Case No. D87/04

Salaries tax – whether compensation for wrongful termination of an employment contract is income from employment – whether an inducement to the taxpayer to enter into the employment agreement is chargeable to tax – when was the payment deemed to be accrued – whether there is distinction between salary owed to an employee and paid on the day of termination and payment in exchange for an existing right to a share of profits which is to be paid in the future – sections 8(1) and 9(1)(a) of the Inland Revenue Ordinance ('IRO').

Panel: Anthony Chan Kin Keung SC (chairman), James Julius Bertram and Susan Beatrice Johnson.

Dates of hearing: 4, 5 and 6 January 2005.
Date of decision: 24 February 2005.

By an employment agreement dated 30 October 1996, the taxpayer was employed as the managing director and the chief executive officer of Company A for a period of five years. The taxpayer was entitled to an incentive compensation plan under the employment agreement. Under a termination agreement dated 12 June 1997, the taxpayer agreed to resign from his directorship and employment at Company A and all its subsidiaries and associated companies with immediate effect. In pursuant to the termination agreement, the taxpayer agrees to the cancellation of his units received from the incentive compensation plan under the employment agreement for a sum of US$11 million. At that time, the taxpayer had 5 million units and additional units which he might have earned had the employment agreement not been terminated (hereinafter referred to as "the 5M units" and "the Future Units"). The issue is whether the said sum is chargeable to salaries tax.

The taxpayer's case is that the said sum was not income from his employment. It was part of the compensation for the abrogation of all his rights under the employment agreement. The taxpayer further submitted that no payment had accrued in respect of the 5M Units whilst the employment agreement was on foot and therefore any payment for the same was a payment for the abrogation of the taxpayer's rights under the employment agreement. The Inland Revenue contends that the said sum represented compensation for the non-receipt of certain payments which might otherwise have to be made under the employment agreement. Such payments, if made to the taxpayer, would have been regarded as part of his employment income. It followed that the said sum, which took its nature from the substance of the payments for which it was substituted, represented the taxpayer's income from employment.

Held:

1. It is well-established that compensation for wrongful termination of an employment contract is not, as a matter of law, income from employment. The Board finds that the sum of US$11 million was a payment made in exchange for the taxpayer's incentive plan units. The Board takes the view that a distinction has to be drawn between the 5M Units and the Future Units. In respect of the latter, the Board has no difficulty in coming to the conclusion that payment therefore was plainly a payment for the abrogation of the taxpayer's rights in respect of the Future Units and such payment is not taxable (Henley v Murray 31 TC 351 followed).

2. The Board rejected the argument that the 5M Units were illusory. The Board find that the taxpayer had the 5M Units and he was entitled to 'cash out' his 5M Units with Company A. Whether the employment agreement was terminated could not have changed that position.

3. It appears to the Board abundantly clear that under the Hong Kong salaries tax regime an inducement to the taxpayer to enter into the employment agreement is chargeable to tax. The fact that the 5M Units had been 'cash out' merely means that instead of the annual payments being liable to salaries tax, the money received for cancellation of the 5M Units became so liable. For the purposes of revenue law, the substitute for the annual payment is treated in the same way as the annual payments themselves (CIR v Yung Tse Kwong, CFI, [2004] 3 HKLRD 192; Mairs v Haughey [1994] 1 AC 303 and Carter v Wadman [1946] 28 TC 41 followed).

4. Where the taxpayer's employment came to an end before any annual payment was due, and he was to be paid a sum by Company A representing what the 5M Units were worth on the termination date, such payment would be deemed to have accrued on that day and would be taxable in the year of assessment during which the employment terminated.

5. There is no real distinction between salary owed to an employee and paid on the day of termination and payment in exchange for an existing right to a share of profits which is to be paid in the future. The payment for the 5M Units is attributable to the employment agreement rather than the termination of it. This is so notwithstanding the fact that one can say that without the termination the 5M Units would not have been bought out (Henley v Murray 31 TC 351 followed).

