

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D84/97

Salaries tax – whether payment for termination of directorships is compensation for loss of office and assessable to salaries tax.

Panel: Robert Wei Wen Nam SC (chairman), Mohan Bharwaney and Herman Fung Man Hei.

Date of hearing: 10 September 1997.

Date of decision: 19 November 1997.

The taxpayer was a director of a number of companies in the A Group including B Co Ltd, C Ltd and D Ltd. His directorships in the A Group companies carried no emoluments, except his directorships in C Ltd and D Ltd each of which carried a regular monthly salary, plus annual double pay and annual special bonus, if any. There was no written employment contract between the taxpayer and any of the companies in the A Group. His directorships were terminated when he was paid by the B Co Ltd the sum of \$1,229,553 in respect of the termination. His last month salaries from C Ltd and D Ltd prior to the termination of the directorships were \$23,000 and \$24,000 respectively.

Held:

The Board found that the sum was not compensation for loss of office but a gratuity on account of the taxpayer's past services to C Ltd and D Ltd though paid by B Co Ltd. The Board also found that the taxpayer is entitled to be paid long service payments by C Ltd and D Ltd and also damages of \$23,000 and \$24,000 for wrongful termination of his contracts with C Ltd and D Ltd respectively. As the Revenue would give concession to the above sums, the Board ordered that the assessment be reduced by the total sum of (a) the amounts of the two long service payments and (b) the amount of \$47,000.

Appeal dismissed.

Chan Wai Mi for the Commissioner of Inland Revenue.

David Lit of Messrs Tang Lit & Co for the taxpayer.

Decision:

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Nature of appeal

1. This is an appeal by an individual (the Taxpayer) against the salaries tax assessment raised on him for the year of assessment 1992/93 as confirmed by the Commissioner of Inland Revenue in her determination dated 2 December 1996. The Taxpayer contends that a sum of \$1,229,553 included in the assessment (the Sum) was compensation for loss of office and is not chargeable to salaries tax.

Facts agreed or not in dispute

2. Prior to 1 December 1992, the Taxpayer was a director of a number of companies in the A Group, including the following companies:

- (a) B Co Ltd, having been first appointed on 12 May 1978, and re-appointed on 26 August 1978, after having resigned on 30 May 1978.
- (b) C Ltd, having been appointed on 19 November 1974.
- (c) D Ltd, having been appointed on 16 December 1982.

3. His directorships in the A Group companies carried no emoluments, except his directorships in C Ltd and D Ltd each of which carried a regular monthly salary, plus annual double pay and annual special bonus, if any. There was no written employment contract between the Taxpayer and any of the companies in the A Group. His directorships in all the three companies were terminated on 1 December 1992, when he was paid by the B Co Ltd the sum of \$1,229,553 in respect of the termination. His last month's salaries from C Ltd and D Ltd prior to the termination of the directorships were \$23,000 and \$24,000 respectively.

4. At the time of the termination of his directorships, the Taxpayer was 61 years old.

5. The B Co Ltd filed a notification of cessation of employment in respect of the Taxpayer showing, inter alia, the following particulars:

Period of employment from 1 April 1992	1-4-1992 to 30-11-1992
Capacity in which employed	Director
Date of cessation of employment	30 November 1992
Reason for cessation	Dismissal
Income from 1 April 1992 compensation for loss of office	\$1,229,553

6. In his salaries tax return for the year of assessment 1992/93, the Taxpayer declared his income from C Ltd and D Ltd but not the income from B Co Ltd.

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7. On 13 August 1993, the assessor raised on the Taxpayer a salaries tax assessment for the year of assessment 1992/93 for the whole of his income amounting to \$1,753,003 with tax payable thereon of \$262,950.

8. By a letter dated 3 September 1993, Messrs Tang, Lit & Co, certified public accountants and tax representatives of the Taxpayer, objected on behalf of the Taxpayer against the salaries tax assessment for the year of assessment 1992/93 as follows:

‘The principal income from [B Co Ltd] \$1,229,553 was in the nature of compensation for loss of office in connection with the termination of employment ... Such receipt is not for services rendered and it is not exigible to salaries tax.’

