HCIA12/2005

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE

INLAND REVENUE APPEAL NO.12 OF 2005

BETWEEN

COMMISSIONER OF INLAND REVENUE Appellant

and

ELLIOT, STEWART WILLIAM GEORGE Respondent

Before: Deputy High Court Judge Poon in Court
Date of Hearing: 12 May 2006
Date of Judgment: 28 June 2006

J U D G M E N T

Issue

1. This appeal raises the question whether a certain portion of US$11 million paid to the Taxpayer by his employer, Consolidated Electric Power Asia Ltd ("CEPA"), upon termination of

his employment was his income from employment chargeable to salaries tax under the Inland Revenue Ordinance, Cap.112 ("the Ordinance").

Background

2. The background facts are not in dispute. They are summarized as follows.

3. CEPA is a listed company in Hong Kong. On 29 January 1997, Southern, a USA company, acquired control of CEPA. The Taxpayer was one of the co-founders of CEPA.

4. By an employment agreement dated 30 October 1996 ("the Employment Agreement") made between Southern, CEPA and the Taxpayer, the Taxpayer was employed as CEPA's managing director and chief executive officer for a period of five years effective on 29 January 1997.

5. Clause 5 of the Employment Agreement set out the Taxpayer's remuneration package for the five years concerned. It included, among other things, incentive compensation plan units. Clause 5.f.(i) provides :

> "As soon as practical following the Effective Date, Executive shall be awarded 5,000,000 nontransferable, nonassignable, Incentive Compensation Plan Units ('the Units'). During the term of this Agreement and for a period of two years thereafter, Executive shall be entitled to additional Units in the amount of 500,000 units each upon the declared commercial operation date of the Company's next six 660MW electrical generating units. Each 500,000 Unit block shall entitle Executive to an annual payment in an amount equal to the Next Income of the Company multiplied by 0.0385 percent (the 'Compensation Percentage') less the Retention Percentage (as hereinafter defined) to be paid on or before the 15th day of the third month following the end of the Company's fiscal year; provided, however, that if and upon the event of each and every Extraordinary Corporate Transaction (such 'Extraordinary Corporate Transaction' being defined herein as any contributions following the Effective Date whereby the Company receives from its shareholders in excess of $500,000,000 U.S., and, thereafter, any one or series of contributions whereby the Company receives from its shareholders an amount equal to or exceeding $100,000,000 U.S. and every U.S.$100,000,000 U.S. increment thereafter), the 0.0385 percent Compensation Percentage shall be re-determined on and following the date of such extraordinary Corporate Transaction and shall be equal to:
>
> (x) 990,605 plus
>
> (A) the amount of any election made by Executive pursuant to subparagraph f.(ii) hereof, divided by

(B) the number of 500,000 Unit blocks held by Executive

(y) divided by the sum of

(A) 2,572,009,395 plus the amount received by the Company pursuant to each and every such Extraordinary Corporate Transaction and plus

(B) the amount determined under subclause (x) above.

If and to the extent that Executive is or becomes liable for Hong Kong salaries tax on any of the payments made under this Paragraph 5.f.(i) or the grant of the Units, the Company agrees to reimburse Executive for the amount of such taxes and to ' gross up' such reimbursement to take into account any salaries tax which may be due on such reimbursement.

…."

6. Further, under clause 9 of the Employment Agreement, the Taxpayer may, as CEPA agrees, elects to receive a lump sum payment in lieu of the Units granted to him under Clause 5.f.

7. There is no dispute that the Taxpayer had since the Employment Agreement been awarded the 5 million Units ("the 5M Units').

8. On 12 June 1997, Southern requested the Taxpayer to resign from CEPA because Southern took the view that the Taxpayer' s management style was incompatible with others. On the same day, the parties signed a termination agreement ("the Termination Agreement"). Under the Termination Agreement :

(1) The Taxpayer agreed to resign from his directorship and employment with CEPA and all its subsidiaries and associated companies with immediate effect (Clause 1).

(2) CEPA agreed to pay the Taxpayer a sum of US$2 million on 13 June 1997 (Clause 2).

