INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D80/00

Salaries tax - section 8(1) of the Inland Revenue Ordinance (' IRO')– whether income arising in or derived from employment – whether ' top-up supplement' amount paid on leave was in the nature of an ex gratia payment.

Panel: Benjamin Yu SC (chairman), Lam Andy Siu Wing and David Yip Sai On.

Dates of hearing: 21 July and 22 September 2000.
Date of decision: 30 October 2000.

The taxpayer was employed by Organization B by a letter of appointment dated 10 January 1996. There is a clause in the appointment letter that Organization B shall have a discretion to pay to the taxpayer such additional amount as, in aggregate, with the amount of benefits under scheme.

After serving in his employment for some two years and six months, the taxpayer was made redundant by Organisation B on 23 October 1998. On the termination of his employment, the taxpayer was paid leaving service benefits under the retirement benefits scheme and a sum described as ' top-up supplement' amount.

The taxpayer contented that the ' top-up supplement' was not in the nature of an ex gratia redundancy payment which Organisation B was morally, though not legally obliged to pay. The taxpayer argued that the ' top-up supplement' was not taxable. The question, which arises in this appeal, is whether the top-up supplement was income ' arising in or derived from any office or employment of profit within the meaning of section 8(1) of the IRO.

Held:

1. The principles which should apply in cases where the issue is whether a payment received by an employee upon termination of his employment is taxable under section 8(1) of the IRO are : (1) a payment would be taxable if it is in the nature of a gift on account of past services. The word ' gratuity' connotes a gift or present usually given on account of past services; (2) a payment made on account of compensation for loss of employment or a payment in lieu of or on account of severance pay is not taxable; (3) it is not the label, but the real nature of the payment, that is important; (4) the way in which the sum in question was arrived at is a material factor in determining the real nature of the payment (D24/88, IRBRD,

vol 3, 289; D13/89, IRBRD, vol 4, 242; D12/92, IRBRD, vol 7, 122; D19/92, IRBRD, vol 7, 156; D15/93, IRBRD, vol 8, 350; D43/93, IRBRD, vol 8, 323; D13/94, IRBRD, vol 9, 136; D16/95, IRBRD, vol 10, 144; D90/96, IRBRD, vol 11, 727; D3/97, IRBRD, vol 12, 115; D24/97, IRBRD, vol 12, 195; D50/99, IRBRD, vol 14, 474; D30/00, IRBRD, vol 15, 339 considered).

2. Based on the evidence before the Board, the Board found that the top-up supplement paid by Organization B to the taxpayer was entirely ex gratia and made on account of past services and the payment was not a compensation for loss of office. It is not the label, but the real nature of the payment, that is important. It would not be right for this Board to take say-so of an employee or that of the representative of the employer in determining what is the real nature of the payment. The Board cannot abdicate its responsibility of finding objectively what is the nature of the payment on the basis of the evidence before it (D3/97, IRBRD, vol 12, 115 followed).

Appeal dismissed.

Cases referred to:

D24/88, IRBRD, vol 3, 289
D13/89, IRBRD, vol 4, 242
D12/92, IRBRD, vol 7, 122
D19/92, IRBRD, vol 7, 156
D15/93, IRBRD, vol 8, 350
D43/93, IRBRD, vol 8, 323
D13/94, IRBRD, vol 9, 136
D16/95, IRBRD, vol 10, 144
D90/96, IRBRD, vol 11, 727
D3/97, IRBRD, vol 12, 115
D24/97, IRBRD, vol 12, 195
D50/99, IRBRD, vol 14, 474

D30/00, IRBRD, vol 15, 339

Yeung Siu Fai for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

The appeal

1. This is an appeal by Mr A ('the Taxpayer') against a determination by the Commissioner of Inland Revenue dated 2 February 2000. In that determination, the Commissioner overruled the Taxpayer's objection on the salaries tax assessment of the Taxpayer for the year of assessment 1998/99 ('the relevant year of assessment') showing net chargeable income of $331,316, with tax payable thereon of $45,823.

