HCIA1/2008

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION

COURT OF FIRST INSTANCE
INLAND REVENUE APPEAL NO. 1 OF 2008

BETWEEN

FUCHS, WALTER ALFRED HEINZ Appellant

and

COMMISSIONER OF INLAND REVENUE Respondent

Before : Hon Burrell J in Court
Date of Hearing : 29 May 2008
Date of Judgment : 26 June 2008

J U D G M E N T

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1. This is an appeal from a determination of the Deputy Commissioner of Inland Revenue ("the determination") dated 22 October 2007. By consent the case has been transferred to this court pursuant to section 67 of the Inland Revenue Ordinance ("IRO"), Cap. 112, thereby bypassing the Inland Revenue Board of Review. The court's task is to decide whether the

determination was correct or not after consideration of fact and law. The appellant has the burden to show that the determination was wrong or excessive.

2. A six-page statement of agreed facts has been produced. An outline summary of that statement is as follows :

(i) The appellant taxpayer, Mr W.A.H. Fuchs (who gave evidence to this court in accordance with his witness statement and was cross-examined) first became employed by the international German bank Bayerische Hypo-und Vereinsbank ("HVB") in 1976.

(ii) He worked for the bank in Germany until 2000 when he was transferred to the Singapore branch. In late 2003 he became "head of Asia region" and was transferred to Hong Kong. He signed a three-year contract with effect from 1 January 2004.

(iii) His annual salary was HK$3,120,000. He was also entitled to an annual bonus, the amount of which depended on the bank' s results and performance.

(iv) In addition to a salary and bonus the agreement contained clause 9(c) which provided as follows :

"c) In the event that the Bank terminates or purports to terminate this agreement on any grounds other than as set out in clause 9a) and 9b), — despite your prior written consent to extend this agreement on the basis of customary market conditions for another 3 years and although you have not reached the age of 60 — the Bank shall pay to you as agreed compensation or liquidated damages :

- 2 annual salaries

- an average amount of the bonuses paid in the 3 previous years of your employment with the Bank.

The Bank shall, not later than the effective date of termination, pay to you the compensation determined in accordance with the above.

Any possible mandatory severance payments are included in the above mentioned compensation sum."

(Clause 9(a) related to termination by effluxion of time and 9(b) to termination because of misconduct.)

(v) Mr Fuchs' contract was in fact terminated under clause 9(c) after about two years of the three-year term due to a bank take-over.

(vi) Upon termination and by agreement Mr Fuchs was paid the following sums :

Sum A — $3,120,000 being a sum equivalent to his salary under the remaining period of his contract (12 months);

Sum B — $6,240,000 being "two annual salaries" referred to in clause 9(c); and

Sum C — $8,916,667 being "the average of his three previous annual bonuses" also referred to in clause 9(c).

(vii) The Revenue levied salaries tax on Sums B and C, but not on Sum A. The core reason for its decision was that Sums B and C were paid pursuant to his contract of employment. He was contractually entitled to receive them on premature termination and as such were liable to tax. The determination stated :

"Clearly, the sums stemmed from the terms of the employment … the sums are obviously income from employment which should be chargeable to Salaries Tax."

(viii) The determination upheld the levying of tax on Sums B and C. Mr Fuchs through his lawyers contends that the sums were paid as compensation for abrogation of office and are thus not taxable.

THE IRO

3. The relevant sections of the IRO are sections 8 and 9.

4. Section 8 provides that :

"(1) 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 ..."

Section 9 defines the above as including :

> "(a) any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others ...
>
> (b) the rental value of any place of residence provided rent-free by the employer or an associated corporation;
>
> (c) where a place of residence is provided by an employer or an associated corporation at a rent less than the rental value, the excess of the rental value over such rent;
>
> (d) any gain realized by the exercise of, or by the assignment or release of, a right to acquire shares or stock in a corporation obtained by a person as the holder of an office in or an employee of that or any other corporation."

It is a wide definition.

5. Mr Fuchs has been represented in this appeal by Mr Barrie Barlow SC, the Commissioner by Ms Yvonne Cheng.

6. The parties disagree both as to how to define the core issue for this court to resolve and also what is the correct test to be applied when deciding whether tax is chargeable.

7. Mr Barlow says the issue is :

> "Were the payments made under the Termination Agreement (Sums B and C) payments received as compensation or damages for the loss of the Taxpayer's employment or were they income from his employment?"

