

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D81/01

Salaries tax – whether the long service payment forms part of the gratuity payment – sections 31V and 31Y of the Employment Ordinance (‘EO’) – whether long service payment should be exempted from salaries tax under the EO.

Panel: Andrew Halkyard (chairman), David Lam Tai Wai and Sydney Leong Siu Wing.

Date of hearing: 9 August 2001.

Date of decision: 17 September 2001.

The taxpayer was employed by Company A under continuous contracts from 1993 to 1999. On 25 August 1999, the taxpayer was entitled to a gratuity payment for the taxpayer’s cessation of employment. The employer did not pay to the taxpayer any long service payment or severance payment in addition to the gratuity.

The taxpayer claimed tax exemption in respect of the sum that was the long service payment to which he was entitled. The assessor raised salaries tax assessment without the taxpayer’s claimed deduction on long service payment.

The taxpayer appealed on the ground that upon termination of his employment, the long service payment formed part of his gratuity payment and should be exempted from salaries tax under the EO.

Held:

1. Having regard to the evidence of the case, the Board found that the gratuity paid upon termination of the taxpayer’s employment consisted simply of one element, a gratuity paid precisely in accordance with the taxpayer’s contract of employment and is thus liable to salaries tax. In the Board’s view, this conclusion is not one of simply adopting the ‘label’ placed upon the payment by the employer and the label accords with the underlying facts. Once this conclusion is reached, the taxpayer’s arguments upon the EO and the non-taxability of long service payments made under the EO fall away.
2. The effect of section 31Y of the EO is that where an employee receives a gratuity under the terms of his contract of employment, where the gratuity is based upon the

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length of service and the amount exceeds the amount of any long service payment that the employee would have been entitled to under the formula set out in section 31V, then the long service payment is reduced to nil. Section 31Y does not deem all or part of a gratuity to be long service payment.

3. Sections 31Y and 31YAA simply ensure that an employer is not obliged to make any double payment for the same thing.
4. Any long service payment calculated in accordance with section 31V would be less than the gratuity previously paid to the taxpayer under his earlier contracts of employment with the employer. In the Board's view, this conclusion does not have the effect of contracting out of, or contravening, the EO. Section 31Y of the EO does not deem all or any part of a gratuity to be long service payment.

Appeal dismissed.

Cases referred to:

D24/88, IRBRD, vol 3, 289
D32/95, IRBRD, vol 10, 195
D90/96, IRBRD, vol 11, 727
D24/97, IRBRD, vol 12, 195

Chow Chee Leung for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

1. This is an appeal against the salaries tax assessment raised on the Taxpayer for the year of assessment 1999/2000. The Taxpayer claims that, upon termination of his employment, part of his gratuity representing the long service payment to which he was entitled under the EO should not be subject to salaries tax.

The facts

2. The Taxpayer did not give oral evidence before us. We find the following facts on the basis of the Commissioner's determination dated 23 March 2001, supplemented by two bundles of documents produced to us by both parties.

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- (a) The Taxpayer was employed by Company A (' the Employer') under continuous contracts from 1 November 1993 to 30 September 1999.
- (b) Under the third of these contracts, dated 16 January 1997, the Taxpayer was employed by the Employer as a building services resident engineer. The terms of the employment contract contained, inter alia, the following terms:
 - (a) Employment Period

The period of employment will be approximately thirty (30) months commencing from 1 March 1997 to 30 September 1999 or, at the discretion of the employer, until the completion of the construction of the project. Should the project be delayed, it will be extended accordingly. ...
 - (b) Gratuity

Upon satisfactory completion of [the Taxpayer' s] period of contact employment, [the Taxpayer] will be entitled to a lump sum payment equivalent to 25% of [the Taxpayer' s] total base salary.

No such lump sum payment is payable if an early termination of employment is effected by [the Taxpayer] for whatever reason or by the employer on disciplinary grounds or due to [the Taxpayer' s] misconduct. [The Taxpayer is] not entitled to claim any severance payment or compensation other than the said lump sum.' ¹
- (c) On 12 August 1999 the Employer wrote to the Taxpayer advising that the contract of employment would expire on 30 September 1999 and thanking the Taxpayer for his effort and service provided during the engagement.
- (d) On 25 August 1999 the Employer prepared a document entitled ' Gratuity Payment' which showed that for the period 1 March 1997 to 30 September 1999 the Taxpayer was entitled to ' A lump sum payment equivalent to 25% of the total base salary' . In this document the total base salary was calculated at \$1,443,600 and the ' Gratuity Payment' at \$360,900. The Employer mailed this document to the Taxpayer on 5 October 1999.
- (e) Around mid-September 1999, he Employer prepared a document entitled ' Check List for Resigning Employee' . In that document the payment of gratuity was recorded as ' yes' and long service payment was recorded as ' none' . In the event, the payment of \$360,900 was made to the Taxpayer on 4 October 1999.