6. The Board is satisfied that the Board is entitled the apportionment exercise on a rough and ready basis. The Board decided to apportion 50% of the sum, that is, US$5.5 million, to the 5M Units (CIR v Yung Tse Kwong, CFI, [2004] 3 HKLRD 192 and Carter v Wadman [1946] 28 TC 41 followed).

Appeal allowed in part.

Cases referred to:

Henley v Murray 31 TC 351
CIR v Yung Tse Kwong, CFI, [2004] 3 HKLRD 192
Mairs v Haughey [1994] 1 AC 303
Carter v Wadman [1946] 28 TC 41
McLaurin v FCT [1961] 8 AITR 180
D76/98, IRBRD, vol 13, 420

Eugene Fung Counsel instructed by Department of Justice for the Commissioner of Inland Revenue.
Fletcher Timothy Alistair of Messrs Lovells for the taxpayer.

Decision:

1. The Taxpayer before us appeals against a salaries tax assessment made in respect of a sum of money paid to him under an agreement made, inter alia, between him and his ex-employer to terminate his contract of employment.

Material facts

2. Mr Fletcher, who appeared on behalf of the Taxpayer, has informed us that there is no dispute on the facts set out in the determination of the Deputy Commissioner of Inland Revenue dated 30 September 2004 ('the Determination'). The Taxpayer elected not to give evidence and this appeal proceeded on the basis of the written material before us.

3. The undisputed material facts are as follows:

(i) The Taxpayer was a co-founder, Managing Director ('MD') and Chief Executive Officer ('CEO') of Company A. Company A was at all material times listed on the Hong Kong Stock Exchange;

(ii) Company B was a company incorporated in Country C. On the 29 January 1997, Company B acquired the control of Company A;

(iii) By an employment agreement dated 30 October 1996 ('the Employment Agreement') between Company A, Company B and the Taxpayer, the Taxpayer was employed as the MD and CEO of Company A for a period of five years effective on the 29 January 1997;

(iv) The Employment Agreement provided for the Taxpayer's remuneration package. The relevant provisions for the purposes of this appeal were contained in clause 5.f under which the Taxpayer was entitled to an Incentive Compensation Plan ('ICP');

(v) Under the ICP, the Taxpayer was to be awarded 5,000,000 non-transferable and non-assignable ICP units as soon as practical following the effective date of the Employment Agreement (that is, 29 January 1997). During the term of the Employment Agreement and for a period of two years thereafter, he would be entitled to 500,000 additional ICP Units each upon the declared commercial operation date of Company A's next six 660MW electrical generating units. Each block of 500,000 ICP Units would entitle the Taxpayer to an annual payment in an amount equal to the net income of Company A multiplied by a certain percentage to be paid on or before the 15 day of the third month following the end of Company A's fiscal year;

(vi) Clause 9 of the Employment Agreement further provided that following the fifth anniversary of the effective date of the Employment Agreement the Taxpayer would have the right to elect to terminate all or part of the ICP and receive a lump sum payment for ICP Units held by him and agreed to be cancelled. His right to receive a lump sum payment thereunder could be exercised notwithstanding the said five year period if Company A so agreed.

(vii) By a loan agreement dated 30 October 1996 ('the Loan Agreement') entered into between Company B, Company A and the Taxpayer, Company A agreed to make an interest free loan of US$8 million ('the Loan') to the Taxpayer for a term of 10 years subject to certain terms and conditions. The Loan was to be secured over all amounts payable by Company A to the Taxpayer under the Employment Agreement.