9. The assessor addressed three letters of enquiry to the B Co Ltd and obtained replies to the following effect:

9.1 **Reply dated 17 November 1993 to letter dated 29 September 1993**

‘As a result of the closing down of the Company’s construction division a few years ago, and of the change of the Company’s business policy in 1990, holding of real estates for rental purposes was reduced, hence reduction in the number of staff and directors appeared inevitable so as to contain administrative cost. Mr X (the Taxpayer), in the capacity of director, was laid off under the circumstances; since his departure, the Company has not substituted or recruited anyone to fill his position.

Mr X commenced his employment with the Company in March 1963.

A lump sum payment was agreed and paid as compensation for loss of office. For your reference, a copy of the Company’s board resolution dated 3 November 1992 is enclosed.’

Board resolution dated 3 November 1992

‘Present: Mr E and Mr F.

Mr E was the chairman of the meeting.

It was noted that both Mr X and Mr Y had offered to resign from the board of directors of the Company with effect from 1 December 1992 and that agreement had been reached whereby the Company would pay the sums of \$1,229,553 and \$1,087,444 to Mr X and Mr Y respectively as compensation for loss of office.

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It was resolved that the resignation of Mr X and Mr Y as directors of the Company be accepted with effect from 1 December 1992.

It was further resolved that the sums of \$1,229,553 and \$1,087,444 be paid to Mr X and Mr Y respectively as compensation for loss of office.'

9.2 **Reply dated 1 November 1994 to letter dated 24 October 1994**

'Mr X's (the Taxpayer's) date of birth is 22 November 1931.

A lump sum of \$1,229,553 was agreed verbally by the parties, no formula was used in arriving at such figure.

Mr X joined the Company in 1963; no employment contract was made at the time, when the scale of business was small.

Mr X was laid off under the circumstances of closing down of the construction division and a change of the Company's business policy in 1990.

There is no correspondence between the parties in regard to termination of employment and final settlement.'

9.3 **Reply dated 9 November 1996 to letter dated 9 September 1996**

'Mr X (the Taxpayer) was a director of the B Co Ltd and other related companies in the A Group. Whilst he was responsible to oversee operations of all the group companies, he was mainly responsible for the construction operation of C Ltd.

Mr X's monthly receipts before his termination were as follows:

D Ltd	\$24,000
C Ltd	<u>23,000</u>
	<u>\$47,000</u>

There were no written employment contracts between Mr X and the companies in the A Group. Mr X was entitled to a remuneration package of regular monthly salary, an annual one-month double pay and an annual special bonus, if any.

The construction work of the B Co Ltd, normally managed by C Ltd, was not "closed down" in 1992. Instead, because of the adverse tendering conditions and the loss position of the Company, the management decided to reduce the workload and activities of the company. The change of business policy did not affect any other staff members of the Company. At the time the employment

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contract of Mr X was terminated, there were still a number of uncompleted projects on hand.

The B Co Ltd was privatised on 10 July 1990 and the termination of Mr X's engagement on 30 November 1992 was not related to privatisation of the Company. As the termination of employment was given to Mr X verbally, there was no notice of termination issued by the Company.

There was no prior written or verbal agreement between Mr X and the Company in respect of payments in the event of termination. The lump sum was paid as compensation for loss of office and therefore should not be assessable to Hong Kong salaries tax.'

Note The reply did not answer the enquiry 'State whether the alleged compensation of loss of office in the sum of \$1,229,553 was calculated by reference to Mr X's last month salary and the number of years of service with the A Group. If so, give details of the computation.'

10. The B Co Ltd wrote to the Revenue on 2 January 1997 in reply to a letter dated 2 December 1996 from the Revenue to the Taxpayer to the following effect:

'Due to the adverse tendering conditions and the loss position of the Company in 1992, the management decided to reduce the workload and activities of the Company, resulting in reduction of the number of its staff and directors.

The whole sum \$1,229,553 is for damages for lay-off (due) to Mr X's (the Taxpayer's) old age and incapacity for the adoption of modern management techniques and system. The sum did not form part of Mr X's income from employment and office, gratuity or perquisite relating to Mr X's past services.'

