Case No. D90/96

Salaries tax – whether 'Severance pay' constitutes 'gratuity' which is taxable – sections 8(1) and 9(1) of the Inland Revenue Ordinance.

Panel: Ronny Wong Fook Hum QC (chairman), Walter Chan Kar Lok and Yeung Kwok Chor.

Date of hearing: 20 December 1996.
Date of decision: 13 January 1997.

The taxpayer was paid an amount of $719,840 described as 'Severance pay' by Company B she left her employment with. 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 is therefore not taxable. The Revenue argued that the sum constitutes gratuity within section 9(1) of the Inland Revenue Ordinance and is therefore taxable.

Held:

1. There was no breach of contract on the part of employer. To treat the sum in question as compensation for loss of office runs wholly contrary to the express terms between the taxpayer and her employer.

2. The sum is not gratuity which entails something to which a person has no legal right.

3. The Relevant Sum is a perquisite and is taxable.

Appeal dismissed.

Cases referred to:

Dale v de Soissons 32 TC 118
Hochstrasser v Mayes [1960] AC 376
Mairs v Haughey [1993] STC 569
Comptroller-General of Inland Revenue v Knight [1973] AC 428
B/R 116/77, IRBRD, vol 1, 283
Seymour v Reed 11 TC 625
Hochstrasser v Mayes 38 TC 673
D12/92, IRBRD, vol 7, 122
D19/92, IRBRD, vol 7, 156

D43/93, IRBRD, vol 8, 323

J R Smith for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

Preliminaries

1. This Board is indebted to the Taxpayer in 2 respects:

   a. She was seriously inconvenienced in having to appear before 2 differently constituted Boards as a result of the unfortunate death of the last Deputy Chairman seised of this matter before delivery of the decision of that Board.

   b. She has given this Board every assistance at the hearing before us. Her impressive presentation bears all the hallmarks of a good advocate.

The facts

2. The Taxpayer worked with Company A since 1983. She had a distinguished career with that company. Her talents were not unnoticed and she was 'head-hunted' by a firm of consultant in 1990 to work for Company B of B Corporation.

3. Discussions ensued culminating in an employment letter dated 15 March 1990 ['the Employment Contract'] on the letter head of Company B ['the Employer'] and signed 'for and on behalf of B Corporation' by one Mr C, the then Vice President of Human Resources & Management Services. The Employment Contract provided that:

   a. The job title of the Taxpayer was 'Manager Human Resources' of the Employer and she was responsible to Mr C.

   b. The Taxpayer was to undergo a 6 months' probation period. Her employment thereafter could be terminated by 3 months' notice from the Employer.

   c. 'Redundancy' be regulated as follows:

      'In the event of your position becoming redundant Company B will offer you the option of either, payment equivalent to one year earnings or a transfer to a suitable HR position elsewhere with B Corporation <u>subject to a suitable position being available</u>. (Emphasis applied).

      In the event that you elect to transfer, B Corporation will pay all reasonable expenses associated with such a move.'

d. 'Transfer to Country D' be regulated as follows:

> 'Subject to your satisfactory performance within the first two years of employment, Company B will transfer you to a suitable HR position within Country D by the end of the third year…'.

4. The Taxpayer explained to us the rationale behind these specific provisions on 'Redundancy' and 'Transfer to Country D':

> 'The provision was volunteered by employer after considering Taxpayer's concern regarding job security and personal plan to move to Country D. Taxpayer did not expect herself to be made redundant but being a Personnel Manager by profession which taught her that she should have <u>all rights secured in writing</u>.' (Emphasis by the Taxpayer).

In April 1989 the Taxpayer's then boy friend applied for immigration to Country D. On 3 August 1989 the two of them bought an apartment in Country D. The Taxpayer was naturally interested to secure job openings in operations of B Corporation in Country D.

