

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D60/02

Salaries tax – gratuity – whether upon termination of employment – section 9(2) of the Inland Revenue Ordinance ('IRO').

Panel: Patrick Fung Pak Tung SC (chairman), Leung Hing Fung and Mary Teresa Wong Tak Lan.

Date of hearing: 21 February 2002.

Date of decision: 17 September 2002.

By a service agreement dated 2 July 1998 and made between Company A and the taxpayer ('the 1998 Agreement'), Company A agreed to employ the taxpayer as resident engineer from 2 July 1998 for a period of 24 months or such shorter period as might be determined in accordance with the 1998 Agreement.

On 10 January 2000, Company A and the taxpayer entered into another service agreement ('the 2000 Agreement') whereby Company A agreed to employ the taxpayer as resident engineer from 10 January 2000 for a period of 24 months or such shorter period as might be determined in accordance with the 2000 Agreement.

The material difference between the two agreements is only the location of the projects where the taxpayer worked.

However, the taxpayer received a contract gratuity (and a backpay).

The issue is whether it was paid to the taxpayer upon the termination of his employment.

Held:

The Board found that the substitution of the 2000 Agreement for the 1998 Agreement did not amount to a termination of the employment of the taxpayer by Company A which remained his employer. The taxpayer was still a resident engineer receiving more or less the same remuneration except that he was to work in a different project in a different location. The gratuity (and the backpay) was part of his remuneration package under the 1998 Agreement. It was not in the nature of a severance pay. In substance, there was only an internal transfer of the taxpayer from one project to another on slightly different terms of employment (D14/86, IRBRD, vol 2, 250; D67/89, IRBRD, vol 5, 52;

INLAND REVENUE BOARD OF REVIEW DECISIONS

D101/89, IRBRD, vol 6, 375; D43/94, IRBRD, vol 9, 278; D29/95, IRBRD, vol 10, 247 and D131/00, IRBRD, vol 16, 1 considered).

Appeal dismissed.

Cases referred to:

D14/86, IRBRD, vol 2, 250
D67/89, IRBRD, vol 5, 52
D101/89, IRBRD, vol 6, 375
D43/94, IRBRD, vol 9, 278
D29/95, IRBRD, vol 10, 247
D131/00, IRBRD, vol 16, 1

Cheung Mei Fan for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. This is an appeal by the Appellant ('the Taxpayer') against a notice of assessment and demand for salaries tax for the year of assessment 1999/2000 ('the Assessment') issued by the Respondent ('the Commissioner'). An objection was lodged by the Taxpayer. By his letter dated 19 November 2001, the Commissioner made a determination ('the Determination') and partially upheld the Taxpayer's objection. The Taxpayer has brought this appeal against the Determination.
2. The original assessment assessed the net assessable income of the Taxpayer at \$1,555,264 with tax payable thereon of \$232,839. By the Determination, the Commissioner reduced the net assessable income to \$1,164,280 with tax payable thereon of \$187,427.

The facts

3. By a service agreement dated 2 July 1998 and made between Company A as 'the Company' of the one part and the Taxpayer as 'the Employee' of the other part ('the 1998 Agreement'), Company A agreed to employ the Taxpayer as resident engineer from 2 July 1998 for a period of 24 months or such shorter period as might be determined in accordance with the 1998 Agreement at a monthly salary of \$73,815.
4. The other relevant provisions in the 1998 Agreement read as follows:

INLAND REVENUE BOARD OF REVIEW DECISIONS

(a) 'Diligence

2. The Employee shall diligently and faithfully perform the duties of Resident Engineer on [Project 1] and will act in all respects according to the instructions or directions given to him by the Company or other persons duly authorised by the Company.'

(b) 'Duties

4. The duties of the Employee shall include the usual duties of the office in which he is engaged and any other suitable duties which the Company may call upon him to perform. The Employee shall work in such place and occupy himself in such manner as the Company or other persons duly authorised by the Company shall direct. ...'