8. Ms Cheng says the issue is :

> "... whether the Sums B and C were paid as part of the Taxpayer's contractual entitlement under the Agreement (in which case they are assessable to tax) or as damages for breach of agreement (in which case they are not assessable).

9. She added that it is "well established" that payments paid as part of contractual entitlements under a contract of employment are assessable to tax.

10. Mr Barlow, however, says the court should focus on the question of "what was the true nature of the payment". Was it income (taxable) or was it compensation for loss of office or damages for breach of the contract of employment (not taxable)?

11. It seems to me that the difficulty arises in this case because, arguably, the payments (Sums B and C) were paid because the contract was terminated early and he therefore lost his employment earlier than expected *and* this very eventuality was catered for in the contract and payments made thereunder. Is this "compensation for loss of office" or "a contractual payment" or both?

12. Mr Barlow would submit that if it is compensation for loss of office it matters not that there are contractual provisions catering for it. Ms Cheng would submit that if it is income from employment paid pursuant to contract, it does not matter what you call it.

13. It seems unarguable that Sums B and C were paid pursuant to contract. If HVB had, for some bizarre reason, decided to pay Mr Fuchs nothing he would have successfully sued on his contract of employment for the payments he actually received as Sums B and C or similar sums. Mr Barlow submits that this ignores the real question, namely an analysis of the true nature of the payment. He, accordingly, challenges "root and branch" the following extracts from the determination (*inter alia*) :

> "Thus the Taxpayer's entitlement to Sum B and Sum C depended on the proper discharge of services rendered to HVB-HK. They can be regarded as inducement to the Taxpayer for taking up an employment with HVB-HK in Hong Kong. As such, the sums are obviously income from employment which should be chargeable to Salaries Tax."
>
> "It is also well established that for a sum to be a compensation, it must be shown that there is a loss of right on the one side and a legal liability on the other to pay compensation for the loss of such right."
>
> "Finally in relation to the Taxpayer's argument that Sum B and Sum C were reward for his services provided to HVB since September 1976 ... and that the sums were paid to him pursuant to the German law, I am unable to accept this. There is simply no evidence showing that HVB was required to pay the substantial amount of some $18 million under the German law."

THE LAW

14. The difficulty in resolving the differences of principle between the parties is compounded by the fact that authorities have been cited to support both positions.

15. One of the cases cited by Ms Cheng was *Dale v. de Soissons* [1950] 2 All ER at 462 where Evershed MR quoted from Roxburgh J in *Henley v. Murray* as follows :

> "In the present case the taxpayer surrendered no rights. He got exactly what he was entitled to get under his contract of employment. Accordingly, the payment, in my judgment, falls within the taxable class ..."

16. She also referred to Lord Wilberforce in *Comptroller-General of Inland Revenue v. Knight* [1973] AC at 433 where he said :

> "Questions as to the taxability of payments received by employed persons at the end of their employment have frequently come before the courts : they have often been described as difficult, borderline and depending on narrow distinctions. Two propositions are accepted as common ground in the present case. First, 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 : see for example *Henry v. Foster* (1931) 16 T.C. 605. Secondly, where a sum of money is paid as consideration for the abrogation of a contract of employment, or as damages for the breach of it, that sum is not taxable : see for example *Henley v. Murray* (1950) 31 T.C. 351."

17. In *EMI Group Electronics v. Coldicott* [1999] STC 803 Chadwick LJ simply stated that :

> "…. the first step in the enquiry must be to identify what, on a true analysis, the payments were for."

(Mr Barlow, I think, would agree).

18. Both counsel referred to *Henley v. Murray* (1950) 31 TC 351. It establishes the principle that a payment made in compensation may be treated as damages for abrogation of office and is therefore not income. Ms Cheng points out that in that case the sum had not been provided for in the contract. Similar *Mairs v. Haughey* [1994] 1 AC 303 is authority for :

> "... notwithstanding the wide definition of 'emoluments' in section 131(1) of the Income and Corporation Taxes Act 1988, a redundancy payment in its nature was not an emolument from employment but compensation to the employee for his no longer receiving emoluments from the employment ..."

19. Mr Barlow placed considerable reliance on the Hong Kong Court of Appeal case of *CIR v. Elliott* [2007] 1 HKLR 297, the key holding in which was :

> "Payments received as compensation for loss of office were not chargeable to salaries tax. In applying this principle, there was a critical distinction between where the contract of employment persisted, where the employer remained liable for the

> remuneration it had contracted to pay, notwithstanding that it did not require the employee to render service; and where the contract itself went altogether, where some amount became payable for the consideration of the total abandonment of all the contractual rights which E had under the contract. Here, the contract unquestionably came to an end ..."