2. It is not in dispute that the Taxpayer had received a total sum of $469,316 during the relevant year of assessment, and that he was entitled to allowances amounting to $138,000. The Respondent's case is that the whole of the $469,316 was taxable income, so that after deduction for allowances, the net chargeable income was $331,316. The Taxpayer's case is that out of the sum of $469,316, a sum of $190,868.40 described as 'top-up supplement' was not taxable. The question which arises in this appeal is whether the sum of $190,868.40 was income '*arising in or derived from ... any office or employment of profit*' within the meaning of section 8(1) of the IRO.

3. The following facts are not in issue, and we find them proved:

(1) In about January 1996, the Taxpayer was employed by Organization B on the terms set out in a letter of appointment dated 10 January 1996. He commenced work in March 1996.

(2) The Taxpayer was employed in the position of construction engineer III in the project division of Organization B.

(3) Clause 1(d) of the letter of appointment provided, inter alia, that the contract of employment may be terminated by either party at any time by giving the other party not less than two months prior written notice or by the payment of two months' salary in lieu of notice.

(4) Clause 7(a) provided that upon satisfactory completion of the trial period (which was three months), the employee shall become a member of

Organization B' s retirement benefits scheme.

(5) Clause 7(c) provided as follows:

' If your services have been terminated by Organization B under clause 1(d) and in circumstances under which:

(i) benefits under the scheme become payable to you; and

(ii) the amount of the benefits payable under the scheme is less than 25% of all salary paid to you under clause 4 and bonus payments paid to you under clause 6,

then Organization B shall have a discretion to pay to you such additional amount as, in aggregate, with the amount of benefits under the scheme, equals 25% of such salary and bonus payments taking into account tax payable, as estimated by Organization B, on such salary and bonus payments.'

(6) After serving in his employment for some two years and six months, the Taxpayer was made redundant by Organization B on 23 October 1998. Organization B exercised its powers under clause 1(d) giving the Taxpayer notice of termination of the contract.

(7) On the termination of his employment, the Taxpayer was paid leaving service benefits amounting to $55,781.25 under the retirement benefits scheme and a sum described as ' top-up supplement' amounting to $190,868.40.

(8) The top-up supplement was calculated in accordance with the method set out in clause 7(c)(ii) of the letter of appointment. We set out the calculation below:

25% of all salary and bonus payments paid to you for 25-3-1996 to 23-10-1998

	$
Before tax	256,493.40
Less : 15% tax	(38,474.00)
After tax	218,019.40
Less : Leaving service benefits	(55,781.25)
Difference/top-up supplement	162,238.15
Add : Gross up for tax at 15% of (i)	28,630.25
	190,868.40(i)

The evidence

4. The Taxpayer gave evidence before us. He also called a witness, Ms C, who was the manager in personnel services of Organization B to give evidence on his behalf. In his evidence, the Taxpayer said that Organization B paid him the top-up supplement because he was laid off. He claimed that he expected to serve Organization B until the year 2047 but that he was laid off because of changes in Organization B's planning. Indeed, it appears that all the staff in his department were laid off. He said that employees who were employed on a contract for a fixed term would be paid a 25% gratuity. The Taxpayer disagreed, however, that the payment of the top-up supplement was similar to a gratuity. Whilst he accepted that Organization B had the legal right to terminate the employment by giving the requisite notice, and also accepted that the leaving service benefits that he received already exceeded the severance payment he would otherwise be entitled to under the law, he claimed that Organization B, like other major employers such as the Hong Kong Government or Hong Kong Telecom, was under a moral obligation to compensate its staff when they were made redundant for an amount over and above the minimum prescribed by law. In other words, he regarded the top-up supplement in the nature of an ex gratia redundancy payment which Organization B was morally, though not legally obliged to pay.

5. The Taxpayer relied on a letter dated 26 October 1999 from Organization B to the Revenue in which Organization B stated:

> ' Since Mr A's employment was terminated by Organization B with effect from 24 October 1998 due to redundancy, he was paid the top-up supplement payment on 23 October 1998 *as compensation for loss of office*.' (emphasis added)

The letter was prepared by Ms C and signed by some one on her behalf.

