Case No. D60/97

Salaries tax – payment made to employee to continue employment until transfer of employer's business – whether payment from employment or compensation for loss of employment – Inland Revenue Ordinance sections 8(1) and 9(1).

Panel: Andrew Halkyard (chairman), Chiu Chun Bong and David Lam Tai Wai.

Date of hearing: 4 September 1997.
Date of decision: 30 September 1997.

The taxpayer was paid a lump sum by his then employer on condition that he continued employment until the sale of part of the employer's business to a related company was completed. The Taxpayer was not required to repay the sum in the following circumstances: if he resigned after a necessary licence to carry on the business was granted to the related company; or if he resigned after 12 months from the date of the payment but before the issue of the licence to the related company; or if the sale of the business was not completed, except where he resigned within 12 months after the date of payment (in which latter case, the sum must be repaid on a pro-rata basis). In the event, the sale of the business to the related company was completed and the Taxpayer became an employee of the related company.

The Taxpayer claimed that the sum should not be subject to salaries tax because it was compensation for loss of employment.

Held:

(1) The sum was not compensation for loss of employment. As a substantive matter the Taxpayer lost nothing.

(2) The sum was properly subject to salaries tax, being a payment both for being an employee of the employer until the sale of the business was completed and as an inducement for the Taxpayer becoming an employee of the new owner of the business (Shilton v Wilmhurst [1991] STC 88 and D3/94, IRBRD, vol 9, 69 applied).

Appeal dismissed.

Cases referred to:

Hochstrasser v Mayes (1959) 38 TC 673
Shilton v Wilmhurst [1991] STC 88
D3/94, IRBRD, vol 9, 69

So Chau Chuen for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

The facts

The following facts are agreed by both parties.

(1) Mr A ('the Taxpayer') has objected against the salaries tax assessment raised on him for the year of assessment 1994/95. The Taxpayer claims that a sum received from his previous employer was compensation for termination of employment and should not be charged to tax.

(2) On 8 July 1985, the Taxpayer commenced employment with Company B. Clause G of the appointment letter dated 5 June 1985 provided that notice for termination of employment should be one week either way during the probationary period and thereafter, one month either way.

(3) By a letter dated 21 June 1994 (hereafter referred to as 'the Letter'), Company B advised the Taxpayer that the security division of its business was to be sold to its related company, Company C [1] subject to the latter obtaining from relevant Hong Kong Government departments the licences and registrations currently held by Company B for its business. Company B also advised that if the conditions could not be satisfied by 27 November 1995, the sale would not proceed.

(4) In the Letter, Company B:

(a) gave the Taxpayer notice of termination of employment with effect from and conditional upon completion of the sale of the business to Company C,

(b) advised the Taxpayer that Company C offered to employ him on the same terms and conditions as his existing employment with Company B with effect from and conditional upon completion of the sale of the business to Company C,

(c) advised the Taxpayer that until completion of the sale of the business, he would remain its employee, and

[1] Company B retained a 40% shareholding in Company C group.

(d) agreed to make a payment to the Taxpayer upon the Taxpayer accepting the terms of the offer contained in the Letter and its attachments.

(5) The Letter also contained the following provisions in respect of the payment referred to in Fact (4)(d) above:

> 'If you agree to accept this offer, and if the sale is completed, all your rights will be protected in the same way as if you had continued as an employee of [Company B] and [Company C] will treat your prior service with [Company B] as service with it for the purposes of calculating your entitlements as an employee.'
>
> 'If you accept this offer and you resign before the receipt by [Company C] of formal notice from the government of the issuance of Group II licence in favour of [Company C], you will be obliged to repay the gratuity as follows. The gratuity will have to be repaid on a pro rata basis based on a twelve month period from the date of the payment to the effective date of the resignation, (such that the longer you stay the less the repayment amount), to [Company B] immediately upon tendering your notice and you hereby authorise [Company B] to set this amount off against any amounts which would otherwise be due to you on your resignation.
>
> If you accept this offer and the sale is not completed for any reason whatsoever, your employment with [Company B] will continue as before and the terms and conditions of your employment with [Company B] will be unaffected.'