(viii) On the 12 June 1997, there was a request by Mr D, who represented Company B, to the Taxpayer that he should resign from Company A as a result of Company B's conclusion that the management style of the Taxpayer was not compatible with theirs. There was a facsimile from Mr D addressed to the Taxpayer to that effect at page 89 of bundle B1 [B1/89]. Although the facsimile was not dated, it appears from the partially shown header that it was probably sent on the 12 June 1997;

(ix) On that day, the Taxpayer consulted his solicitor (Mr Fletcher) for advice. Together, they had meetings with Mr D, Mr E (another representative of Company B) and the legal representatives of Company B on the same day to discuss the termination of the Employment Agreement;

(x) Later that day, a termination agreement dated 12 June 1997 ('the Termination Agreement') was signed between the Taxpayer, Company A and Company B. It is self-evident from the Termination Agreement, which was full of manuscript amendments, that the document was prepared in some haste.

(xi) Under the Termination Agreement, the Taxpayer agreed to resign from his directorship and employment at Company A and all its subsidiaries and associated companies with immediate effect. The Termination Agreement contained, inter alia, the following terms:

'2. [Company A] agrees to pay [the Taxpayer] US$2 million on 13 June 1997.

3. [The Taxpayer] agrees to the cancellation of his [ICP Units] (which are free and clear of any liens or security interest (save in respect of the Loan referred to in paragraph 4 below)) for a payment of US$11 million to be paid no later than 12 July 1997. …

4. [Company A] agrees to forgive the repayment of the principal on [the Loan], as and when such principal repayments fall due, provided that if [the Taxpayer] is in material breach of his obligations under paragraphs 5 and 8 below (which breach has not been satisfactorily remedied) any repayment of the Loan which have not yet fallen due shall be repayable to [Company A] by [the Taxpayer] in accordance with the payment schedule set out in the Loan Agreement.

5. For a period of two years from the date hereof, [the Taxpayer] agrees that he will not compete with [Company A] or its affiliates. …

6. For so long as any principal amount is outstanding under the Loan Agreement, [the Taxpayer] agrees not to disclose [Company A] confidential information or trade secrets. …

7. Employment Agreement is hereby terminated as of this date and [the Taxpayer] acknowledges that he has no further claims against [Company A], its Subsidiaries or Associated Companies or any

member of the [Company B] Group arising out of such termination or of his employment under such Agreement.

8. Subject to this Agreement, [the Taxpayer] relinquishes any interest (whether direct or indirect) which he may have in [Company F].';

(xii) Company F was a subsidiary of Company A;

(xiii) By a letter dated 12 June 1997, the Taxpayer tendered his resignation as a director of Company A and of its subsidiaries, and from employment with Company A.

The issue

4. The issue before us is a narrow one – whether the sum of US$11 million received by the Taxpayer pursuant to clause 3 of the Termination Agreement ('the Sum') is chargeable to salaries tax.

5. The Taxpayer's case is that the Sum was not income from his employment. It was paid to extinguish his rights to substantial damages in respect of a breach of the Employment Agreement by Company A and/or Company B. In other words, it was part of the compensation for the abrogation of all his rights under the Employment Agreement [see paragraphs 10 and 11 of the grounds of appeal].

6. On the other hand, the Inland Revenue ('IR') contends that the Sum represented compensation for the non-receipt of certain payments which might otherwise have to be made under the Employment Agreement. Such payments, if made to the Taxpayer, would have been regarded as part of his employment income. It followed that the Sum, which took its nature from the substance of the payments for which it was substituted, represented the Taxpayer's income form employment [see paragraph 3(8) of the Determination].

The law

7. The relevant statutory provisions for salaries tax are as follows. Section 8(1) of the Inland Revenue Ordinance, Chapter 112 ('IRO') provides that '*Salaries tax shall … be charged for each year of assessment on every person in respect of his income arising in or derived from Hong Kong from … any office or employment of profit …*'.

8. Section 9(1)(a) of the IRO defines 'income from any office or employment' to include '*any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others …*'.

9. It can be readily seen that in the absence of the termination of the Taxpayer's employment, any annual payment which he might receive for his ICP Units would have been taxable under the aforesaid provisions of the IRO.

10. However, it is well-established that compensation for wrongful termination of an employment contract is not, as a matter of law, income from employment. The leading authority for this proposition is found in Henley v Murray 31 TC 351 (this case is reported at [1950] 1 All ER 908 but the Official Tax Case Report which we have been supplied with by Mr Fletcher is more detailed and helpful).