11. By his determination dated 2 December 1996, the Commissioner of Inland Revenue determined against the objection and confirmed the salaries tax assessment for the year of assessment 1992/93.

Grounds of appeal

12. The grounds of appeal filed by the Taxpayer through his tax representatives may be summarised as follows.

12.1 The Taxpayer was dismissed as a director by his employer the B Co Ltd with effect from 1 December 1992, and was paid the sum of \$1,229,553 as compensation for loss of office. The sum was not income from office or employment, and therefore not assessable to salaries tax.

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12.2 Prior to 1 December 1992, apart from being a director of B Co Ltd, C Ltd and D Ltd, the Taxpayer was also a director of nine other companies in A Group. However, he received no income from the nine companies.

12.3 As a result of the dismissal, the Taxpayer suffered the loss of office of directorship in the flagship of a group of public and private companies and loss of other directorships, loss of right to social status, privileges, opportunity, position, development growth and progress and convenience associated therewith.

12.4 The sum of \$1,229,553 was entirely compensation for loss of office and not income from office or employment. If the sum had been paid as a reward for past services or otherwise as income from office or employment, the sum would have been shared between D Ltd and C Ltd; B Co Ltd would not have been involved in any payment of it.

Parties and witnesses

13. At the hearing of this appeal, Mr Lit of the tax representatives represented the Taxpayer, while Miss Chan, senior assessor, represented the Commissioner of Inland Revenue. The Taxpayer gave evidence on his own behalf. No other witness was called.

Taxpayer's evidence

14. The Taxpayer's evidence may be summarised as follows.

In chief

14.1 The boss asked the accountant to give the Taxpayer a cheque for the amount of some \$1,200,000 on 1 December 92, informing him that they would terminate all his directorships. He had to hand over the keys. They did not need the Taxpayer to take care of engineering matters. In fact they did not have any projects with them and the project on a bank was finished. There was only the submission of tenders. So the Taxpayer packed up.

14.2 The accountant told the Taxpayer that the sum was for dismissing him. It was accompanied by a letter and he had to acknowledge the termination of all directorships. He just signed the letter and returned it to the accountant. They told him that they were firing him. He got angry, so he just got up and left.

14.3 He did not know how they arrived at the sum. He just acknowledged by signing on the letter, handed over the keys and left. They did this to him without any warning.

14.4 As a director of the B Co Ltd, he only signed the minutes of meetings. The main documents were signed by the father and the son.

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14.5 The other group companies such as C Ltd and D Ltd did not pay him anything for giving up the directorships in them or his employment with them. There was only one cheque.

14.6 His monthly salaries were paid by two cheques, one from C Ltd and another from D Ltd. He was never paid any salary by B Co Ltd. He only received salaries from the two companies.

14.7 Since the privatisation of the B Co Ltd, the father handed over the business to the son, and the son would like to restructure the Company and turn it into a more modern company with modern management. The Taxpayer failed to adapt to the changes because there was an engineer to take care of charts and write documents in English for him. They might have found the Taxpayer a bit redundant. They never talked about this with him, so the cheque came as a surprise.

14.8 The Taxpayer did not seek legal opinions because after all he was given such a lump sum. If he had taken legal action it might have embarrassed the father. Since they gave him such a lump sum, he did not want to embarrass them.

In cross-examination

14.9 He did not finish secondary school. In March 1963 he joined Company G as a chief foreman. The firm was incorporated as C Ltd on 28 August 1964. He worked for Company G and C Ltd for a total of twenty-nine years and eight months. Just before he ceased his employment with C Ltd in 1992, he was an assistant managing director, mainly responsible for construction operations.

14.10 It cannot be said that he had no employment with D Ltd. He advised on the management of D Ltd, and he would help to deal with some of the matters relating to landed property which it purchased.

14.11 When shown a copy of the minutes of a directors' meeting dated 3 November 1992, the Taxpayer stated that he did not know about the existence of the minutes. It was a creation of the father and son. He knew about his termination only upon receipt of the cheque. He did not know about such a meeting. The first time he knew about the sum was when he received the cheque.

14.12 When given the cheque of \$1,229,553, he did not think of anything. He just took the cheque because he was not very happy. As for the amount of the cheque, he found it strange too. He was satisfied with the sum so he just took the money and left because he did not want to embarrass the father.