(6) The attachments to the Letter included a memorandum dated 8 June 1994 (hereafter referred to as 'the Memorandum'). The Memorandum contained, among other matters, the formula for computation of the payment referred to in Fact (4)(d) above. It also stated that on accepting the payment, an employee who was a first-line reportee would agree to give three months termination notice after completion. 'Completion' was stated to mean 'the date of issue of the Group II Licence'. The Taxpayer was one of the first-line reportees.

(7) The Taxpayer accepted the offer contained in the Letter. In accordance with the terms contained therein, he received a sum of $240,640 (hereafter referred to as 'the Sum') from Company B on 21 June 1994.

(8) The Group II Licence was issued by the government to Company C on 17 October 1994. The sale of the business from Company B to Company C was completed on 1 November 1994. As a consequence, the Taxpayer's employment with Company B was terminated on 31 October 1994.

(9) For the year of assessment 1994/95, Company B and Company C filed separate Employer's Returns of Remuneration and Pensions in respect of the Taxpayer with the following particulars:

		Company B **$**	**Company C** **$**
(a)	Income		
	Salary	221,319	158,085
	Leave pay	-	14,282
	Bonus	74,830	31,617
	'Payment for termination of service agreement'	240,640	-
		536,789	203,984
(b)	Capacity in which employed	Fire/BMS Sales Manager	Fire/BMS Sales Manager
(c)	Period of employment	1-4-1994 to 31-10-1994	1-11-1994 to 31-3-1995

(10) The assessor raised a salaries tax assessment for the year of assessment 1994/95 on the Taxpayer as follows:

	$
Assessable Income ($536,789 + $203,984)	740,773
Less: Charitable donations	1,000
Net Assessable Income	739,773
Tax Payable thereon	110,965

(11) The Taxpayer lodged an objection against the assessment on the ground that the Sum was compensation for termination of employment and should be excluded from his assessable income. The Taxpayer contended that:

(a) '[The Sum] in question was in no way related to my employment contract with [Company B]. In other words, the payment was non-contractual.'

(b) '[The Sum] so paid to me was a compensation for my loss of employment with [Company B] in consequence of the disposal of part of the company's business. In fact, that payment was made for the termination of my employment and it should not regarded as a payment for my past services with the company.'

(c) '[The Sum] was paid to me in consideration of the loss of rights under my contract with [Company B], and as a waiver for any future claim against the company. ... the payment was capital in nature and should not be subjected to Hong Kong Salaries Tax.'

(12) Company B confirmed that the Taxpayer was not required to repay the Sum in the following circumstances:

(a) if he resigned after the Licence was issued to Company C,

(b) if he resigned after 12 months from the date of the payment but before the issue of the Licence to Company C, and

(c) if the sale of business was not completed, except where he resigned within 12 months after the date of payment of the Sum.

(13) At all relevant times, Company B operated an approved retirement scheme and the scheme was still in operation before termination of the Taxpayer's employment and the sale of its business. Upon termination of employment, Company B's employees were entitled to receive sums from the scheme. The Taxpayer received $290,709.49 from this scheme in addition to the Sum in dispute.

(14) Company B confirmed that the Taxpayer did not receive any other sum except the above on termination of employment.

(15) It was stated on the signature page of the Letter that the person accepting the offer would 'waive any claim [he] may have under the Employment Ordinance to wages in lieu of notice of termination of [his] employment' with Company B. When asked to elaborate what exactly was the claim that the employee waived, Company B stated:

> 'Upon the successful sale of the security business, [the Taxpayer's] employment with Company B would be terminated. [The Sum] was paid to [the Taxpayer] as a compensation for switching from Company B to Company C in which [the Taxpayer] suffered in terms of job security and status since Company B was a more established company whereas Company C was a newly formed entity.'

(16) On 11 November 1996 the Commissioner disallowed the Taxpayer's objection and confirmed the assessment set out at fact (10).

(17) On 9 December 1996 the Taxpayer appealed to this Board against the Commissioner's decision on the ground that the Sum should not be subject to salaries tax.

(18) Some of the Taxpayer's colleagues have not been subject to salaries tax in respect of similar payments made to them by Company B. They fall into two groups:

(a) Several were simply assessed on the amount of the employment income returned by them, excluding the amount set out in Company B's Employer's Return under the heading 'Payment for termination of service agreement' (compare fact (9)(a)); and

(b) Others were assessed on the same basis as the Taxpayer, but the assessment had later been reduced on objection. In each of these cases, however, the objection was determined by the assessor under delegated authority. None of these cases had been considered personally by either the Commissioner or Deputy Commissioner.