20. However, Ms Cheng submits that *Elliott* is of no special assistance to the appellant. The judgment acknowledges that Mr Elliott was paid a large sum as damages. There was nothing in the contract which provided for the sum paid or for the circumstances in which it would be paid.

21. Lord Woolf in *Mairs v. Haughey* highlighted the difficulties which such cases often create :

> "... It is not always easy to reconcile these authorities since as is to be expected they are frequently concerned with situations close to the borderline between payments which fall within and payments that fall without the statutory provision. It is possible to have almost an infinite variety of situations which, although they have common characteristics, as a matter of fact and degree fall on one side of the border or the other. In each case ultimately it is a matter of applying the statutory language to the facts. However, general assistance is provided by the speeches in *Hochstrasser v. Mayes* [1960] A.C. 376 and *Shilton v. Wilmshurst* [1991] 1 A.C. 684. In the former case I find the passage in the speech of Lord Radcliffe, at pp. 391-392, of help where he said of the statutory language :
>
> ' 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.' "

22. Before I turn to the application of the law to the facts of this case there are two further matters.

(1) Inducement?

23. It is suggested in some of the authorities (and also relied on in "the determination" in the present case) that a feature which supports the contention that tax is payable because the sum is not damages for loss of office is that the terms of the contract which provide for such payments would have been an inducement to the taxpayer to enter the contract.

24. An "inducement" is to be construed objectively as a matter of law. It is not a matter of what did or did not entice the employee to enter into the contract. In this case Mr Fuchs acknowledged that when signing the contract in 2004 he would expect it to contain some sort of

security, either by way of a financial payment or by the guarantee of re-engagement with the bank in Germany, to be included.

25. I conclude that section 9(c) of the agreement does, as a matter of law, contain an inducement. This, however, is not conclusive of the nature of the payment but it is a factor to be weighed in the balance in the Commissioner's favour.

(2) Labels

26. What an employer calls the payment is not conclusive either. In this case HVB described the payment (in the termination agreement) as "a one time payment as compensation for the loss of his position ..."

27. Also section 9(c) of the employment contract refers to "agreed compensation or liquidated damages". Such language may be loose. It does not necessarily assist in the court's task of analysing the true nature of the payments.

PRINCIPLES TO BE APPLIED

28. Having reviewed the authorities and considered the submissions advanced thereon in relation to the facts of this case, my approach in this appeal is as follows :

(i) The starting point is to look at the contract. If a payment has been made upon premature termination which is not a contractual entitlement it is *prima facie* not income from employment and not assessable.

(ii) On the other hand, if a payment is made pursuant to the contract and is an entitlement on early termination, it is *prima facie* "income arising in or derived from the office ...".

(iii) But the matter does not end there. It does not automatically follow that all payments made pursuant to contract fall to be assessed without further consideration. If it can be shown that the payment is truly compensation for loss of office or damages for breach of contract, it will not be assessable.

(iv) Logically, the latter (damages for breach) would not be provided for in the contract. Contracts do not usually say "if I breach this agreement I will pay you damages as follows ...". "Breach" in this context means a failure by the employer to follow the terms of the agreement resulting in a loss to the employer for which damages would be due. Such "damages" may well be different from the sums due under clause 9(c).

In this context, I reject Mr Barlow's submission that this is a "damages" case; his argument being that the employer is in breach by virtue of the contract coming to a premature end.

(v) This not being a "damages for breach of contract" payment what remains is the question — is it a payment of compensation for loss of office albeit provided for in the contract? The two concepts are not mutually exclusive.

THE PAYMENTS IN QUESTION

29. Mr Fuchs received three separate payments. The commissioner regarded Sum A as "compensatory in nature" and therefore was not liable to be taxed. The fact that there were no contractual provisions for its payment was no doubt a factor. Sum A is not in issue in this appeal.

30. I will analyse Sums B and C separately.

Sum C

31. This was for $8,916,667 paid pursuant to section 9(c) being the average of the last three annual bonus payments.

32. In my judgment common sense dictates that the *raison d'etre* for this payment (which the employer agreed to pay in the event of early termination) was to ensure the employee received the bonus he might have received if the contract had continued for another year. The "bonus" was in reality the most important part of the employee's income. It was reasonable to expect that it would comfortably exceed the annual salary (which in Mr Fuchs' case it always had). The loss of this "income" would be a serious blow if the contract was terminated early. By the mechanism used in clause 9(c) an equivalent payment in substitution was guaranteed. Moreover, it was an inducement.

