment Ordinance. It follows that there was no entitlement to long service payment under the Employment Ordinance and the case does not fall within the extra statutory concession of the Commissioner (D26/94, IRBRD, vol 9, 189 and D38/94, IRBRD, vol 9, 264 followed).

(2) Company X Internal Scheme was part of the taxpayer's contractual entitlements as a clerk of Company X. The scheme once formed was part of the terms and conditions regulating the taxpayer's employment with

Company X. In seeking to put an end to that scheme by its notice dated 20 September 1995, Company X committed 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. The whole package was designed to absolve Company X from liabilities for breach of the then subsisting contract. For those reasons, the taxpayer is not liable to salaries tax in respect of the sum of $20,227 (D26/94 is distinguished; Hochstrasser v Mayes [1960] AC 376, Du Cros v Ryall 19 TC 444 and Henley v Murray 31 TC 351 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

Fung Ka Leung for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

Background

1. The Taxpayer commenced employment with Company X as a clerk on 1 August 1989. Company X operated a retirement scheme ['Company X Internal Scheme'] for the benefit of its employees.

2. On 15 October 1993, the Occupational Retirement Schemes Ordinance ['the ORSO'] came into operation. The ORSO established a registration system for certain occupational retirement schemes to ensure that such schemes are properly regulated.

3. By notice dated 20 September 1995, employees of Company X were informed that:

a. Company X had decided against registration of Company X Internal Scheme under the ORSO.

b. Company X Internal Scheme would be abolished as from 1 October 1995.

c. Company X's employees would thereafter be entitled to 'long service payment' upon their retirement in the future.

d. Given differences in the mode of calculation of entitlements under Company X Internal Scheme and for the purpose of long service payment, a computation was to be effected on the basis of notional retirement of all Company X's employees as at 30 September 1995:

i. No allowance would be made in favour of any Company X's employee should such computation produce no difference in his/her entitlement.

ii. A cash allowance would be given to a Company X employee should his/her entitlement under Company X Internal Scheme differ from those computed for the purpose of long service payment.

e. Employees with more than 5 years of service with Company X could, instead of the provisions outlined in the preceding paragraph, opt for 'retirement' on 30 September 1995 and receive his/her entitlements under Company X Internal Scheme/long service payment. An employee so opted would be re-employed on the same salary save that his year of service would be computed as from 1 October 1995.

4. By notice dated 30 September 1995, the Taxpayer opted to retire on 30 September 1995. A sum of $20,227 was paid in her favour.

5. On 13 November 1996, Company X filed two employer's return in respect of the earnings of the Taxpayer.

a. The first return was in respect of the Taxpayer's earnings as a clerk for the period between 1 April 1995 to 30 September 1995. The sum of $20,227 was included as 'long service fund'. 'Dismissal' was given as the reason for cessation of the Taxpayer's employment.

b. The second return was in respect of the Taxpayer's earnings also as a clerk for the period between 1 October 1995 to 31 March 1996.

6. In her tax return for the year of assessment 1995/96, the Taxpayer declared the sum of $20,227 as her 'pension'.

7. The issue before us relates to the taxability or otherwise of this sum of $20,227.

The authorities

8. The Respondent (the CIR) drew our attention to 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. 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 Taxpayer cited to us 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.'

Save for these strong expressions of sentiment, we are of the view that the Taxpayer can derive limited assistance from this case given the course taken by that Board.

11. The Taxpayer seeks to distinguish D26/94 on three grounds:

a. The relevant sum was described by the employer in D26/94 as 'back pay, terminal awards, and gratuities, etc.' whereas the sum in question in this case was described in the employer's return as 'long service fund'.

b. In D26/94, it was the taxpayer who sought termination of the subsisting employment contract whereas in this case she was presented by her employer with a situation over which she had no control.

c. She disagreed with the finding in D26/94 that 'As there was no loss of employment, there is no question of compensation for such a loss'. The Taxpayer pointed out that losing the benefit of her years of service called for compensation.

12. We do not think the present case is distinguishable from D26/94 on the first of these three grounds. 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 of 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.

13. The second and third grounds argued by the Taxpayer are much more substantial. The starting point is the distinction one finds in 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'.*

14. 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.

15. 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 was 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.'*

16. 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

17. We are of the view that Company X Internal Scheme was part of the Taxpayer's contractual entitlements as a clerk 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 by virtue of the coming into force of the ORSO.

18. In seeking to put an end to that scheme by its notice dated 20 September 1995, Company X committed 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.

19. 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.

20. For these reasons, we hold that the Taxpayer is not liable to salaries tax in respect of the sum of $20,227. We discharge the assessment accordingly.