11. The principle in Henley lies at the heart of the Taxpayer's case. In that case, T was employed as managing director of G under a service agreement determinable at the earliest on 31 March 1944. By agreement, and at the request of G's board of directors, T resigned from G on 6 July 1943. He was paid by G a total sum of £2,779 which was made up of (a) £577 being remuneration under the service agreement for the period 6 April 1943 to 6 July 1943 and (b) £2,202 being remuneration which he would have been entitled to for the period from 7 July 1943 to 31 March 1944 if his employment had continued to that date. The issue on appeal was whether the sum of £2,202 was taxable. The Court of Appeal considered it important to determinate what was the bargain struck between T and G and took the view that the sum of £2,202 was consideration for the abandonment altogether of T's contractual rights under his service agreement. It was held that the said sum was not assessable to income tax. The *ratio* of that decision can be found in the following passages of the leading judgment of Sir Raymond Evershed MR:

> '*I think in the circumstances of this case … it is not open to the Crown to say that the sum of £2,000 odd constituted profits from the office or employment, since I think upon its true analysis it constituted the consideration payable to [T] for the total abrogation imposed upon him of his contract of employment; so that from 6 July 1943, no contract existed under which that figure or any other sum could be paid' [page 363];*

> '*… there ceased to be any contract of service and therefore from that date onwards there was no remuneration. This was not a sum paid in advance because there was no future claim which [T] could ever assert. Nor was it reward for his past service. It was … a cash consideration paid for his agreeing to submit to the terms …' [page 365, emphasis added].*

12. It should be borne in mind that in respect of the sum of £577, there was no appeal by T against the decision of the General Commissioners that it was assessable to income tax [see page 360]. Plainly, that sum of money was earned by T during the currency of his employment contract and must be taxable. In this appeal, there is no quarrel between the parties that remuneration earned by the Taxpayer during the currency of the Employment Agreement is taxable. Before going further into the law, like the Court of Appeal in Henley, we need to consider the bargain

struck between the Taxpayer and Company A/Company B under the Termination Agreement. In particular, what was the Sum paid for?

The Bargain struck under the Termination Agreement

13. First and foremost, we have no difficulty in finding that the Taxpayer was put under pressure by Company B to resign on the very day he was asked to do so. More likely than not, the request to resign must have come as an unpleasant surprise to him. In our view, it is not necessary for the proper determination of this appeal to decide whether Company A and/or Company B was in breach of the Employment Agreement by asking the Taxpayer to resign in the way it did (which is one of Mr Fletcher's contentions).

14. It was said by Jenkins LJ in Henley that *'it is often very difficult to determine the character of a payment made to the holder of an office when his tenure of the office is determined …'* [page 367]. Fortunately, the parties in this case encapsulated their bargain in the Termination Agreement. We are of the view that the terms of the Termination Agreement must be given due weight for the purposes of this exercise save where compelling reason based on cogent evidence exists to the contrary.

15. It is the Taxpayer's case that the Sum was part and parcel of a lump sum settlement of US$21 million 'without specific allocation'. 'The allocation of US$11 million for cancellation of the [ICP Units] made under paragraph 3 of the [Termination Agreement] was not of any real significance nor does it reflect the real nature of the bargain' [see paragraph 29 of the grounds of appeal].

16. In support of such contentions, the Taxpayer relies heavily upon (i) Mr Fletcher's attendance note of the events of the 12 June 1997 ('the Note') and (ii) a letter from Company A to IR dated 26 May 1999 ('the Letter') in answer to IR's enquiries concerning the Taxpayer's remuneration received upon termination of the Employment Agreement.