Preliminary matter before the Board

In light of fact (18) the Commissioner's representative, Mr So Chau-chuen, explained that, following the determination issued by the Commissioner to the Taxpayer, it was the Commissioner's considered view that the similar payments made to the Taxpayer's colleagues by Company B should have been subject to salaries tax. If this Board finds in favour of the Commissioner, Mr So explained that the previous assessments issued to the Taxpayer's colleagues would be reviewed and that, to the extent authorised by the Inland Revenue Ordinance (the IRO), additional salaries tax assessments would be raised.

We thank Mr So for his explanation. In the circumstances before us, it was particularly appropriate for the Taxpayer to be made aware of the past and future action contemplated by the Commissioner. Both the law and good administration require fair treatment between taxpayers in similar circumstances.

The Taxpayer's contentions

<u>The Sum was compensation for loss of employment</u>. Notwithstanding that Company B was only required to give the Taxpayer one month notice on termination of employment, the Taxpayer argued that it was normal practice for large companies such as Company B to make an ex gratia payment in an amount which was greater than that to which an individual employee was legally entitled. The Taxpayer contended that the payments made by Company B were part of a so-called 'outplacement arrangement' and were paid to employees who made contributions in the past. In this regard, the Taxpayer stressed that although the Sum was calculated on the basis of past service, it was non-taxable compensation for loss of employment and not a taxable payment for services.

In response to a question from the Board, the Taxpayer admitted that he did not suffer any financial loss by transferring his employment from Company B to Company C. But he did argue that the transfer resulted in reduced job security because Company C was less capitalised than Company B and did not have such a prominent status.

In response to a question from the Board, the Taxpayer admitted that his legal rights as an employee after the transfer of employment to Company C were the same as they were prior to the transfer.

<u>The Sum was not additional remuneration to stay on during the transition; nor was it an inducement for joining the new company</u>. The Taxpayer noted that the Sum was paid by Company B and that it could not, therefore, be classified as an inducement to join

Company C. In this regard the Taxpayer simply stated that it was not necessary for his former employer to induce him to enter into a new employment with a new employer.

The Law

Section 8 of the Inland Revenue Ordinance (the IRO) provides that:

'(1) Salaries tax shall, subject to the provisions of this IRO, be charged for each year of assessment on every person in respect of his income ... from the following sources:

(a) any office or employment of profit ...'

Section 9 goes on to provide that:

'(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 ...'

On the basis of various authorities brought to our attention, including Hochstrasser v Mayes (1959) 38 TC 673 per Viscount Simonds at 705, to be liable to salaries tax the Sum must arise from the employment, be referable to the services the Taxpayer rendered by virtue of his office and must be something in the nature of a reward for services past, present or future.

This basic proposition was expanded upon in a further House of Lords decision, Shilton v Wilmhurst [1991] STC 88 per Lord Templeman at 91:

> *'[The relevant UK taxing provision] 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, second, 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 Board of Review in D3/94, IRBRD, vol 9, 69 has accepted that, notwithstanding differences in statutory language, Shilton v Wilmhurst can be applied in the context of Hong Kong salaries tax. We agree and adopt the following statement of the Board at 73:

> *'It may be said that the Shilton case is not an authority on inducement payments from an employer. However, clearly the principle stated therein applies to payments from an employer as well as from a third party; we think that it is open to us to adopt that principle ... In our view, therefore, "income*

from employment" in [section 8(1) of our IRO] means "income from being or becoming an employee"'.

On the basis of these and other like authorities, this Board must decide what is in substance the nature of the Sum in dispute. If it is 'income from employment', as that term has been interpreted, it is subject to salaries tax. A different result will apply if it is compensation for loss of employment. In any event, the label placed upon the payment by either employer or employee is not conclusive.

Analysis

One of the major difficulties facing the Taxpayer in this case was that he could not show explicitly what 'loss' he had suffered which the Sum was alleged to have recompensed. What is clear, however, is that:

(1) It was not for loss of retirement benefits (fact (13) refers). Company B operated an approved retirement scheme (as then called) and the Taxpayer received a substantial tax-free sum therefrom.