(3) The Taxpayer agreed to the cancellation of his ICP Units for a payment of US$11 million ("the Sum") to be paid no later than 12 July 1997 (Clause 3).

(4) CEPA agreed to forgive the repayment of the US$8 million loan from CEPA to the Taxpayer.

9. On 12 July 1997, the Taxpayer tendered his resignation.

The Deputy Commissioner's determination

10. In the determination dated 30 September 2004, the Deputy Commissioner of Inland Revenue determined, among other things, that the Sum was the Taxpayer's incomer from employment chargeable to salaries tax for the year of assessment 1997/98.

The Board's decision

11. The Taxpayer appealed to the Board of Review. He argued 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 CEPA and/or Southern. In other words, it was part of the compensation for the abrogation of all his rights under the Employment Contract.

12. The Commissioner of Inland Revenue contended before the Board that the Sum represented 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 from employment.

13. By its decision dated 24 May 2005, the Board concluded that :

(1) The Sum was a payment made in exchange for the Taxpayer's ICP Units, including both the 5M Units and the additional Units which he might have earned had the Employment Agreement not been terminated ("the Future Units").

(2) The portion of the Sum attributed to the Future Units was not taxable as it was a payment for the abrogation of the Taxpayer's rights in respect of the Future Units.

(3) The 5M Units, however, were an inducement to the Taxpayer to enter into the Employment Agreement and therefore the portion of the Sum attributed to the 5M Units was taxable.

(4) 50% of the Sum should be apportioned to the 5M Units by adopting a "rough and ready" method of apportionment.

Questions of law

14. The Commissioner accepts the Board's finding that the payment made in exchange for the 5M Units is taxable whereas the payment made in exchange for the Future Units is not. However, the Commissioner considers that the Board has erred in making the 50% apportionment. By letter dated 16 March 2005, the Commissioner asked the Board to state a case on the following question for the opinion of this Court:

> "Whether on the facts found by the Board, the Board's conclusion that 50% of the Sum should be apportioned to the 5M Units was one which a reasonable tribunal could arrive at. ('Question 1')"

15. The Taxpayer takes the view that the Sum in its entirety is not taxable. Alternatively, he disputes the 50% apportionment. By letter dated 23 March 2005, he asked the Board to state a case on the following questions:

> "Did the Board err in law in failing to conclude that, upon the true construction of the Termination Agreement and the Employment Agreement, all of the Sum, including the part representing the Taxpayer's entitlement in respect of the 5M Units, was damages for the abrogation of the Taxpayer's Employment Agreement and therefore not chargeable to tax? ('Question 2')
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> Was the Board correct in law in concluding that Part III of the Ordinance (as it stood in June 1997) permitted apportionment of sums received by the Taxpayer under the Termination Agreement for the purpose of determining what part of the Sum was taxable thereunder? ('Question 3')
>
> If apportionment is permitted by Part III, was the Board correct in law in adopting the "rough and ready" method of apportionment? ('Question 4')"

16. At the hearing before me, the Taxpayer did not pursue Question 3. If he did, the answer would be "Yes".

17. It can be readily seen that Question 2 deals with the Taxpayer's liability to tax, and Questions 1 and 4, apportionment. It is therefore logical to first consider Question 2.

Question 2 : Liability to tax

18. Section 8 of the Ordinance provides that salaries tax is charged upon income arising in or derived from Hong Kong from any office or employment of profit. Under section 9(1)(a), income from any office or employment includes any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance whether derived from employer or others.

19. The Sum was a payment made on termination of employment. When considering whether or not it is caught by sections 8 and 9(1)(a) of the Ordinance, the court looks at its true nature. The label which the parties chose to put on the payment is not determinative : *Commissioner of Inland Revenue v. Yung Tse Kwong* [2004] 3 HKLRD 192, *per* Tang J (as he then was) at para.16 at p.198C.

20. The parties have cited a number of authorities relating to payments made upon termination of employment. I do not propose to deal with them in detail. For present purposes, it will be sufficient to state two well-established propositions derived from the cases thus :

(1) Payment made as an inducement to enter into an employment is taxable, and it does not matter whether it was paid before, during or on termination of the employment : *Mairs (Inspector of Taxes) v. Haughey* [1994] 1 AC 303; see also *Yung Tse Kwong* for Tang J's discussion of the English authorities at paras.29-40.