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¹ This clause providing for a gratuity was in the same terms as that contained in the two previous contracts of employment. In other words, each of the employment contracts provided for a gratuity to be paid upon satisfactory completion of the respective employment period. See further, fact (m).

- (f) On 7 October 1999 the Employer filed a notification with the Inland Revenue Department regarding the Taxpayer's cessation of employment. The notification showed, inter alia, the following particulars:

(i) Capacity in which employed	:	Building services resident engineer
(ii) Reasons for cessation	:	Completion of contract
(iii) Period of employment	:	1-4-1999 to 30-9-1999
(iv) Particulars of income	:	
		\$
Salary		252,707
Leave pay		1,001
Gratuities		<u>360,900</u>
		<u>614,608</u>

- (g) The Employer did not pay to the Taxpayer any long service payment or severance payment in addition to the gratuity described at facts (b) and (e).
- (h) In his tax return – individuals for the year of assessment 1999/2000, the Taxpayer declared the same income from the Employer as per fact (f). Against the income, the Taxpayer claimed tax exemption in respect of \$88,750 (representing \$22,500 x 2/3 x 5 11/12). He claimed that this was the long service payment to which he was entitled.
- (i) The assessor raised a salaries tax assessment for the year of assessment 1999/2000 on the Taxpayer that included all the income disclosed at fact (f).
- (j) The Taxpayer objected to the assessment in the following terms:
- ‘ ... you had not assessed my request on deduction on long service payment from my income.’
- (k) To support his grounds of objection, the Taxpayer put forward the following arguments:
- (i) ‘I worked with [the Employer] for more than five years, and thus I am eligible to obtain long service payment if there is no gratuity.’

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- (ii) According to Employment Ordinance ... gratuity can be deducted from long service payment.
- (iii) [The Employer] did not pay me long service payment in addition to gratuity. Hence, long service payment is included in the gratuity.
- (iv) I understand that gratuity is taxable while long service payment is not.

In conclusion, it is unfair to me that you merely considered the term "GRATUITY" without considering the ingredient of the gratuity, and required whole gratuity to be taxable.'

- (l) After rejection of his objection by the Commissioner, the Taxpayer appealed to this Board on 20 April 2001.
- (m) In or slightly before early May 2001, the Taxpayer lodged a claim dispute against the Employer with the Labour Department regarding the details of his long service payment calculation. A conciliation meeting was held on 21 May 2001. On 6 June 2001 the Employer signed the 'Terms of Settlement' under which it agreed to provide the Taxpayer with a written statement of his entitlement to long service payment in accordance with section 31ZE of the EO. That statement calculated the entitlement to long service payment to be \$88,726.5 and the total gratuity payment to be \$584,150. The statement then declared: 'The above long service payment ... is to be reduced by the total amount of all the gratuities of \$584,150 for the employment period from 1 November 1993 to 30 September 1999 paid by the [Employer].'

The Taxpayer's contentions

3. At the Board hearing the Taxpayer drew our attention to two previous Board of Review decisions, D24/88, IRBRD, vol 3, 289 and D32/95, IRBRD, vol 10, 195. In those cases the Commissioner conceded that part of a lump sum payment by the employer to the employee on termination of employment was attributable to severance pay (D24/88) and long service payment (D32/95) made in accordance with the provisions of the EO. In both cases the Commissioner accepted that part – and that part only – as not liable to salaries tax. The Taxpayer thus argued that these cases show that a lump sum paid upon termination of his employment should be characterised by its substance, and not by the label attached to it, and could be split into a taxable portion (gratuity) and a tax-free portion (long service payment).

4. Specifically, the Taxpayer contended that according to sections 31R and 31T of the EO, he was continuously employed for more than five years and was entitled to long service payment on the basis that the Employer did not require him to be re-employed in writing before

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completion of his employment contract. Given that the Commissioner accepts that long service payments made under the EO are not taxable, the Appellant asserts that the sum of \$88,750, to which he was entitled under the EO, was related to his gratuities (which accrued by reference to years of service) and should be extracted out of the sum assessed and exempted from salaries tax. In other words, the long service payment forms part of his gratuity payment and can, and should, be treated separately for taxation purposes. The Taxpayer reminded us that he had not received any long service payment in addition to his gratuity (fact (g) refers).

² This figure represents the total of the three gratuities paid to the Taxpayer under the continuous contracts referred to at facts (a) and (b).