(2) There was no liability for Company B to make a severance payment, or indeed any other compensatory payment, to the Taxpayer under the provisions of the Employment Ordinance. In order for such a liability to exist, the Taxpayer must have been 'dismissed' and there is no dismissal where an existing employment is taken up by a new employer upon change of ownership of a business (see Employment Ordinance, sections 31B and 31J). In any event, the Taxpayer's entitlement to a severance payment, assuming it existed, under the Employment Ordinance would have been wholly absorbed and set-off against the payment received under the retirement scheme (section 31I).

(3) It was not for any financial loss suffered by the Taxpayer transferring his employment from Company B to Company C. The Taxpayer admitted this in argument.

(4) It was not for loss of any legal rights as an employee after the transfer of employment to Company C. The Taxpayer admitted that his legal rights were the same as they were prior to the transfer. In this regard, the Taxpayer also admitted that, if his new employment with Company C were terminated, for the purpose of determining any benefits payable to him by Company C his length of service with his former employer, Company B, would be taken into account (compare the extract from the Letter at fact (5)).

(5) It could not simply have been compensation for loss of employment because the Taxpayer was not required to repay the Sum if the transfer of the business was not completed and, in that event, the Taxpayer did not resign from Company B within 12 months after the date of receiving the Sum (fact (12(c) refers).

(6) It could not have been for any legal liability owed to the Taxpayer by Company B under the Taxpayer's contract of employment. This matter was also conceded by the Taxpayer in argument.

The only specific matter that the Taxpayer referred to in arguing that the Sum was compensation for loss of employment was the contention that his transfer from Company B to Company C resulted in reduced job security in the long term. Whatever the respective financial strengths of Company B and Company C may be (and we have no direct evidence of this matter), the fact is that, after the transfer of the business, Company B still held a sizeable 40% interest in Company C. In the circumstances, looking as we must to the substance of the matter in determining the nature of the Sum in dispute, we attach very little weight to the Taxpayer's allegation in this regard.

In the result, the Taxpayer has totally failed to convince us that the nature of the Sum was compensation for loss of employment. As a substantive matter the Taxpayer lost nothing. On this basis alone, we could without further analysis simply dismiss this appeal as one involving the payment of a taxable gratuity arising from the employment (see Hochstrasser v Mayes; see also sections 8(1) and 9(1) which provide that income from employment includes a gratuity).

For the sake of completeness, we also deal with the Taxpayer's argument that the Sum was neither additional remuneration to stay on during the transition nor an inducement for joining the new company. The substance of the matter however is that it was both. We reject the Taxpayer's contention that only the employer (Company C) can induce him to enter into a new employment with that company. As transferor of an operating business, as well as being a significant shareholder in the transferee, Company B had every legitimate interest in ensuring a smooth transition with the key employees still in place. Indeed, this was essentially admitted by the Taxpayer who stated in argument that:

> 'When a business is successfully transferred to a new company, the transferor assists the transferee in various operational ways and that, in this case, Company B did assist Company C in arranging the transfer of certain licences and to help Company C to become operational.'

It must follow that the Sum was not merely an inducement for the Taxpayer to enter into a new employment with Company C; it was also a payment to encourage the Taxpayer to continue employment with Company B until completion of the transfer of business. The Taxpayer responded to this argument by reiterating that the ex gratia payments made by Company B were only paid to employees having more than 12 months standing and were calculated by reference to the length of service each employee had with Company B. Why were all employees not encouraged on equal terms to continue employment with Company C? We simply do not know. Perhaps it was invidious for Company B to distinguish payments made to employees on any basis other than seniority; perhaps Company B considered that the greater the length of service, the more encouragement was justified. It seems pointless to speculate further. Suffice to say that in

so far as the Taxpayer was concerned, the Sum was undoubtedly paid to him to continue employment both up to and beyond the transfer of the business. In this regard we reiterate the fact that if the transfer of business did not proceed to completion then, subject to early resignation by the Taxpayer (in which case the Sum would have to be repaid on a pro-rata basis), no amount need be repaid by the Taxpayer. How this Sum can, in substance, be anything other than a payment from the employment for services defies logic.

Applying Shilton v Wilmhurst and D3/94 the Sum is properly subject to salaries tax, being a payment both for being an employee of Company B and for becoming an employee of Company C.

For all the above reasons the appeal is hereby dismissed.

It is left to us to thank the Taxpayer and Mr So for the clear and capable manner in which they handled this appeal before us.