17. In respect of the Note, it is a fairly detailed document of seven and half pages. There is no evidence before us on when it was compiled. Expectedly, the Note contains some details of the negotiation leading to the Termination Agreement. Nothing much of relevance can be found therein about the drafting of the Termination Agreement. The Note suggests that the compromise reached was a payment of US$21 million which, in simple terms, was made up of US$2 million cash that was available to Company A, US$11 million by a post-dated cheque and a waiver of the Loan (US$8 million). According to the Note, there were specific discussions both between Company B and the Taxpayer and between the Taxpayer and Mr Fletcher about payment for the ICP Units.

18. The Letter contains the following paragraph:

'Our former managing director, [Mr E], and another director, [Mr D], were primarily responsible for formulating the financial terms of a separation package. These gentlemen confirm that no precise calculations, or detailed breakdown, were made. They looked at the combined value of [the Taxpayer]'s total compensation as he might have expected had he executed the business plan for [Company A] that was the basis of [Company B's] acquisition of [Company A]. They concluded that this could be a gross sum in the range of US$30 million to $50 million payable over a number of years. On a highly subjective basis, they determined to propose to [the Taxpayer] a figure of US$20 million as being fair, being an appropriate discount for time and uncertainty. [The Taxpayer] negotiated an additional $1 million bringing the total to $21 million. These gentlemen kept no notes of their discussions and events on 12 June. They had no recollection of how the $11 million was allocated for cancellation of the [ICP Units]. I have also checked with the Human Resources manager who would have been the person to advise [Mr E] and [Mr D]. He has advised me that he was neither involved nor consulted.'.

19. Our attention has been drawn by Mr Fung, who appeared for the IR, to the following documents:

(i) three months after the cessation of his employment, the Taxpayer wrote to Company A on 24 September 1997 querying the correctness of information provided by Company A to the IR concerning his remuneration and stated that:

'the sum of US$11,000,000 which was paid to me is <u>specifically in payment to me for my Compensation Units</u> (quasi shares). As such, this is the sale of an asset and not remuneration and should therefore not be included on the form …' [emphasis added];

(ii) In a letter from the Taxpayer's tax representatives dated 26th January 1999 and copied to the Taxpayer, the US$21 million was classified as follows:

'a) US$2 million as compensation for loss of office …;

b) US$11 million as compensation for cancellation of the [ICP] Units held by our client under the employment agreement; and

c) US$8 million, being forgiveness of the repayment of [the Loan], for restricting our client's activities in future not to compete with [Company A] or its affiliates nor to disclose [Company A] confidential information or trade secrets.'.

20. We are unable to accept the Taxpayer's contention to the effect that clause 3 of the Termination Agreement did not mean what it said. Mr Fletcher has accepted in the course of submission that the Note was his 'partial version' of the events. The critical point must be what was the consensus reached by the parties. Apart from its hearsay nature, the Letter does not deserve much weight, certainly not such as to cast doubt on the express terms of the Termination Agreement, given that there was no explanation given therein on how the Sum was allocated for cancellation of the ICP Units. We bear in mind also the fact that the Letter came into existence some two years after the Termination Agreement.

21. Further, we cannot ignore the fact that both the Taxpayer and his tax representatives relied upon the terms of clause 3 of the Termination Agreement in the documents identified in paragraph 19 above. In particular, the Taxpayer's letter to Company A was written only three months after the Termination Agreement.

22. In respect of Mr Fletcher's submission that the US$11 million came about because Company A could not find more than US$2 million in cash, this does not answer the point that the parties, with their lawyers at their disposal, were free to formulate the Termination Agreement and they signed that document with their eyes open.

23. There is neither valid reason nor cogent evidence to dissuade us from the view that the terms of the Termination Agreement must be given due weight and that the payment of the Sum was, as stated, for cancellation of the ICP Units.

24. Arguably, it may be said that clause 3 provided for the payment of the Sum in respect of the cancellation of only the five million ICP Units which the Taxpayer had on the 12 June 1997 pursuant to clause 5.f of the Employment Agreement (there is no evidence that any entitlement to any of the additional blocks of 500,000 ICP Units had crystallised prior to that date). Such argument would be against the weight of the evidence that the parties had agreed a full and final settlement of all the Taxpayer's rights under the Employment Agreement. Plainly, the settlement was intended to, and we so find, embrace the Taxpayer's rights in respect of the additional ICP Units. Indeed, very fairly, Mr Fung did not seek to argue the contrary.