6. Ms C was subpoenaed by the Taxpayer to give evidence to the Board.

(1) Organization B gave to the Taxpayer six months' notice. Apart from giving him notice, Organization B paid to the Taxpayer leaving service benefits and top-up supplement payment. The top-up supplement payment roughly equalled six months' salary.

(2) The leaving service benefit was sufficient to set off the Taxpayer's entitlement to severance payment under the Employment Ordinance.

(3) She stated that the Taxpayer was released by Organization B after the completion of the construction project and he was made redundant and that was why Organization B paid him the top-up supplement payment.

(4) Ms C said that the payment was to compensate the Taxpayer for the loss of

office. But when asked why she believed that the top-up supplement was paid to compensate the Taxpayer for loss of office, she answered

' because we will no longer employ him' .

(5) Organization B was under no legal obligation to make the payment. Organization B exercised its discretion to pay the top-up supplement. The person who authorised the payment was either the human resources manager or the project director.

(6) At one stage of her evidence Ms C explained that because it was difficult to recruit people at the very beginning, Organization B needed to use this top-up supplement to attract people to work for Organization B for the short term.

(7) The amount of the top-up supplement was calculated in exactly the same way as the payment of gratuity to contract staff. In this way, the two types of staff, that is contract staff (that is staff serving under a contract for a fixed term) and staff serving on a continuous contract such as the Taxpayer, would receive comparable benefits on their leaving service.

(8) In answer to questions from a member, Ms C agreed that Organization B was ' topping-up' the benefits in order to ensure that the retirement scheme employees were not deprived of the ' future benefits' . What she meant by that was that the retirement benefits would eventually exceed the gratuity payment and the top-up supplement was paid to ensure that when they leave Organization B, the benefits they received would be comparable to those entitled to a gratuity.

The law

7. The question, as we stated above, is whether the top-up supplement payment is income arising in or derived from Hong Kong from ' *any office or employment of profit*' within the meaning of section 8 of the IRO. Section 9 defines income from employment to include any wages, salary, leave pay, fee, commission, bonus gratuity, perquisite or allowance, whether derived from the employer or others.

8. We have reviewed a number of authorities on the question of whether a payment made by an employer to an employee upon termination of the employment amounts to such income or not. These are:

D24/88, D13/89, D12/92, D19/92, D15/93, D43/93, D13/94, D16/95, D90/96,

D3/97, D24/97, D50/99, D30/00.

9. In D24/88, the Taxpayer received a lump sum of $80,000 from his employer on cessation of his employment. Of this $26,667 was attributable to severance pay which was agreed as non-taxable. The Revenue assessed the remainder of $53,333 to tax. The Board attached significance to the way in which the sum of $53,333 was arrived at, and found that it was paid by reference to the Taxpayer's service with a *previous* employer and the payment was made in discharge of the personal obligation of a director of the employer to the employee. It was therefore not a payment for services and not taxable. The case illustrates the point that where it is possible to ascertain how the payment in question was calculated, it can help in identifying the nature of the payment.

10. D13/89 was a decision which has been quoted in subsequent cases as laying down what was called the 'wider approach'. The case, however, did not concern a payment made by an employer to an employee on the termination of service. Rather, it was to do with a removal allowance. The Board sounded a word of warning when applying case law from overseas such as Hochstrasser v Mayers 38 TC 673 which deals with a different statutory regime. The Board stated:

> *'The charge to salaries tax under section 8(1) of the Inland Revenue Ordinance is in respect of the taxpayer's income arising in or derived from Hong Kong from his employment. If the section stood alone, there would be a strong case for looking closely at the English authorities to see how the words "income arising from employment" appearing in the United Kingdom statutes have been construed. But section 8(1) of the Ordinance does not stand alone. It is followed by section 9(1) which reads:*
>
> *"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 ..."*
>
> *These words are very wide, and in construing section 8(1) effect have to be given to them. There is in our view no room for reading into section 9(1) some implied limitation such as "provided that the income is received by him in the nature of a reward for services past, present or future", or "provided that the payment is made in reference to the services the employee renders by virtue of his office"; (these are the words of qualification quoted in the judgment of Upjohn J in the Hochstrasser case). To do so is to read into the statute words which are simply not there.'*

11. In D12/92, the employee had worked for some 40 years with the same employer. On the cessation of the business, the employer made to the employee an ex gratia payment of $500,000. It was held that such a payment was taxable. The position of the Revenue, which appears to have been accepted by the Board, was that a payment which is not damages for breach of contract and which is not paid out of an approved provident fund or retirement scheme was subject to salaries tax if it is paid in respect of services provided by the employee to his employer.