(2) Payment as consideration for the abrogation of a contract of employment or as damages for it is not taxable : *Henley v. Murray* (1950) 31 TC 351, [1950] 1 All ER 908; *Comptroller-General of Inland Revenue v. Knight* [1973] AC 428.

21. As noted, the Board found that the 5M Units were an inducement to the Taxpayer to enter into the Employment Agreement. Thus the portion of the Sum attributed to the cancellation of the 5M Units was taxable.

22. Mr Barlow, appearing for the Taxpayer, readily accepts that any right to remuneration (or to other emoluments capable of monetary quantification) that had accrued by the date of termination of his employment is subject to salaries tax. However, he argues that none of the Sum represents such an accrued right or accrued quantifiable entitlement. His contention runs like this.

23. On a proper construction of Clause 5.f(i), the 5M Units entitled the Taxpayer, in the absence of dismissal or termination, to an annual share in the Net Income of CEPA indefinitely calculated at 0.0385% per 500,000 Units x Net Income = 0.385% x Net Income. The period of employment being between 29 January and 12 June 1999, no entitlement to payment in respect of 0.385% of CEPA's Net Income for the 1st year of the Employment Agreement had accrued when the parties entered into the Termination Agreement. Further, there is no provision for apportioning any Unit entitlements over a part of any one year's net Income. At the date of the Termination Agreement, no sum was payable to the taxpayer in respect of the 5M Units. Thus in terms of sections 11B and 11D of the Ordinance :

(1) No amount of income in respect of the 5M Units had accrued to the Taxpayer in the year of assessment : section 11B[1].

(2) No income in respect of the 5M Units had been received by the Taxpayer in the year of assessment and therefore no such income could be included in his assessable income for that year of assessment : section 11D(a)[2].

(3) No payment, in respect of any income from the 5M Units, was made to the Taxpayer after he ceased to derive income from the employment which, had it been made on the Taxpayer's last day of employment, would have been included in that year of assessment : section 11D, and proviso (ii) in subparagraph (b)[3].

24. Mr Barlow accordingly submits that the Sum was paid as compensation for the cancellation of the 5M Units and his entitlement to earn other Units as CEPA's business grew and the abrogation of the Taxpayer's contractual rights to share in the Net Income of CEPA annually.

25. I accept that at the time of termination, no annual payment arising from the 5M Units had accrued. There is no evidence to suggest that the parties had agreed to a "buy-out" of the 5M Units under Clause 9 upon termination either. However, it does not necessarily follow that none of the Sum represents an accrued quantified entitlement which is subject to salaries tax.

26. I will first consider the nature of the 5M Units. The 5M Units formed part and parcel of the Taxpayer's remuneration package under the Employment Agreement. The 5M Units would entitle the Taxpayer to annual payments as provided under Clause 5.f(i); or subject to CEPA's agreement a lump sum payment in lieu under Clause 9. Plainly, it was an inducement, and an attractive one indeed, to the Taxpayer to enter into the Employment Agreement. The finding by the Board in this respect cannot be flawed.

27. I then consider what the Sum covered. Under Clause 5.f(i) of the Employment Agreement, the Taxpayer was entitled to the 5M Units and the Future Units. Clause 3 of the

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[1] Section 11B stipulates that the assessable income of a person in any year of assessment shall be the aggregate amount of income accruing to him from all sources in that year of assessment.

[2] Section 11D(a) provides that for the purpose of section 11B, income which has accrued to a person during the basis period for a year of assessment but which has not been received by him in such basis period shall not be included in his assessable income for that y ear of assessment until such time as he shall have received such income…

[3] Subparagraph (b) and proviso (ii), read together, stipulates that income accrues to a person when he becomes entitled to claim payment thereof, provided that, subject to proviso (i), any payment made by an employer to a person after that person has ceased or been deemed to cease to derive income which, if it had been made on the last day of the period during which he derived income, would have been included in that person's assessable income for the year of assessment in which he ceased or is deemed to cease to derive income from that employment, shall be deemed to have accrued to that person on the last day of that employment.