25. For these reasons, we find that the Sum was a payment made, to use a neutral term, in exchange for the Taxpayer's ICP Units, including both the five million Units he had on the 12 June 1997 ('the 5M Units') and the additional Units which he might have earned had the Employment Agreement not been terminated ('the Future Units').

Is the Sum chargeable to salaries tax?

26. We take the view that a distinction has to be drawn between the 5M Units and the Future Units. In respect of the latter, we have no difficulty in coming to the conclusion that payment

therefor was plainly a payment for the abrogation of the Taxpayer's rights in respect of the Future Units and, in accordance with the principle adumbrated in Henley, such payment is not taxable.

27. A different consideration applies in respect of the payment for the 5M Units. As noted in paragraph 12 above, there is no quarrel between the parties that remuneration earned by the Taxpayer during the currency of the Employment Agreement is taxable. Under clause 5.f of the Employment Agreement, the Taxpayer was awarded the 5M Units as soon as the Employment Agreement became effective. The 5M Units were clearly an inducement to the Taxpayer to enter into the Employment Agreement.

28. Pursuant to clause 9 of the Employment Agreement, the Taxpayer and Company A were free to agree to cancel the 5M Units in return for a lump sum payment. Indeed, the right to come to an arrangement in respect of the 5M Units must have existed with or without clause 9.

29. Mr Fletcher argued that the 5M Units were illusory (as a springboard to his submission that the entirety of the Sum was compensation for abrogation of the Taxpayer's rights under the Employment Agreement). He said that the Taxpayer had no right to anything under clause 5.f when the Employment Agreement was terminated. We have some difficulty in understanding this argument. Mr Fletcher drew our attention to the suggestion in the documents before us that the ICP was something unique which only applied to the Taxpayer amongst the employees of Company A. The documents suggest also that there was no formal grant or award of the 5M Units to the Taxpayer, no certificate or other documentation for the same and no document in respect of the ICP apart from what was contained in the Employment Agreement. Mr Fletcher further submitted that as of the date of termination of the Employment Agreement, no 'annual payment' had arisen under the 5M Units. We accept that on the evidence before us, the annual payment, if any, was not due on the date of termination.

30. We fail to see any relevance in the lack of documents (apart from the Employment Agreement) in respect of the 5M Units. There was never any dispute that the Taxpayer had been awarded the 5M Units!

31. The argument that no annual payment was due is also a bad point. Clause 9 of the Employment Agreement envisaged that the ICP Units could be bought out at any time. It is certainly not unknown for businessmen to put a value on a contingent right for purposes of trade. It should not be overlooked that the Taxpayer and Company B were in the best position to know whether and how much profits were to be made by Company A. Test it this way, had it been the case that the Taxpayer failed to reach a compromise with Company B on the 12 June 1997 and he were to sue Company A and/or Company B for breach of the Employment Agreement, it is inconceivable that no value would be put on the 5M Units in his Statement of Claim (assuming that Company B had said that it would not honour the annual payment obligations).

32. Moreover, the argument that the 5M Units were illusory is flatly against the evidence before us in the form of the Note. The Note suggests that Mr Fletcher had said to Mr D that the ICP Units (we infer that it was a reference to all the Units, present and future, under clause 5.f) had a 'cash out value' of 'around $33 million between years 8, 9 and 10'. Mr D was recorded to have said that the ICP Units were worth $8 million.

33. We reject this argument of the Taxpayer.

34. On the 12 June 1997, the Taxpayer undoubtedly had the 5M Units and he was entitled to annual payments in accordance with the terms of clause 5.f. Equally, he was entitled to 'cash out' his 5M Units with Company A (whether under clause 9 or otherwise). Whether the Employment Agreement was terminated on that day could not have changed that position. The principle of Henley has no application here. The payment for the 5M Units is not different in nature from the sum of £577 in Henley, being remuneration earned by an employee during the currency of his employment contract.