(c) 'Gratuity

6. On completion of the Period of Service the Employee shall be entitled to a gratuity unless the duration of the Period of Service is determined by the provisions of Clauses 13.1 or 14.2 in which case the Employee shall not be entitled to such gratuity. Such gratuity shall be calculated as 25% of the total salary paid in accordance with Clause 3.1. In the event of the Employee's death during the period of this Agreement, the amount of the gratuity shall be paid to the Employee's estate.'

(d) 'Housing Benefit

- 7.1 The Employee shall be eligible for housing benefit at a rate of HK\$24,980.00 per month.'

(e) 'Determination of Employment

- 14.1 The Company may at any time determine the employment of the Employee by giving him three calendar months' notice in writing or by paying him three months' salary in lieu of notice.'

5. By a letter dated 10 February 2000, Company A wrote to the Taxpayer as follows:

'We are pleased to confirm that you have been transferred from [the site of Project 1] to this project as Resident Engineer (Civil) commencing on 10th January 2000. As from this date, your terms of employment are governed by the new service

INLAND REVENUE BOARD OF REVIEW DECISIONS

agreement that you have signed, which supersedes all your previous terms of employment with the company.

From the date of your transfer to [Project 2], life insurance benefit ceased to apply. As mutually agreed, your service agreement which commenced on 2nd July 1998 has been resolved by mutual consent effective retrospectively on 10th January 2000. You will be paid gratuity calculated in accordance with Clause 6 for the period from 2nd July 1998 to 9th January 2000. Please note that any severance payment, long service payment and/or other payment(s) based on length of service that may be due to you under the Employment Ordinance shall be reduced by any gratuities that may be paid to you for your services on [Project 1] and [Project 2].

Please confirm your acceptance of the above terms and conditions of employment by signing and returning to us the attached duplicate of this letter.'

6. The Taxpayer put his signature on a copy of the said letter against the words 'I confirm my acceptance of the above terms and conditions of employment'.

7. It transpired that on 10 January 2000, Company A and the Taxpayer had entered into another service agreement ('the 2000 Agreement') whereby Company A agreed to employ the Taxpayer as resident engineer from 10 January 2000 for a period of 24 months or such shorter period as might be determined in accordance with the 2000 Agreement at the same monthly salary of \$73,815 as under the 1998 Agreement.

8. The other relevant provisions under the 2000 Agreement are as follows:

(a) 'Diligence

2. The Employee shall diligently and faithfully perform the duties of Resident Engineer on [Project 2] and will act in all respects according to the instructions or directions given to him by the Company or other persons duly authorised by the Company.'

(b) 'Duties

4. The duties of the Employee shall include the usual duties of the office in which he is engaged and any other suitable duties which the Company may call upon him to perform. The Employee shall work in such place and occupy himself in such manner as the Company or other persons duly authorised by the Company shall direct. ...'

(c) 'Gratuity

INLAND REVENUE BOARD OF REVIEW DECISIONS

6. On completion of the Period of Service the Employee shall be entitled to a gratuity unless the duration of the Period of Service is determined by the provisions of Clauses 12.1 or 13.2 in which case the Employee shall not be entitled to such gratuity. Such gratuity shall be calculated as 25% of the total salary paid in accordance with Clause 3.1 from the first day of this Service Agreement up to a date immediately before section 7A of the Mandatory Provident Fund Schemes Ordinance (Cap. 485) (“the Ordinance”), as amended by the Provident Fund Schemes Legislation (Amendment Ordinance) 1998 (“Amendment Ordinance”), comes into effect, or the end of this Service Agreement, whichever is earlier. Starting from the commencement date of section 7A of the Ordinance, as amended by the Amendment Ordinance, the Company will make a monthly contribution in respect of the Employee to a scheme registered under the Mandatory Provident Fund Schemes Ordinance (“MPF Scheme”) for the remainder of this Service Agreement at the statutory contribution rate (i.e. initially 5% of the Employee’s monthly relevant income or HK\$1,000, whichever is the less). The gratuity payable for the remainder of this Service Agreement shall be the sum which, when added to the Company’s contribution to the said MPF Scheme, equals 25% of the total salary drawn under Clause 3.1 during that period. In the event of the Employee’s death during the period of this Agreement, the amount of the gratuity shall be paid to the Employee’s estate. Any severance payment, long service payment and/or other payment(s) based on length of service that may be due from the Company to the Employee under the Employment Ordinance shall be reduced by the sum of gratuity payable hereunder.’