5. The Taxpayer commenced work with the Employer on 2 July 1990. She was asked to focus on restructuring the human resources function in Hong Kong and Country E with a view to free herself to oversee the same for Country F afterwards. However, the Taxpayer was informed in about October 1990 that there were changes in strategies and plans were made to down-size the Country F operation.

6. In early 1991, B Corporation announced that it was in major financial difficulties and had to 'consolidate and right-size its activities'. In February 1991, the Taxpayer was informed by Mr C that he would be leaving by the end of March 1991 as a result of a 'major right-sizing programme in the Corporation'. Mr C's position would not be replaced. He did not expect a position for her elsewhere in the Corporation. [The Taxpayer] was asked to discuss her position with the local general manager.

7. The Taxpayer wrote to Mr C on 4 March 1991. She said this:

> 'I understand from our teleconversation earlier that in the light of the current down sizing exercise we have, availability of a suitable HR position in other parts of B Corporation is very difficult if not impossible. As such, in line with my contract of employment, I would be grateful if you could confirm that I will be made redundant after July 1991. A redundancy package equivalent to one year earning (viz 12 base salary plus housing allowance as well as Chinese New Year Bonus & Good Performance Bonus being cashable income) will be paid to me on or before my last date of service'.

8. Mr C replied on 28 March 1991. He confirmed that the Taxpayer's position 'will become redundant' on 31 July 1991. He further confirmed that 'the company will honour all commitments included in your letter of employment dated 15 March 1990'.

9. The Taxpayer duly left her employment. She was paid a sum of $719,840 ['the Relevant Sum'] which the Employer described in its return to the Revenue as 'Severance pay'. The issue for our determination is whether the same is taxable.

The Statutory Provisions

10. Section 8(1) of the Inland Revenue Ordinance (the IRO) provides:

> *'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…'*

11. Section 9(1) of the IRO provides that income from an office or employment includes-

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

Contentions of the parties

12. The Taxpayer maintains that the Relevant Sum is not taxable because:

a. the Relevant Sum is a compensation for loss of office and

b. the Relevant Sum is a compensation for breach of contract in that she was deprived of her right to be transferred to Country D.

13. The Revenue maintains that the Relevant Sum is taxable as the same constitutes 'gratuity' within the statutory provisions. Heavy reliance is also placed on Dale v de Soissons 32 TC 118.

The English authorities

14. In Dale v de Soissons 32 TC 118 the taxpayer was employed as assistant to the managing director of a company. His remuneration consisted of a fixed salary of £3,000 per annum and a commission calculated on profits. Under the terms of his service agreement, the taxpayer's appointment was to be for 3 years from 1 January 1945, but the company was entitled to terminate the agreement at 31 December 1945 or 31 December 1946, on payment of £10,000 or £6,000 respectively, as 'compensation for loss of office'.

The company terminated the agreement at 31 December 1945, and paid the £10,000 to the taxpayer. The question was whether this sum constituted 'salaries, fees, wages, perquisites or profits' from the taxpayer's office or employment. At first instance, Roxburgh J thought that the agreement must be read as a whole. The taxpayer's employment was to be for 3 years unless curtailed when he would receive as profits of his employment the payments provided by the agreement. He accepted for the purpose of his decision that 'compensation for loss of office' means 'a payment to the holder of an office as compensation for being deprived of profits to which as between himself and his employer he would, but for an act of deprivation by his employer, have been entitled'. The Court of Appeal affirmed his judgment and held this sum taxable. Evershed MR said at page 127:

> *'As I have already indicated, to my mind the correct answer is that given by Roxburgh, J namely, that this £10,000 was part of the remuneration which [the Taxpayer] was entitled to get under, and received from, his contract of service. The contract provided that he should serve either for three years at an annual sum or, if the company so elected, for a shorter period of two years or one year at the annual sum in respect of the two years or the one year, as the case might be, plus a further sum, that is to say it was something to which he became entitled as part of the terms upon which he promised to serve, something which he was entitled to receive in the particular event specified, namely, the term not running the three years but being earlier determined'.*