35. It appears to us abundantly clear that under the Hong Kong salaries tax regime an inducement to the Taxpayer to enter into the Employment Agreement is chargeable to tax [see CIR v Yung Tse Kwong, CFI, [2004] 3 HKLRD 192]. The fact that the 5M Units had been 'cashed out' merely means that instead of the annual payments being liable to salaries tax, the money received for cancellation of the 5M Units became so liable. For the purposes of revenue law, the substitute for the annual payments is treated in the same way as the annual payments themselves. The authority for this proposition is Mairs v Haughey [1994] 1 AC 303 where it was held, at page 319D-E, that:

> '*It is inevitable 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. There will usually be no legitimate reason for treating the two payments in a different way.*'.

36. Our conclusion is supported by Carter v Wadman [1946] 28 TC 41. In that case, the employment contract was prematurely terminated. £2000 was paid 'in full settlement of all past, present and future claims' of the employee. It was a term of the contract that the employee was entitled to a ¼ share of the net profits which was to be assessed in a way set out in the contract [page 50, penultimate paragraph]. At the time of termination (less than 12 months after the contract), there was no assessment. During his employment, nothing had been received by the employee in respect of his share of the profits. The employee argued that the £2000 was compensation for loss of employment.

37. The Court of Appeal had no difficulty in holding that as per the terms of the settlement letter, the payment was partly for past and present claims. One of such claims was the claim for a

share of the profits down to the date of termination. The right to such claim was 'clearly a profit arising from an employment' [*ratio* at page 52, penultimate paragraph].

38. We see no distinction between the case before us and Carter. The Court of Appeal went on to refer the matter back for apportionment which was described as 'a matter of estimate' [top of page 53].

39. Before we consider the issue of apportionment, we should deal with another point raised by the Taxpayer. It was submitted to us that no payment had accrued in respect of the 5M Units whilst the Employment Agreement was on foot and therefore any payment for the same was a payment for the abrogation of the Taxpayer's rights under the Employment Agreement. We were referred to the provisions of section 11B to 11D of the IRO.

40. With respect, this submission is premised upon a conflation over two issues. Firstly, as a matter of taxability, there can be no doubt that pursuant to the terms of sections 8 and 9 of the IRO, any payment derived from the 5M Units (whether annual payment or buy out) is taxable.

41. Secondly, there is a question of when such payment should be taxed or within which assessment year it should fall. Section 11B-11D of the IRO are concerned with this second issue. We find the Encyclopaedia of Hong Kong Taxation by Willoughby & Halkyard, vol 3, paragraph II[4143]-[4368] quite helpful on the operation of these sections. It is correct that the 'rights' under the 5M Units were, in the absence of the Termination Agreement, not taxable on 12 June 1997, because no income had accrued on that date. Pursuant to section 11D(b), 'income accrues to a person when he becomes entitled to claim payment thereof ...'. On that day, the Taxpayer would not be able to claim any payment, because (even assuming profitability on the part of Company A) no annual payment had arisen yet.

42. However, as one might have expected, the authors of the revenue legislation would not have overlook these matters. By virtue of the second proviso of section 11D, where a payment is made after an employment has ceased, the same should be deemed to have accrued to the employee on the last day of employment [section 11D(b)(ii)]. In other words, where the Taxpayer's employment came to an end before any annual payment was due, and he was to be paid a sum by Company A representing what the 5M Units were worth on the termination date, such payment would be deemed to have accrued on that day and would be taxable in the year of assessment during which the employment terminated.

43. Once the accrual point is understood, there is no real distinction between salary owed to an employee and paid on the day of termination (the £577 in Henley) and payment in exchange for an existing right to a share of profits which (the share of profits) is to be paid in the future (the payment for the 5M Units). Applying the *ratio* of Henley, the payment for the 5M Units is attributable to the Employment Agreement rather than the termination of it (or loss of employment).