(d) ‘Housing Benefit

7.1 The Employee shall be eligible for housing benefit at a rate of HK\$20,890.00 per month.’

(e) ‘Determination of Employment

13.1 The Company may at any time determine the employment of the Employee by giving him three calendar months’ notice in writing or by paying him three months’ salary in lieu of notice.’

(f) ‘Earlier Agreement

INLAND REVENUE BOARD OF REVIEW DECISIONS

17. This Agreement shall supersede all previous agreements between the Employee and the Company.'

9. It will be noted that for all practical purposes, there is little difference in substance between the provisions of the 1998 Agreement and the 2000 Agreement. The noticeable differences between the two are the following features:

- (a) The location of the projects.
- (b) The 'Gratuity' provisions in that in the 2000 Agreement the wording of clause 6 was changed to provide for the coming into force of the Mandatory Provident Fund legislation.
- (c) The 'Housing Benefit' provisions in that under the 1998 Agreement the sum was \$24,980 per month whereas under the 2000 Agreement the sum was \$20,890 per month.
- (d) There is the new clause 17 in the 2000 Agreement.

10. In a letter to the Inland Revenue Department dated 13 December 2000, the Taxpayer said this:

'I have terminated my 2 year Employment Contract (which commenced on July 2 1998) with [Company A] with effect from Jan 10 2000. On the same date, I was employed by the same company on a new employment contract on a different construction project.'

The relevant sections in the IRO

11. The relevant parts of section 8 of the IRO provide as follows:

'8. Charge of salaries tax

(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.*

INLAND REVENUE BOARD OF REVIEW DECISIONS

(1A) *For the purposes of this Part, income arising in or derived from Hong Kong from any employment –*

(a) *includes, without in any way limiting the meaning of the expression and subject to paragraph (b), all income derived from services rendered in Hong Kong including leave pay attributable to such services’.*

12. The relevant parts of section 9 of the IRO provide as follows:

‘9. Definition of income from employment

(1) *Income from any office or employment includes –*

(a) *any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others ...*

(b) *the rental value of any place of residence provided rent-free by the employer or an associated corporation ...*

(1A)(a) *Notwithstanding subsection (1)(a), where an employer or an associated corporation –*

(i) *pays all or part of the rent payable by the employee; or*

(ii) *refunds all or part of the rent paid by the employee,*

such payment or refund shall be deemed not to be income;

(b) *a place of residence in respect of which an employer or associated corporation has paid or refunded all the rent therefor shall be deemed for the purposes of subsection (1) to be provided rent free by the employer or associated corporation;*

...

(2) *The rental value of any place of residence provided by the employer or an associated corporation shall be deemed to be 10% of the income as described in subsection (1)(a) derived*

INLAND REVENUE BOARD OF REVIEW DECISIONS

from the employer for the period during which a place of residence is provided after deducting the outgoings, expenses and allowances provided for in section 12(1)(a) and (b) to the extent to which they are incurred during the period for which the place of residence is provided and any lump sum payment or gratuity paid or granted upon the retirement or termination of employment of the employee’.

13. Section 11B of the IRO provides as follows:

‘11B. Ascertainment of assessable income

The assessable income of a person in any year of assessment shall be the aggregate amount of income accruing to him from all sources in that year of assessment.’

14. The relevant part of section 11D of the IRO provides as follows:

‘11D. Receipt of income

For the purpose of section 11B –

...