15. In Hochstrasser v Mayes [1960] AC 376 the House of Lords had to consider whether a benefit which an employee received falls within the meaning 'perquisite or benefit' from his employment. Lord Radcliffe at page 391 said:

> *'For my part, I think that their meaning is adequately conveyed by saying that, while it is not sufficient to render a payment assessable that an employee would not have received it unless he had been an employee, it is assessable if it has been paid to him in return for acting as or being an employee'.*

16. Our attention was drawn to the decision of the House of Lords in Mairs v Haughey [1993] STC 569. In that case the taxpayer was employed by Company H & W on terms which included non-statutory enhanced redundancy payments. In the course of privatisation of H & W, as an alternative to redundancy, the taxpayer was offered terms of employment with Company C which included an ex gratia payment comprised of 2 elements. The first element [Element A] amounted to 30% of the sum which he would have been entitled under the non-statutory enhanced redundancy scheme. The second element [Element B] was computed on the basis of his complete years of service with H & W with a minimum of £700. The Special Commissioner decided it was appropriate to apportion the lump sum into the 2 elements and to treat Element A as compensation to the taxpayer for the loss of contingent rights under the enhanced redundancy scheme and Element B as consideration for acceptance of the new terms and conditions of Company C. The Crown contended before the House that the entire sum was paid as an inducement to become or remain employed by Company C. This was rejected by the House at page 577 who upheld the Special Commissioner's view that the lump sum was made up of 2 separate

considerations and should be apportioned to reflect the same. On this basis, Element B was taxable under Schedule E of the English Act. The House was then pressed by a further argument from the Crown in relation to Element A. It was submitted that under English law a payment made to an employee under an enhanced redundancy scheme would have been taxable as an emolument under his employment. The House of Lords rejected this submission. They were of the view that *'if a payment is made in substitution for a payment, which might, subject to a contingency, have been payable that the nature of the payment which is made in lieu will be affected by the nature of the payment which might otherwise have been made'*. The House thought that *'Prima facie a payment made after the termination of employment is not an emolument from that employment. It can be, however, an emolument from the employment if for example it is a lump sum payment in the nature of deferred remuneration.'* The House held that a redundancy payment would not be an emolument from the employment and a sum paid in lieu of the right to receive redundancy payment is also not chargeable. The Crown relied [at 580 e-g] on a statement of Lord Wilberforce in Comptroller-General of Inland Revenue v Knight [1973] AC 428 at page 433 that *'where a sum of money is paid under a contract of employment, it is taxable even though it is received at or after the termination of the employment.'* The House of Lords pointed out that *'Lord Wilberforce was doing no more than citing an agreed general proposition. As with most propositions of this kind it is subject to exceptions. For example, pension payments will usually be payable in consequence of a contract of employment but they are not emoluments "in respect of the employment" or "from the employment" taxable under Sch E'*.

The Hong Kong authorities

17. In B/R 116/77, the Board of Review stated:

> *'* *The mere fact that a payment in question is made to an employee as the result of or in connection with his employment is not enough to render him liable to tax: Seymour v Reed 11 TC 625 the circumstances under which the payment was made must all be taken into account. "Not every payment made to an employee is necessarily made to him as a profit arising from his employment."*
>
> *The authorities show that to be a profit arising from the employment the payment must be made in reference to the services the employee renders by virtue of his office and it must be something in the nature of a reward for services, present or future: per Upjoin J in Hochstrasser v Mayers 38 TC 673…*
>
> *It goes without saying that one must look to the character of the payment to determine its true nature. We are not to be tied down to the label which any of the parties may think fit to ascribe to any particular payment since it is the substance of the matter, viewed in the light of the evidence, that must decide what in truth was the real bargain'*.