5. The Taxpayer then referred to section 31Y and section 31YAA of the EO. He contended that these sections provide that long service payment is to be reduced by the total amount of any gratuity paid upon termination of employment to the extent that it relates to the employee's years of service for which the long service payment is payable, and vice versa. The Taxpayer reiterated that his employment contracts (fact (b) refers) show that his gratuities were related to the period of service and thus there is a clear relation between his gratuities and his legal entitlement to receive long service payment. In this regard, the Taxpayer also contended that his entitlement to long service payment, being granted by statute, is predominant and should take precedence over his purely contractual right to receive a gratuity.

6. In relation to the authorities quoted by the Commissioner's representative (see below), the Taxpayer contended that they should not assist us because they were not concerned with long service payment integrated into a lump sum on termination of employment.

The Commission's contentions

7. Ms Chow Chee-leung appeared for the Commissioner. She drew our attention to two previous decisions of the Board of Review, D90/96, IRBRD, vol 11, 727 and D24/97, IRBRD, vol 12, 195. In each case a specific contractual provision for redundancy payment or payment on termination of contract was taxable because it was inserted in return for the taxpayer acting as an employee for the employer and was thus a payment from the employment for services.

8. Specifically, Ms Chow argued that the Taxpayer's gratuity was assessable in full. Ms Chow contended that the long service payment, which the Taxpayer claimed entitlement to, should under section 31Y of the EO be reduced to nil by the gratuity paid according to the terms of his employment contract.

Analysis

9. Section 8 of the Inland Revenue Ordinance ('IRO') provides:

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'(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...'

10. Section 9(1) goes on to provide:

'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...'

11. On the basis of the Board of Review cases referred to above, both parties accept that in deciding whether the amount in dispute is taxable, the label given to it should be disregarded and that all relevant circumstances should be examined to determine its true nature. In essence, the Taxpayer contends that part of his termination payment represented his entitlement to long service payment under sections 31R and 31T of the EO and should be exempt from salaries tax. The Commissioner disagrees and contends that the payment is just a contractual gratuity paid upon satisfactory completion of the Taxpayer's employment. It was thus taxable being from the employment for services.

12. We must state at the outset that we found the Taxpayer's case both interesting and challenging. After a lengthy Board hearing, in which we pursued the merits and ramifications of both parties' arguments in detail, and after further deliberation, a majority of this Board concludes that the Commissioner is correct in contending that the payment in dispute is contract gratuity payable under the Taxpayer's employment contract. The majority further concludes that no amount can be split out from the total gratuity as partly being attributable to long service payment. In any event, a majority of this Board considers that the payment in dispute was derived from the Taxpayer's employment for services and is thus liable to salaries tax.

The majority decision

13. In short, the facts found show:

- (a) The lump sum paid on 4 October 1999 comprised only one element, namely, the contract gratuity paid under the Taxpayer's contract of employment (facts (b), (d), (e) and (f) refer).
- (b) When the lump sum was calculated and paid by the Employer, no reference was made in any contemporaneous document to the Taxpayer's entitlement to long service payment under the EO. The Employer gave no written particulars of any

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long service payment to the Taxpayer under section 31ZE of that Ordinance. The lump sum was calculated solely as gratuity and by reference to 25% of the Taxpayer's base salary for the employment period in accordance with his contract of employment (facts (b), (d), (e) and (f) refer).

- (c) At the time the lump sum was calculated and paid by the Employer, there is no evidence before the Board that the Employer contemplated anything other than to pay the Taxpayer precisely what was due to him as gratuity under his contract of employment.
- (d) The only evidence before the Board that the Employer considered its obligations to make any long service payment relates to the labour dispute detailed at fact (m). This evidence concerns events taking place some 18 months after payment of the gratuity to the Taxpayer. In any event, the documents referred to at fact (m) do not record that long service payment was actually made. Instead, the Terms of Settlement explicitly stated: 'The above long service payment ... is to be reduced by the total amount of all the gratuities previously paid by [the Employer]' (emphasis added). This wording indicates the Employer's view that, although the Taxpayer was entitled to long service payment, the quantum of such entitlement was reduced to nil. We agree and note that the gratuities paid, even prior to the termination of the employment, far exceeded the amount that otherwise would have been paid as long service payment (see section 31Y of the EO which, on its terms, does not restrict the reduction of long service payment to gratuities paid for the last in a continuing series of employment contracts).