- (b) income accrues to a person when he becomes entitled to claim payment thereof:*

Provided that –

- (i) any lump sum payment received on or after 1 April 1966, being a lump sum payment or gratuity paid or granted upon the retirement from or termination of any office or employment or any contract of employment of an employee or a lump sum payment of deferred pay or arrears of pay arising from an award of salary or wages, whether such a payment is paid by an employer to a person during employment or after that person has left his employ, shall upon the application in writing of the person entitled to claim payment thereof within 2 years after the end of the year of assessment in which the payment is made be related back and shall then be deemed to be income which has accrued during the periods in which the services or*

INLAND REVENUE BOARD OF REVIEW DECISIONS

employment, in respect of which the payment was made, were performed or exercised, or, if the relevant periods of service or employment exceed 3 years, the payment shall be deemed to be income accruing at a constant rate over the 3 years ending on the date on which the person became entitled to claim payment thereof or ending on the last day of employment, whichever is the earlier; and, notwithstanding section 70, an application made by any person under this proviso for the adjustment of an assessment shall, to that extent, be regarded as a valid objection to the assessment under section 64'.

The respective cases of the parties

15. The respective arguments of the parties are conveniently set out in paragraphs (6) to (14) of the Determination which, for the sake of convenience, we set out below:

' (6) In the 1999/2000 employer's return in respect of the Taxpayer, [Company A] provided the following particulars:

- (a) Capacity in which employed : Resident Engineer
- (b) Period of employment : 1 April 1999 to 31 March 2000
- (c) Particulars of income :

Salary	\$1,076,212
Backpay, terminal awards, and gratuities, etc.	<u>336,930</u>
Total	<u><u>\$1,413,142</u></u>
- (d) Particulars of quarters provided –

Address	: [A flat at Housing Estate B]
Period provided	: 7 April 1999 to 31 March 2000
Rent paid to landlord by employee	: \$154,232
Rent refunded to employee	: \$154,232

(7) In his 1999/2000 tax return, the Taxpayer –

INLAND REVENUE BOARD OF REVIEW DECISIONS

- (a) declared the same total income and particulars of quarters provided as in Fact (6);
- (b) remarked that a gratuity of \$336,930 covering 2 July 1998 to 9 January 2000 and a backpay of \$87,666 covering 15 April 1998 to 2 July 1998 were included in the total income of \$1,413,142 received from the Company; and
- (c) claimed for deduction subscriptions to the Institution of Civil Engineers of \$1,538 and approved charitable donations of \$500.
- (8) On 31 October 2000, the Assessor raised on the Taxpayer the following 1999/2000 Salaries Tax assessment:

Income per return	\$1,413,142
<u>Add:</u> Rental value	
$(\$1,413,142 - \$1,538) \times 10\%$	<u>141,160</u>
Assessable Income	\$1,554,302
<u>Less:</u> Outgoings and expenses	(1,538)
Charitable donations	<u>(500)</u>
Net Assessable Income	<u>\$1,552,264</u>
Tax Payable thereon at standard rate	<u>\$232,839</u>

- (9) The Taxpayer objected to the above assessment on the grounds that the gratuity and the backpay should not be included in the income for calculating the rental value. He was of the view that the assessment should be revised as follows:

Income per return	\$1,413,142
<u>Add:</u> Rental value	
$(\$1,413,142 - \$336,930 - \$87,666)$	
$\times 10\% - \$500 - \$1,538$	<u>96,817</u>
Assessable Income	\$1,509,959
<u>Less:</u> Outgoings and expenses	(1,538)
Charitable donations	<u>(500)</u>
Net Assessable Income	<u>\$1,507,921</u>
Tax Payable thereon at standard rate	<u>\$226,188</u>

INLAND REVENUE BOARD OF REVIEW DECISIONS

(10) In response to the Assessor's enquiries, the Taxpayer made the following assertions and contentions:

(a) Gratuity of \$336,930

(i) "... I have terminated my 2 year Employment Contract (which commenced on July 2 1998) with (the Company) with effect from Jan 10 2000. On the same date, I was employed by the same company on a new employment contract on a different construction project."