18. The taxability of payment made on termination of an employment was considered in D12/92. The taxpayer had been employed all his working life by one company. After working for some 40 years with the same employer, his employer closed his business. An ex-gratia sum of $500,000 was paid to the taxpayer. The Board accepted the Commissioner's submission that *'as a matter of law a payment which is not damages for breach of contract and which is not paid out of an approved provident fund or retirement scheme is subject to be assessed to salaries tax if it is paid in respect of the services provided by the taxpayer to his employer'* (emphasis applied).

19. In D19/92, the taxpayer was employed in the United Kingdom in a senior post by a financial company. He was approached by a company in Hong Kong to assume the position of Managing Director. The taxpayer was not prepared to join the employment of this Hong Kong company unless he received a lump sum payment. This lump sum payment was negotiated and calculated with reference to what the taxpayer thought would be the costs of himself and his family moving from the United Kingdom and setting up residence in Hong Kong. The Board found as a fact that this lump sum payment *'was a payment made by the HK employer to recompense the taxpayer at least in part for the removal expenses which he would incur in coming to Hong Kong, and that such payment was also an inducement without which the Taxpayer would not have come to work in Hong Kong.'* After referring to the English and Hong Kong authorities cited before them the Board said:

> *' The starting point in any salaries tax matter must be section 8 of the IRO. Sub-section (1) states that "salaries tax shall … be charged … on every person in respect of his income … from … any office or employment of profit." These are words which impose the charge of salaries tax. The question can then be simply stated. We must decide whether or not the lump sum payment was part of the income of the Taxpayer from his employment with the HK employer.*
>
> *The heading of section 9 of the IRO reads "definition of income from employment" but this heading is a little misleading because the opening sub-section (1) states that "income from any office or employment includes". Section 9 is not an exhaustive definition but merely a list of items which are included. Though it appears clear to us that the lump sum payment can be described as either a "perquisite" or "allowance", both being words contained in section 9(1)(a) this is also of little help. Allowance means a sum of money allotted or granted for a particular purpose such as expenses and a perquisite is a little more complex meaning an incidental emolument, fee, or profit over and above fixed income, salary, or wages or alternatively any bonus or fringe benefit granted to an employee. On the facts which we have found the lump sum payment is closer in meaning to an allowance but as the same was paid to the Taxpayer free and clear of any obligations as to how it was to be expended it could also come within the meaning of perquisite. However, as we have said, this does not answer the question before us. The fact that the lump sum payment was a perquisite or allowance or indeed any other form of income does not answer the question whether or not its source was the employment of*

the Taxpayer with the Hong Kong employer. That is what section 8 says it must be if it is to come within the charge of salaries tax.

The source of something is a matter of fact and not of law. A careful analysis of the facts before us leads us to the conclusion that the source of the lump sum payment was the employment of the Taxpayer with the HK employer. Indeed it could be nothing else. It was not a payment made to the Taxpayer unrelated to his employment and it certainly was not a gift. It was not a payment made some time before his employment and unrelated to his employment. It was a front end payment but was an integral part of his employment and indeed part of his employment contract. There is nothing in sections 8 or 9 of the IRO which limit taxable payments to remuneration for services rendered or to be rendered. Section 8 relates to income from a source namely the employment. This lump sum payment was part and parcel of the employment of the Taxpayer with the HK employer. It arose directly from the employment which the HK employer offered to the Taxpayer and which the Taxpayer accepted. Accordingly it is assessable to salaries tax.'

20. D19/92 was distinguished by the Board in D43/93. In that case the taxpayer was employed on an ongoing employment contract. The employer informed the taxpayer that it intended to terminate his service and a termination package was negotiated and agreed between the employer and the taxpayer. The termination package included a severance payment which the Commissioner considered to be a gratuity subject to salaries tax. The Board rejected this submission. They said this:

