

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D98/03

Salaries tax – whether shares of employer company issued and allotted to its director to settle salary due chargeable to salaries tax – section 9 of the Inland Revenue Ordinance ('IRO').

Panel: Ronny Wong Fook Hum SC (chairman), Agnes Ng Ka Yin and Alan Wong Chiu Ming.

Date of hearing: 29 November 2003.

Date of decision: 9 February 2004.

Company A, Company B and the appellant entered into a settlement agreement whereby Company A shall issue and allot a number of ordinary shares in its capital to the appellant in full and final settlement of, inter alia, the salary and other employment and director's remuneration due by Company A to the appellant under the terms of a service contract between Company A and the appellant. The settlement shares were duly allotted in favour of the appellant.

The appellant put forward two principal submissions:

- a) The settlement amounts to an accord and satisfaction for the release of the liabilities of Company A to pay the outstanding salaries. The settlement shares are not payment of arrears of salaries and are not taxable.
- b) If the settlement shares were given to the appellant as settlement of arrears of salaries, the appellant should be assessed 'in accordance with the principles of Share Option Cases'.

There is no dispute between the parties that the sum was the outstanding salaries due to the appellant from Company A. The Revenue further accepts the principle that 'income means that which comes in, and that it refers to what is actually received'.

The issue before the Board was whether the appellant is chargeable to salaries tax for the sum being the salary and other remuneration due to him under his contract of employment.

Held:

The position is that the sum was income from the appellant's employment with Company A. He received that sum when he agreed to appropriate the same in payment of shares to

INLAND REVENUE BOARD OF REVIEW DECISIONS

be allotted by Company A. The sum constitutes his income for the purpose of section 9 of the IRO. The settlement shares are totally irrelevant to his liability pertaining to the income which he received. The Board is of the view that the appellant's liability attaches to the sum and not to the settlement shares. No issue of valuation arises. For like reasons, the appellant's reliance on the provisions pertaining to share options and the cases relating thereto is wholly misplaced.

Appeal dismissed.

Cases referred to:

Lambe v Commissioner of Inland Revenue [1993] KB 178

Parker v Chapmen 13 TC 677

Lord Hanworth, MR 696

Cheung Mei Fan for the Commissioner of Inland Revenue.

Keung Shu Hoi Joseph of Messrs Johnny K K Leung & Company for the taxpayer.

Decision:

Facts as found by this board

1. Company A is a company listed in the Hong Kong Stock Exchange. It held a 60% interest in Company B. The Appellant held the remaining 40% interest in Company B. At all material times, the Appellant was a director of Company A and Company B.
2. On 23 November 2001, Company A, Company B and the Appellant entered into a settlement agreement [‘the Settlement Agreement’]. The Settlement Agreement recited the indebtedness of Company A towards the Appellant in the sum of \$564,000 ‘being the salary and other employment and director’s remuneration due by [Company A] to [the Appellant] under the terms of a service contract dated 8 October 2000 entered between [Company A] and [the Appellant]’. The Settlement Agreement further recited an indebtedness of \$932,000 due from Company B to the Appellant in respect of ‘cash advances’ made by the Appellant to Company B. The Settlement Agreement provided that Company A shall issue and allot 149,600,000 ordinary shares of \$0.01 each in its capital to the Appellant [‘the Settlement Shares’] in full and final settlement of the aforesaid indebtedness.
3. The Settlement Shares were duly allotted in favour of the Appellant on 20 March 2003.

INLAND REVENUE BOARD OF REVIEW DECISIONS

4. The issue before us is whether the Appellant is chargeable to salaries tax for the sum of \$564,000 being the salary and other remuneration due to him under his contract of employment dated 8 October 2000.

Contention of the Appellant

5. Mr Keung for the Appellant put forward two principal submissions:
- (a) The Settlement Agreement amounts to an accord and satisfaction for the release of the liabilities of Company A to pay the outstanding salaries. The Settlement Shares are not payment of arrears of salaries and are not taxable.
 - (b) If the Settlement Shares were given to the Appellant as settlement of arrears of salaries, the Appellant should be assessed 'in accordance with the principles of Share Option Cases'.

Sworn testimony of the Appellant

6. The Appellant explained that Company A was in severe financial difficulties in 2000 and 2001. There were substantial arrears of salaries due in favour of its employees. He himself had to make advances in order to support the operations of Company B. The solution eventually arrived at in November 2001 was for Company A to allot shares to discharge the outstandings.

7. The Revenue challenged the testimony of the Appellant by reference to the public announcement of Company A published by order of its Board on 26 November 2001. According to that announcement:

'Whilst the Company is not in financial difficulties, the issue of the Settlement Shares ... will relieve the Company from the outstanding liability under the Director Creditors Debt ... and at the same time assist the Directors in managing the financial position of the Group and strengthening the cash outflow position of the Group. The Company confirms that it has sufficient financial resources to satisfy the outstanding salaries and consultancy fees (if not by issuing new Shares in the Company)'.