12. In D15/93, an employee who was paid a lump sum when she resigned from her employment after some 20 years of service was held liable to pay salaries tax on the payment. The Board followed D12/92, taking the view that a payment which is not damages for breach of contract and not paid out of an approved provident fund or retirement scheme is subject to tax if it is paid in respect of the services provided by the taxpayer to his employee. By way of contrast, in D13/94 and also in D43/93, the Boards held the sums not taxable when the Boards accepted that the sums in question were made by way of damages for breach of contract or compensation to avoid a claim being made.

13. In D16/95, the employee received, amongst other payments, a sum of $368,238 described as ' lay off/long service allowance' upon the termination of his employment. The Board said in respect of this payment:

> ' *The employer wished to get rid of the Taxpayer. The employer could have followed their procedure for termination which would have given rise to disputes as to whether they were entitled to invoke the same. The employer opted to avoid any unpleasantness. The wished to secure the immediate departure of the Taxpayer. The agreement reached was a compromise between the parties whereby the employment relationship was terminated. This specific sum was put in as a sweetener in favour of the Taxpayer. The sum in question was paid in consideration of the Taxpayer accepting an outright severance. It was not paid to him pursuant to the terms of his then employment.*'

The Board held that this sum did not constitute income arising in or derived from the taxpayer' s office or employment.

14. In D90/96, the employee was paid an amount described as ' severance pay' when she left her employment. The taxpayer claimed that the sum in question was a compensation for loss of office and breach of contract on the part of the employer and therefore not taxable. The Revenue argued that the sum was a gratuity, and hence taxable. The Board held that there was no breach by the employer of the redundancy provision in the employment contract. Thus:

> *'[t]o treat the Relevant Sum as compensation for the employer's breach of contract runs wholly contrary to the express terms of the contract of employment.'*

The Board, however, also rejected the Revenue' s argument that the sum was a gratuity. On the facts, the Board found that the payment was designed as an inducement to the employee to leave a former employer, and was in the nature of a reward for services to be rendered in the future. It was a perquisite and taxable.

15. In D3/97, the Board stated the following principles:

(1) a payment would be taxable if it is in the nature of a gift on account of past services. The word ' gratuity' connotes a gift or present usually given on account of past services;

(2) a payment made on account of compensation for loss of employment or a payment in lieu of or on account of severance pay is not taxable;

(3) it is not the label, but the real nature of the payment, that is important.

16. In D24/97, the Board reviewed many of the authorities and identified two different approaches. The Board stated:

> ' *The wider approach is that adopted by the Board of Review in D13/89 ... We should not read into the legislation implied limitation such as "provided that the income is received by him in the nature of a reward for services past, present or future". We do not need to know if the payment might have been for compensation for loss of the employment or a reward for employment. Indeed it could be for a combination of one or more of those reasons. All we need to know is that the payment was sourced from the employment ...'*
>
> ' *... The narrower approach is that adopted in Hochstrasser or Mairs. Adopting this approach, we have to examine the reason for the payment and be satisfied that the payment was to the employee for services and not as compensation for loss of employment. There is some support from section 8(1A) of the Ordinance which defines income arising in or derived from Hong Kong as income derived from services rendered in Hong Kong. This does suggest that income ought to be referable to services past, present or future, although the opening words do provide that this is without limiting the meaning of the general expression.'*

17. In D50/99, the employee received a sum from Company A described as long service pay under the following circumstances. Company A experienced poor business and its workers were concerned that they might not get their long service pay if the business took a turn for the worse. Payment was therefore advanced and the workers were thereafter employed on new contracts. The Board applied D24/97 and considered both the wider and the narrower

approaches. On the wider approach, the payment in question was *sourced* from the employment. On the narrower approach, it was not a compensation for loss of employment. The Board accordingly held the sum taxable.