(ii) "My new service agreement in [Project 1] commenced on 2 July 1998 ... this service agreement has been resolved by mutual agreement effective from 10 January 2000. Therefore the contract gratuity for the period 2.7.98 to 9.1.2000 should not be included in calculating the rental value."

(b) Backpay \$87,666

(i) "I attach a letter dated 15.4.99 which confirm a housing benefit has been paid for the service agreement from 15 April 1998 to 1 July 1998 in [Project 3]. During the period, I was paid housing allowance of \$34,170 per month. I have not claim this as housing benefit for taxation purpose for the year 1.4.98 to 31.3.99 and therefore fully taxable for year 1.4.99 to 31.3.2000 in retrospect."

Copies of the said letter dated 15 April 1999 and another letter dated 29 June 1999 regarding revisions in the terms of the Taxpayer's service agreement covering his service period from 15 April to 1 July 1998 are at Appendices D and D1.

(ii) "The total amount of housing allowance has been included in the assessable income for 1999/2000 as 'backpay 15/04/98 – 02/07/98' which amounts to \$87,666."

(11) In response to the Assessor's enquiries, the Company –

(a) provided the following breakdown of the salary of \$1,076,212 [Fact (6)(c)]:

Salary	\$885,780
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INLAND REVENUE BOARD OF REVIEW DECISIONS

Housing benefit		
15 April 1998 to 1 July 1998	\$87,666	
1 April 1999 to 31 March 2000	<u>102,766</u>	<u>190,432</u>
Salary per employer's return		<u><u>\$1,076,212</u></u>

- (b) confirmed that the backpay housing benefit of \$87,666 for the period from 15 April 1998 to 1 July 1998 had been included in the salary of \$1,076,212.
- (12) The Assessor had since formed the following views:
- (a) The termination of the Taxpayer's service agreement dated 2 July 1998 did not constitute a termination of his employment with the Company. As such, the contract gratuity of \$336,930 and the backpay of \$87,666 should not be excluded from the computation of the rental value.
- (b) It was advantageous for the Taxpayer to have the contract gratuity and housing allowance related back to the relevant periods.
- (c) Since the Taxpayer was provided with quarters during the period from 7 April 1999 to 31 March 2000 instead of throughout the year ended 31 March 2000, the rental value should be adjusted accordingly.
- (13) By a letter dated 31 August 2001, the Assessor explained her views to the Taxpayer and proposed to revise the 1998/99 and 1999/2000 Salaries Tax assessments as follows:

- (a) Year of Assessment 1998/99 [after relating back]

Income previously assessed	\$1,217,160
<u>Add:</u> Gratuity related back to 2.7.1998 to 31.3.1999	
\$336,930 × 273/557	165,138
Backpay related back to 15.4.1998 to 1.7.1998	<u>87,666</u>
Assessable Income	\$1,469,964
<u>Less:</u> Outgoings and expenses	<u>(1,450)</u>
Net Assessable Income	<u><u>\$1,468,514</u></u>
Tax Payable thereon at standard rate	<u><u>\$220,277</u></u>

INLAND REVENUE BOARD OF REVIEW DECISIONS

(b) Year of Assessment 1999/2000 [after relating back]

Income previously assessed	\$1,413,142
<u>Add:</u> Gratuity related back to the year 1998/99 [per (a) above]	(165,138)
Backpay related back to the year 1998/99 [per (a) above]	(87,666)
	<u>\$1,160,338</u>
<u>Add:</u> Rental value (\$1,160,338 - \$1,538) × 360/366 × 10%	113,980
Assessable Income	\$1,274,318
<u>Less:</u> Outgoings and expenses Approved charitable donations	(1,538)
	<u>(500)</u>
Net Assessable Income	\$1,272,280
<u>Less:</u> Basic allowance	(108,000)
Net Chargeable Income	<u>\$1,164,280</u>
Tax Payable thereon at progressive rates	<u>\$187,427</u>

(14) The Taxpayer did not accept the Assessor's proposal but applied for relating back the contract gratuity of \$336,930 and backpay of \$87,666. The Taxpayer put forward the following contentions to support his objection:

(a) "You have not taken into account of my letter dated 10 Feb 2001 [Appendix C] ... in which it was confirmed that my service agreement commencing 2 July 1998 had been resolved by mutual consent effective from 10 Jan 2000. As such there is a termination of service. Please note in clause 15 of the service agreement my salary and benefit which include my gratuity is subject to approval of the Hong Kong Special Administrative Region."