Termination Agreement provides for the cancellation of the Taxpayer's incentive compensation units for US$11 million. No distinction had been drawn between the 5M Units, which had already been awarded at the time of termination, and the Future Units, which had not. In these circumstances, it is open to the Board to find that one portion of the Sum was attributed to the cancellation of the 5M Units and the other was for the abrogation of his rights to the Future Units. Again, the Board's finding cannot be flawed.

28. I next turn more specifically to the portion of the Sum attributed to the cancellation of the 5M Units. As noted above, the 5M Units were an inducement to the Taxpayer to enter into the Employment Agreement. They also entitled the Taxpayer annual payments under Clause 5.f or a lump sum payment in lieu under Clause 9. In the circumstances, the Sum attributed to the cancellation of the 5M Units must have covered :

(1) A sum representing the value of the inducement, which is taxable.

(2) A sum representing the compensation for abrogating the Taxpayer's rights to annual payments under Clause 5.f and the lump sum payment under Clause 9, which is not taxable.

29. Thus analyzed, only the portion of the Sum attributed to the cancellation of the 5M Units which represented the value of the inducement is taxable.

30. In my view, Mr Barlow's submissions have ignored the value of inducement entirely. He is therefore wrong in his contention that none of the Sum represents any quantified entitlement that is taxable. On the Board's part, it had erred in (a) failing to differentiate the two distinct elements covered by the portion of the Sum attributed to the cancellation of the 5M Units; and (b) concluding that the entire portion attributed to the cancellation of the 5M Units is taxable.

31. For these reasons, my answer to Question 2 is this : "No, but the Board had erred in not finding that only the portion of the Sum attributed to the cancellation of the 5M Units which represented the value of the inducement is taxable."

32. I now turn to the Questions relating to apportionment.

Questions 1 and 4 : Apportionment

33. Logically, Question 4 should be dealt with first because it touches upon the approach adopted by the Board in apportionment. Mr Fung, appearing for the Commissioner, submits that at the hearing before the Board, the Taxpayer did not provide any material assistance to the Board, although he bears the burden of proving that the assessment in question was excessive or incorrect. In such circumstances, it is most difficult to see how the Board can be said to be wrong in following

Yung Tse Kwong and adopting the "rough and ready" method of assessment. I agree. The answer to Question 4 is "No".

34. I then turn to Question 1 which deals with the actual apportionment. The Board proceeded to deal with apportionment on the footing that the entire portion of the Sum attributed to the cancellation of the 5M Units was taxable. Unfortunately, that is, as I have demonstrated, a wrong footing. Accordingly, the 50% apportionment cannot stand. The answer to Question 1 must be "Yes".

Remitting the case

35. In light of the above, what remains outstanding is apportioning the Sum attributed to the cancellation of the 5M Units by putting a proper value to the inducement. Neither Mr Fung nor Mr Barlow has addressed the question of apportionment on this footing. In the circumstances and having considered the matter carefully, I think the best way to proceed is to remit the case back to the Board for reconsidering apportionment. For as rightly pointed out by Tang J in *Yung Tse Kwong* (para.49), the Board is best able to deal with this question, which is a question of fact.

36. I will therefore order that the case be remitted to the Board pursuant to section 69(5) of the Ordinance to reconsider the proportion of the Sum assessable to salaries tax in light of the opinion contained herein for the purpose of revising the 1997/98 salaries tax assessment raised on the Taxpayer.

Costs

37. Having regard to how this appeal is argued and disposed of, I think it is proper to award the Commissioner (a) half of her costs on Question 2 and (b) full costs on Questions 3 and 4; and make no order as to costs on Question 1. Taking the matter in the round, I will make an order *nisi* that the Commission shall have half of the costs of this appeal, to be taxed if not agreed.

(J. Poon)
Deputy High Court Judge

Mr Eugene Fung, instructed by Department of Justice, for the Appellant

Mr Barrie Barlow, instructed by Messrs Lovells, for the Respondent