' In this case the employer decided to terminate the employment of the Taxpayer. To do this according to the contract between the employer and the Taxpayer it was necessary for the employer to wait for a period of nine months and then to give three months' notice of termination. No doubt to follow such a procedure would have caused difficulties. It had been decided to close down the department which the Taxpayer managed with immediate effect. It was not possible to relocate the Taxpayer within the structure of the employer. The employer would then have been in the position of continuing to employ a person with (sic) no doubt have been considerable and indeed might have led to claim for damages from the Taxpayer. In such circumstances it is customary for the employer to negotiate an amicable settlement with the employee. The question of damages for breach of contract does not arise because there has not as yet been any such breach. Clearly the Taxpayer had valuable contractual rights which the employer wished to extinguish. Terms of settlement were agreed between the employer and the Taxpayer which included the sum of $737,460 being compensation for the loss of employment. According to the Commissioner's own guidelines a payment made as compensation for loss of employment and a payment made in settlement of a claim for damages for wrongful dismissal are not assessable to salaries tax. It is quite clear to us on the evidence and facts before us that the sum of $737,460 which we have described as a severance payment was a payment made to

terminate the employment of the Taxpayer and compensate him for the loss of his employment. If the payment had not been made the Taxpayer would have been entitled to claim damages for wrongful dismissal and it appears clear to us that he was entitled to a minimum of twelve months employment and/or notice of termination.

Perhaps the assessor and indeed the Deputy Commissioner have been confused because the employer and the Taxpayer used the word "gratuity" when referring to the payment. By dictionary definition a gratuity is something to which a person has no legal entitlement. It is also a word used in section 9 of the IRO. However the representative for the Commissioner quite rightly pointed out to us that the label which the parties give to a payment is not the governing factor. What one must do is to look at the real nature of the payment. The real nature of the payment in this case before us was compensation for loss of office. It was a payment which the employer agreed to make as compensation to the Taxpayer in order to bring his employment to a premature end.

This appeal is significantly different from D19/92 because this payment neither arose out of the employment contract of the Taxpayer nor was it in return for services rendered by the Taxpayer to his employer. It was the opposite. It was a payment made to terminate the contractual obligations of the employer and to compensate the Taxpayer for what would otherwise have been a breach of contract. In such circumstances the severance payment is not assessable to salaries tax.'

Our Decision

21. We reject the Taxpayer's attempt to seek to draw an analogy between these cases and those cases where an employee obtains payment in settlement of the employer's breach of contract. There was no breach by the Employer in this case of the Redundancy provision in the Employment Contract. The post in Country D was subject to a suitable position being available. No such position was available and the relationship between the parties fell to be regulated by the rest of the Redundancy provision. There was also no breach of the 'Transfer to Country D' provision. That clause is subject to the Taxpayer's satisfactory completion of 2 years of service. To 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.

22. We also reject the Revenue's contention that the Relevant Sum constitutes gratuity. As pointed out by the Board in D43/93, a gratuity is something to which a person has no legal right and there is no doubt that the Relevant Sum was part of the Taxpayer's contractual entitlement. We find Dale v de Soissions of limited assistance. It relates to compensation for loss of office and centres on the word 'profit' in the English provision. That case is however instructive in directing that the agreement should be read as a whole.

23. Had it not been for the fact that the Relevant Sum was expressly provided for in the Employment Contract, the Revenue would have accepted that the same would not be taxable. The question is whether such express provision makes any difference. Such express provision certainly renders the Relevant Sum as one 'arising in or derived from Hong Kong from … [an] office or employment'. However we have to be further satisfied that the Relevant Sum constitutes 'income'.

24. The Revenue says that the Relevant Sum is 'gratuity'. For reasons outlined above, we find that the Relevant Sum is clearly not a 'gratuity'.

25. We refer to the evidence set out in paragraph 4 above. We are of the view that such evidence clearly indicates that the Redundancy provision was inserted in return for the Taxpayer acting as employee for the Employer. When viewed in the light of the possible Country D job opening, the entire provision was designed as an inducement to the Taxpayer to leave Company A and to join the Employer. It was in the nature of a reward for services to be rendered in the future. It was a fringe benefit granted to the Taxpayer from inception of her employment. The Relevant Sum is a perquisite and taxable as such.

26. We would therefore dismiss the appeal.