14. We appreciate that the above conclusion does not deal in detail with all of the Taxpayer's arguments. If the evidence had shown that the Employer had contemplated, and then actually paid, an amount of long service payment to the Taxpayer upon termination of employment, then those arguments would be relevant. In such a case, the Commissioner may have been prepared to apply her practice not to assess a long service payment made according to the terms of the EO. We hope that the Commissioner would apply this practice, even though Ms Chow was not able to assure us on this matter given that the source of the payment was found in an express provision in the contract of employment.

15. But the concerns raised in the previous paragraph are not before us. Rather, we must deal with this appeal on the facts found, namely, that the gratuity paid upon termination of the Taxpayer's employment consisted simply of one element, a gratuity paid precisely in accordance with the Taxpayer's contract of employment. In our view, this conclusion is not one of simply adopting the 'label' placed upon the payment by the Employer. In this case the label accords with the underlying facts. The Employer paid the Taxpayer a gratuity and not a gratuity and a long service payment. Once this conclusion is reached, the Taxpayer's arguments upon the EO and the non-taxability of long service payments made under the EO fall away.

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16. Whether the Taxpayer was also entitled to an actual payment for long service and, if so, whether this would then be affected by sections 31V, 31Y and 31YAA of the EO are not matters we are strictly required to decide. However, in view of the minority opinion in this appeal, we offer the following comments:

- (a) The effect of section 31Y is that where an employee receives a gratuity under the terms of his contract of employment, where the gratuity is based upon the length of service and the amount exceeds the amount of any long service payment that the employee would have been entitled to under the formula set out in section 31V, then the long service payment is reduced to nil. Section 31Y does not deem all or part of a gratuity to be long service payment.
- (b) Sections 31Y and 31YAA do not assist the Taxpayer. They simply ensure that an employer is not obliged to make any double payment for the same thing.
- (c) There is no dispute that any long service payment calculated in accordance with section 31V would be less than the gratuity of \$360,900 paid to the Taxpayer in accordance with his final contract of employment with the Employer. Indeed, any such payment would be less than the gratuities previously paid to the Taxpayer under his earlier contracts of employment with the Employer (facts (a), (b) and (m) refer).
- (d) Hence, despite his length of service, any entitlement of the Taxpayer for long service payment under the EO would have been reduced to nil because of the gratuities previously paid to him by the Employer. In our view, this conclusion does not have the effect of contracting out of, or contravening, the EO. We reiterate that section 31Y does not deem all or any part of a gratuity to be long service payment.
- (e) In the final analysis, we must examine the true nature of the payment in dispute. There is no doubt that this was part of the emoluments of employment agreed between the Taxpayer and the Employer at the commencement of his employment contract. It was an inducement to the Taxpayer to enter into and provide services under that contract. And it was payable upon proper completion of the contract without any breach by the Employer. The payment satisfies all the requirements for chargeability to salaries tax.

The minority decision

17. One member of the Board, Mr Sydney Leong Siu-wing, would allow the appeal. His reasons are as follows:

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- (a) The facts are not in dispute. In particular, the Taxpayer was entitled to long service payment under the EO. As no employer should enter into any agreement with any employee in contravention of the EO, the payment by the Employer of \$360,900 to the Taxpayer as gratuities must include the statutory duty of the Employer to pay long service payment to the Taxpayer. Either due to ignorance of the law or oversight, no mention of long service payment was made when the gratuities were paid. But this was rectified in writing by the Employer signing the Terms of Settlement confirming the Taxpayer was entitled to \$88,726.5 as long service payment that was to be reduced by the total amount of all the gratuities paid by the Employer. The word ‘gratuities’ is only a label and all relevant circumstances should be examined to determine its true nature. As the Employer could not act against the EO, the Terms of Settlement confirmed its rectification. In other words, the ‘gratuities’ include the long service payment.
- (b) The Commissioner’s contentions
 - (i) The two cases quoted above by the Commissioner’s representative are different from the present case, for in the present case the Employer did admit in the Terms of Settlement, taking place about 18 months later, that the Taxpayer was entitled to long service payment, which was to be reduced by the gratuities.
 - (ii) With regard to the argument that the long service payment should under section 31Y of the EO be reduced to NIL by the gratuities paid according to the Taxpayer’s employment contract, personally I do not see the reason because that section says that ‘long service payment is to be reduced by the total amount of all of the gratuities and benefits...’. This is exactly what the Employer did when the Terms of Settlement were signed to comply with the EO.

Concluding remarks

18. It is left for the Board to thank both the Taxpayer and Ms Chow for vigorous and stimulating argument. In the event, on the basis of the facts found by us, we conclude, by majority, that the Taxpayer derived the amount in dispute from his contract of employment for services. The amount in dispute is thus liable to salaries tax under sections 8(1) and 9(1) of the IRO. The appeal is hereby dismissed.