18. D30/00 was a case where the facts were very similar to those in the present case. The contract in question contained the same terms; the circumstances of the termination of employment were the same. Indeed, the employer was the same in both cases. However, the appellant in that case did not appear before the Board, and did not present any evidence from the employer as to the nature of the payment. Consequently, we are not able to place much weight on this decision.

19. For reasons which will emerge, it is unnecessary for this Board to decide whether the wider or the narrower approach is correct. We prefer, however, to proceed on the basis of the ' narrower approach' , firstly because there had already been quite a few decisions of this Board which proceeded in effect on the narrower approach, and secondly, the case in D13/89 was not concerned with a payment made on termination of employment and whilst the remarks of the Board were of a general nature on the effect of the provisions of sections 8 and 9 of the IRO, the Board in that case did not specifically deal with the question of whether a payment made in compensation for the loss of office was taxable.

20. It may be helpful if we were to re-state the principles which we believe should apply in cases where the issue is whether a payment received by an employee upon termination of his employment is taxable under section 8(1) of the IRO. These are derived from the Board' s previous decisions:

(1) a payment would be taxable if it is in the nature of a gift on account of past services. The word ' gratuity' connotes a gift or present usually given on account of past services;

(2) a payment made on account of compensation for loss of employment or a payment in lieu of or on account of severance pay is not taxable;

(3) it is not the label, but the real nature of the payment, that is important;

(4) the way in which the sum in question was arrived at is a material factor in determining the real nature of the payment.

Our findings and conclusions

21. We find on the facts that the top-up supplement was clearly *sourced* from the employment. If the wider approach is the correct one, the sum is clearly taxable and the appeal must be dismissed.

22. On the evidence, we are unable to find that the top-up payment was made to compensate the Taxpayer for loss of his employment. Both Ms C and the Taxpayer accepted that Organization B had no legal obligation to make the payment. Its obligation to make severance payment was fully discharged by the payment of leaving service benefits. It is significant that:

(1) the payment was expressly provided for under the terms of the letter of appointment, although it was a payment which was to be made entirely at the discretion of the employer,

(2) the amount of top-up supplement was arrived at by reference to past services, and was determined in such a way as to ensure that the Taxpayer would in effect receive the same amount he would have received by way of gratuity if he were hired on a fixed term contract.

Since the payment of top-up supplement was envisaged in the contract, it may, objectively, be considered as a possible inducement to the employee to enter into the employment. The fact that the amount of top-up supplement was calculated on the basis of past services, and the fact that Organization B intended, by making the top-up supplement, to ensure that the Taxpayer would not lose out compared with those entitled to a gratuity strongly suggest that the payment was made on account of past services. They all go to negative the suggestion that the payment was made for compensation for loss of office.

23. In our view, the top-up supplement paid by Organization B to the Taxpayer was entirely *ex gratia* and made on account of past services. The payment was not a compensation for loss of office. Before arriving at this conclusion, we have carefully considered what weight we should put on the evidence of Ms C both in her oral evidence and in the form of the letter dated 26 October 1999. We consider it significant that when she was asked *why* she believed that the top-up supplement was paid to compensate the Taxpayer for loss of office, she answered ' because we will no longer employ him' . Of course, Organization B decided to make the payment because it was going to terminate the employment, but that does not begin to explain why the payment could be regarded as compensation for loss of office. Consequently, we do not feel able to attach much weight to Ms C' s understanding of the nature of the payment. We have already referred to the Board' s decision in D3/97 which made the point that it is not the label, but the real nature of the payment, that is important. Similarly, it would not be right for this Board to take the say-so of an employee or that of the representative of the employer in determining what is the real nature of the payment. This is not to say or suggest in any way that Ms C was not truthful to the Board. It is simply that the Board cannot abdicate its responsibility of finding objectively what is the nature of the payment on the basis of the evidence before it.

24. For the reasons we have stated above, we would dismiss this appeal.