14.13 When shown a formula prepared by Miss Chan for the calculation of the amount of the cheque (IRD-1), the Taxpayer stated that even the Employment Ordinance would not allow years of service to go as much as twenty-nine years.

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14.14 The A Group had no retirement scheme, no specific retirement age, no informal retirement arrangement. They just fired them.

14.15 The secretary just told him that he was director in so many companies. 'You are going to resign from all those directorships because we have to take your name off the records in the Companies Registry.' He did not even get a copy of the paper he signed.

14.16 As to this sum of \$1,229,553, they told him it was for firing him, so he did not put the sum in the tax returns.

Findings and reasons

15. The Taxpayer's evidence is that, on 1 December 1992, the accountant or secretary of B Co Ltd gave the Taxpayer a cheque for \$1,229,553 and told him that all his directorships in the A Group companies were terminated and that the Sum was for dismissing him (see paragraphs 14.1, 14.2 and 14.15 and 14.16 above). In its correspondence with the Revenue, B Co Ltd had supplied a board resolution dated 3 November 1992 describing the termination of the directorship in B Co Ltd as resignation (see paragraph 9.1 above). That description was contradicted by the Company's statements in other documents using expressions such as 'dismissal' (see paragraph 5 above), 'laid off' (see paragraph 9.1, Reply dated 17 November 1993, and paragraph 9.2 above) and 'damages for lay-off' (see paragraph 10 above). We prefer the Taxpayer's evidence referred to above and find that the Taxpayer was dismissed by all those companies in the A Group in which he was a director on 1 December 1992 and that the payment of the sum was on account of the dismissal.

16. The Taxpayer's case is that the Sum was paid as compensation for the loss of the office of directorship in B Co Ltd and that the loss consisted of loss of right to social status, privileges, etc (see paragraphs 12.1 and 12.3 above). That cannot be right. As pointed out by Miss Chan, for the Sum to be compensation, it must be shown that there is a loss or surrender of right on the one side and a legal liability on the other to pay compensation for the loss of the right. In the present case, the directorship carried no emoluments, nor was there any enforceable obligation to provide the alleged social status, privileges and so on. So there was no question of any compensation being claimable against B Co Ltd in respect of the loss of office of directorship. It follows that the Sum of \$1,229,553 was not compensation for loss of office.

17. The ground of appeal contained in paragraph 12.4 above takes the point that, if the Sum had been paid as a reward for past services or otherwise as income from office or employment, the Sum would have been shared between D Ltd and C Ltd, and that B Co Ltd would not have been involved in any payment of it. The implication seems to be this: since B Co Ltd was in fact involved in the payment, the Sum cannot have been paid as a reward for past services or other income from office or employment. That does not necessarily follow. The question turns on whether the circumstances of the case support an inference that the payment was made by B Co Ltd on behalf of D Ltd and C Ltd.

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18. It is unlikely that an odd figure like \$1,229,553 would have been paid on account of the loss of the non-remunerative directorship in B Co Ltd. On the other hand, Miss Chan has demonstrated that it is likely (and we find) that the Sum was arrived at as follows:

$$\begin{aligned} \text{Last month's salary} \times \frac{2}{3} \times \text{number of years of service} + \text{a lump sum} &= \text{the Sum} \\ \$47,000 \times \frac{2}{3} \times 29.6666 + \$300,000 &= \$1,229,553 \end{aligned}$$

The \$47,000 is made up of \$23,000 being the last month's salary from C Ltd and \$24,000 being the last month's salary from D Ltd. The formula contains features which are found in the calculations of severance payments or long service payments prescribed by the Employment Ordinance. Section 31G (relating to the amount of severance payment) and section 31V (relating to the amount of long service payment) of that Ordinance contain, inter alia, expressions such as 'two-thirds of last full month's wages ... for every year (and pro rata as respects an incomplete year) of employment' which correspond with 'last month's salary $\times \frac{2}{3} \times$ number of years of service' in the formula. This shows that the Sum was based on a concept borrowed from the Employment Ordinance but was calculated on a much more generous scale because: (1) the Sum included a lump sum of \$300,000 and (2) there were provisions in that Ordinance which restricted the amount of severance payment or long service payment. In other words, the intention behind the Sum was to settle the Taxpayer's statutory claims arising from his dismissal by C Ltd and D Ltd and to pay him the balance as a gratuity on account of his past services.