8. The announcement is an important public document. It was published pursuant to the authority of Company A's Board of which the Appellant was a member. Given the serious consequences attached to any misleading announcement, we are not prepared to afford weight to the oral testimony of the Appellant before us.

What is being taxed - \$564,000 or the Settlement Shares?

INLAND REVENUE BOARD OF REVIEW DECISIONS

9. There is no dispute between the parties that the sum of \$564,000 was the outstanding salaries for the period between 1 January 2001 and 30 November 2001 due to the Appellant from Company A. The Revenue further accepts the principle explained in Lambe v Commissioners of Inland Revenue [1933] KB 178 at page 182 that ‘*income means that which comes in, and that it refers to what is actually received*’. The Revenue’s case is that the Appellant did receive the sum of \$564,000 and reliance is placed on the decision of the Court of Appeal in Parker v Chapman 13 TC 677.

10. In Parker v Chapman, the taxpayer was the general manager of a company involved in the sugar trade. He was entitled under his contract of employment with the company to commission on the amount of all sales and purchases by the company. At the material time, £ 2,357 was due in his favour by way of commission. The taxpayer applied for shares in the company and the sum of £ 2,357 standing to the credit of the appellant’s commission and personal account was transferred in the company’s book to the credit of share capital account. The issue before the Court was whether ‘his commission is to be treated as paid or whether it is not’ for the purpose of Schedule E of the Income Tax Act.

- (a) Rowlatt J at first instance rejected the submission of the taxpayer that he did not receive the sum of £ 2,357. His Lordship analysed the position thus:

‘What happens must be that the parties come together, and the company must say to the creditor: “Well, will you take some securities of the company, or will you take some shares of the company” ... If he says: “I will”, he gets them. It is not capitalisation at all; it is accord and satisfaction really, or payment somewhere or other ... What the Appellant says is this: “Oh, but I have not had this money; I have simply been given paper instead of it; that is all I have been able to get. It is as if I had a bad promissory note given me. I have not got anything”. He says: “I have been paid in shares” But that is quite an inaccurate way of putting it. A company cannot pay its debt in shares, giving an aliquot part of the existing capital to a new shareholder. That is not what it really is. What it really is, is applying the money which it owes its creditor by the consent of the creditor in buying shares. That is all it can be’.

- (b) The decision of Rowlatt J was affirmed by the Court of Appeal. Lord Hanworth, MR at page 696 explained that:

‘What we have here to see is whether this commission receivable by [the taxpayer], and entered as a sum due to him in the books of the Company, but afterwards appropriated by him for payment of a liability due from him to the Company, was a sum which he had received. It appears to me by the simplest analysis of the case it is quite plain that this commission

INLAND REVENUE BOARD OF REVIEW DECISIONS

was a sum which [the taxpayer] did receive and subsequently appropriated to the benefit of the Company. The Company may be very grateful to him. He may have unfortunately adopted a course which was contrary to his own interest; but from the point of view of taxation this commission was a sum paid to Mr Parker personally for his commission, and it must suffer its aliquot tax accordingly’.

11. Mr Keung sought to distinguish Parker v Chapman on the basis that the company in that case was in a financial position to pay the commission whilst Company A was financially embarrassed as described by the Appellant. Quite apart from the evidential difficulties as explained in paragraph 8 above, the decision in Parker v Chapman did not rest on cash changing hands. The company in that case was also under financial stress due to the downturn of the sugar market. That decision is based on the setting off of a subsisting debt (the commission) in favour of the taxpayer against the liability (in respect of the subscription price) in favour of the company. We are of the view that Parker v Chapman is directly applicable with the result that the Appellant did receive the sum of \$564,000.

12. Mr Keung laid considerable emphasis on the fact that the Settlement Agreement amounted to an accord and satisfaction. The objective of that exercise is to persuade us that we should simply look at the Settlement Shares. He boldly asserted that ‘the nature of the Settlement Shares is not payment of arrears of salaries and is not taxable’. We reject this submission. The concept of accord and satisfaction was expressly referred to in the judgment of Rowlatt J in Parker v Chapman. That concept did not affect the analysis of Rowlatt J as outlined above. The position is that the sum of \$564,000 was income from the Appellant’s employment with Company A. He received that sum when he agreed to appropriate the same in payment of shares to be allotted by Company A. The sum of \$564,000 constitutes his income for the purpose of section 9 of the Inland Revenue Ordinance. The Settlement Shares are totally irrelevant to his liability pertaining to the income which he received.

Value of the Settlement Shares

13. We are of the view that the Appellant’s liability attaches to the sum of \$564,000 and not to the Settlement Shares. No issue of valuation arises. For like reasons, the Appellant’s reliance on the provisions pertaining to share options and the cases relating thereto is wholly misplaced.

Our decision

14. We reject the Appellant’s appeal and confirm the assessment.