This is so notwithstanding the fact that one can say that without the termination the 5M Units would not have been bought out.

Apportionment

44. Having concluded that the Sum was for both the 5M Units and the Future Units (paragraph 25 above) and that payment for the 5M Units is taxable (paragraph 35 above), we need to consider how much of the Sum was for the 5M Units.

45. We fully accept Mr Fletcher's submission that we are ill-equipped to deal with apportionment given the material available to us. No doubt normally such an exercise is carried out with the assistance of expert(s). On the other hand, Mr Fletcher seems to have overlooked the fact that the burden of proving that the assessment in question is excessive or incorrect rests on his client [section 68(4) of the IRO]. There is no material assistance to us from his side on this issue.

46. We are satisfied that we are entitled to approach the apportionment exercise on a rough and ready basis. Support for this can be found in Carter (see paragraph 38 above) as well in Yung Tse Kwong where Mr Justice Tang (as he then was) was asked by the parties to undertake an apportionment exercise and he did the best he could taking into consideration the relevant circumstances. Mr Justice Tang was at pains to point out that his approach was not 'scientific or entirely logical' [page 206F to 207A]. Ironically, it was observed by the learned Judge that 'this kind of question is best decided by the Board of Review with its special experience'. We confess to having no such special experience.

47. Mr Fletcher drew our attention to the Australian authority of McLaurin v FCT [1961] 8 AITR 180 which was cited in D76/98, IRBRD, vol 13, 420 at page 430-431. It appears that the Australian court may be more reticent about apportionment than the courts in Hong Kong and the UK. However, the Hong Kong approach is applied here and it is simply wrong, given our finding on the chargeability to tax of part of the Sum, not to have the Sum apportioned so that the appropriate tax can be assessed.

48. Mr Fung submitted to us that on a rough and ready basis, the Future Units could amount to 3 million Units (six blocks of 500,000 Units) making a total entitlement under clause 5.f of 8 million Units (the 5M Units plus 3 million Future Units). Out of the total of 8 million, 5 million constituted 62.5%. Mr Fung invited us to apply that percentage to the Sum in arriving at the appropriate apportionment.

49. Whilst having the attraction of simplicity, this method allows too much weighting for the Future Units (this is to the Taxpayer's advantage). We say so because there was, as of the 12 June 1997, no certainty that the Taxpayer would have been given all the 3 million Units had the Employment Agreement not been terminated. Further, more annual payment would likely have been derived from the 5M Units given that the Taxpayer was awarded those Units from day 1.

Plainly, intelligent businessmen like the Taxpayer and Mr D would have had those matters in mind in negotiating a figure to buy out the clause 5.f rights. Indeed, the Note suggests that it was discussed between Mr D and the Taxpayer that two of the power stations might not be built [B1/93].

50. However, there is hardly anything else upon which we can even make a rough and ready apportionment. The figures floated during negotiation (see paragraph 32 above) are unhelpful. Further, it seems to us that the figure eventually agreed by the parties for the ICP Units (the Sum) was itself a rough and ready one given the lack of any proper assessment or profits projection or the like. In the premises, the exercise we have to carry out is a rough and ready assessment upon a rough and ready assessment.

51. None of the parties has suggested to us that we should remit these matters back to the Commissioner for apportionment.

52. In these difficult circumstances, we have decided to apportion 50% of the Sum, that is, US$5.5 million, to the 5M Units. We may be erring in favour of the Taxpayer in such an assessment. However, with the difficulty we have, there is some attraction in ‘equity is equality’.

Conclusion

53. For the reasons set out above, we allow this appeal in part and set aside the Determination with a direction to the Commissioner of Inland Revenue to re-assess the tax liability in question in light of this decision.

54. Last but not least, we are grateful to the assistance rendered to us by Mr Fung and Mr Fletcher.