(b) "The fact that I continued to be employed by (the Company) on a new contract should not be different from the case if I were employed by another company on the second contract. Otherwise, the taxation system would penalise and therefore restrict my freedom to choose my employment."

(c) "I have checked with my colleagues who renewed their contract under the same company and they agree with my point of view from their

INLAND REVENUE BOARD OF REVIEW DECISIONS

experience with your department. Please review my case in line with same cases of other tax payers.””

16. The arguments advanced by the parties at the hearing of the appeal were but elaboration upon their original arguments with the addition of submissions in relation to the decided cases.

The issue

17. Hence, the only issue for our decision is whether the contract gratuity in the sum of \$336,930 and the backpay in the sum of \$87,666 were paid to the Taxpayer upon ‘the termination of employment of the employee’ within the meaning of section 9(2) of the IRO.

18. We take the view that the substitution of the 2000 Agreement for the 1998 Agreement for the purpose of governing the employment relationship between Company A and the Taxpayer did not amount to a termination of the employment of the Taxpayer by Company A which remained his employer. The Taxpayer was still a resident engineer receiving more or less the same remuneration except that he was to work in a different project in a different location. The gratuity (and the backpay) was part of his remuneration package under the 1998 Agreement. It was not in the nature of a severance pay. In substance, there was only an internal transfer of the Taxpayer from one project to another on slightly different terms of employment.

19. The authorities on this aspect of the law are ample. There have been many decided cases by the Board of Review.

20. In D14/86, IRBRD, vol 2, 250 where the facts were very similar to those in the present case, the Board said:

‘In our view the words “termination of employment” must be construed and interpreted independently and be given their own independent meaning.

The question to be decided is whether there was a termination of employment, at the moment in time when the period of the Appellant’s contract of employment with the Hong Kong Government came to an end when he completed his period of resident service in Hong Kong and the period of leave to which he was entitled at the end thereof and immediately prior to his commencing the new period of the further employment to which he and the Government had agreed.

At first sight on reading the wording of paragraph 2.3 of the Conditions of Service it would appear that there was a termination of employment and we would have so found if there had been so [sic] supervening events. Paragraph

INLAND REVENUE BOARD OF REVIEW DECISIONS

2.3 of the Conditions of Service is clear and precise. It states that “the appointment will cease on the date or expiry of any leave granted in respect of his agreement”. If an appointment ceases then the employment must likewise terminate. However there was a supervening event. Prior to the expiry of the employment agreement between the Appellant and the Hong Kong Government, the parties agreed that the Appellant would be re-engaged or re-appointed for a further contractual period on the same terms and conditions as then existed subject only to such additional or different terms as the Appellant and the Hong Kong Government then agreed.’

21. In D67/89, IRBRD, vol 5, 52 in which the taxpayer was re-located by his employer in Hong Kong to work for an associated company (a different legal entity) in China, it was held that there was no termination of his employment by his employer in Hong Kong.

22. The same results were arrived at in D101/89, IRBRD, vol 6, 375; D43/94, IRBRD, vol 9, 278; D29/95, IRBRD, vol 10, 247 and D131/00, IRBRD, vol 16, 1.

23. By a letter dated 14 February 2002 addressed to the Commissioner, the Taxpayer sought to distinguish his case from the decided cases. We have given consideration to his arguments in the letter. Although there are some differences in some of the factual aspects of the Taxpayer’s case, the differences are not material and the legal principles enunciated in the decided cases are equally applicable to the Taxpayer’s case.

Conclusion

24. In all the circumstances, we have no alternative but to dismiss the Taxpayer’s appeal.