19. In this connection, Miss Chan indicated that the Revenue would be prepared to waive salaries tax on the amounts of statutory claims for severance payment or long service payment and/or damages for wrongful termination of contract, if the Board should find that the Taxpayer is entitled to be paid such claims or any of them.

20. No case for a severance payment has been made out. B Co Ltd's statements are inconsistent as to whether there was a clause of the construction division thereby making the Taxpayer redundant (see paragraphs 9.1 and 9.2 where 'closing down' was alleged and paragraph 9.3 where 'closing down' was denied). We agree with Miss Chan that there is no satisfactory evidence of redundancy within the meaning of section 31B(2) of the Employment Ordinance.

21. We find that the Taxpayer is entitled to be paid a long service payment on account of his dismissal by each of the two companies, C Ltd and D Ltd. The relevant date is the date of termination (see section 2 of the Employment Ordinance, 'relevant date' (g)) which is 1 December 1992. On that day, his contracts of employment with the two companies were terminated without notice or payment in lieu thereof other than in accordance with s 9 of the Employment Ordinance (see section 31T (1)(a) of that Ordinance), and he was thereby dismissed by the two companies. He was 61 years old at the relevant date (see paragraph 4 above). There being no evidence to the contrary, we find, by reason of the presumption of continuance, that the Taxpayer's contract of employment with each of the two companies was a continuous contract which is deemed to have been a contract for one month renewable from month to month (see sections 3 and 5 of the

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Employment Ordinance). We find that his contract of employment commenced on 28 August 1964 in the case of C Ltd (see paragraph 14.9 above) and 16 December 1982 in the case of D Ltd (see paragraph 2 above). We further find that C Ltd and D Ltd are each liable to pay to the Taxpayer a long service payment in accordance with Part VB of the Employment Ordinance.

22. We find that the Taxpayer is entitled to be paid damages for wrongful termination of his contract of employment with each of the two companies. The termination in each case was without notice or payment in lieu. In accordance with section 8A(1) of the Employment Ordinance, the Taxpayer is entitled to be paid a sum equal to the amount of wages which would have accrued to him during the period of notice required by section 6(2)(a) of that Ordinance. The required period of notice is 'not less than one month', which in our view means that it may be one month. The Taxpayer is therefore entitled to be paid \$23,000 and \$24,000 in respect of his contracts with C Ltd and D Ltd respectively.

23. The number of years of service, twenty-nine years and eight months or 29.6666 years, used in the formula for the sum of \$1,229,553 includes a short period of employment by Company G prior to the incorporation of C Ltd (see paragraph 14.9 above). Further, the same number of years of services is applied to his employment with both companies. This reflects an approach to apportion the sum in the ratio of 23 to 24, with \$601,696 thereof to be borne by C Ltd and the remaining \$627,857 to be borne by D Ltd. In view of the Revenue's concession, each of the said two sums is to be reduced by the total sum of the amounts of the relevant long service payment and one month's salary.

24. In all the circumstances, we are satisfied that:

- (1) The payment of the Sum was unconnected with the Taxpayer's directorship in B Co Ltd;
- (2) The payment was entirely connected with the Taxpayer's directorships in or employment with C Ltd and D Ltd;
- (3) The payment was gratuity on account of the Taxpayer's past services to C Ltd and D Ltd;
- (4) The payment was made by B Co Ltd on behalf of C Ltd and D Ltd; and
- (5) Subject to the deductions mentioned in paragraph 23 above, the Sum is the Taxpayer's income from office or employment and is assessable to salaries tax.

25. We therefore order (1) that the assessment in question be reduced by the total sum of (a) the amounts of the two long service payments and (b) the amount of \$47,000, (2) that the case be remitted to the Commissioner for the amounts of the two long service payments to be agreed with the Taxpayer, and (3) that, failing such agreement, the

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Commissioner be at liberty to apply for directions. Subject to the above order, this appeal is dismissed.