33. Mr Barlow contended that the use of the previous bonuses to calculate the sum due was a "mere yardstick" or "mechanism" to calculate the amount of compensation for loss of office.

34. I do not agree. The fact that the bonus figures were used is a clear indication that it was intended as a substitute for the bonus he would have received had employment continued. If for example, the employer had wanted the sum to represent compensation for long service then the duration of employment would, more likely, have been used as the yardstick or mechanism.

35. I am satisfied that Sum C was rightly regarded as coming within sections 8 and 9 of the IRO. It was an entitlement under the contract and not compensation for loss of office or damages for breach of contract. It was income arising from employment.

36. Returning to Lord Wilberforce's remarks cited at paragraph 16 of this decision, it seems to me that Sum C fits into his first category but not his second. Sum C is a contractual entitlement representing income derived from his services rendered during the contract. Similarly, Sum C has been paid to him, to borrow Lord Radcliff's words cited in paragraph 21 herein "in return for acting as or being an employee". The fact that it was paid pursuant to a contract which was terminated early does not change its true nature. It is an attempt to pay him a sum equivalent to his bonus entitlement had the contract continued to its full term.

Why two separate sums under clause 9(c)?

37. Before moving on to Sum B the above question merits consideration. If Mr Fuch's employers had wanted to pay him money which was purely compensatory for loss of office, it is arguable that they would have paid a single sum (calculated by whatever mechanism they saw fit). Clause 9(c) however provides for two separate sums. There are two possible explanations for this. Either they are two components of the same payment (i.e. two lumps of income or two lumps of compensation, albeit with different mechanisms of calculation) or they are two separate payments which are arguably different in nature and attract different legal consequences. I prefer the latter explanation.

38. Adopting Mr Barlow's approach of analysing the "true nature" of the payment I have come to the conclusion that Sum C falls on one side of the borderline and Sum B on the other. I have explained my reasoning for Sum C, I now turn to Sum B.

Sum B

39. Sum B has characteristics which fall on both sides of the dividing line between what is chargeable and is not.

40. Ultimately, the characteristics of substance rather than form which have persuaded me to place this sum on the non-chargeable side are *(taken together)* that :

(i) it is akin to a non-contractual redundancy payment because it is calculated by reference to a multiplier of an annual salary;

(ii) the employer called it "agreed compensation";

(iii) the contract had come to an end. All future mutual rights and obligations were terminated;

(iv) it is not referable to work done;

(v) it is not calculated by reference to work done under the contract;

(vi) it would not have been paid if the contract had gone its full term of three years; and

(vii) it may be regarded as an arbitrary amount, payable in the event of early termination, designed to soften the blow of premature unemployment.

I appreciate that some of these characteristics may apply to Sum C as well. Accordingly, I have emphasized the words "taken together" in parenthesis above.

41. Although both payments are borderline, I find, on Sum B, in the taxpayer's favour. Its substance is in the nature of a payment he would have received by virtue of his seniority in the circumstances that occurred. I acknowledge that, against this finding, it could be said that Sum A represented his "compensation". There is some force in this argument but I have not been required to rule on Sum A and thus the Commissioner's decision that it was "compensatory in nature" is the end of the matter and has no bearing on this court's evaluation of Sums B and C.

42. Ultimately, it seems to me that Sum B can be fairly categorised as capital and Sum C can properly be categorised as income. The final test is to return to sections 8 and 9 of the IRO and pose the question : do these findings offend the words of the statute? I am satisfied that they do not.

ISSUE TWO

43. The second issue in this appeal is as follows. If any sums are chargeable (I have decided that Sum C is chargeable), then, it is submitted by the appellant that the liability should be apportioned so that only that proportion of his income derived in Hong Kong (about two years of income) in relation to his entire career with the Bank (about 29 years) should be taxed.

44. In this case the result would be that about 6.8% of Sum C would be chargeable.

45. In my judgment this second limb to the appellant's submission is without merit. In my judgment it falls to be taxed because it is Hong Kong income. It is not referable to pre-Hong Kong employment. It was a provision in the 'HVB-HK" contract (i.e. the contract with the Hong Kong branch) with the taxpayer. It was calculated with reference to bonuses (mainly) earned in Hong Kong and paid in Hong Kong dollars. Its chargeability arises because it falls within section 8 of the IRO, the Hong Kong law.

46. Attempts to redefine it by reference to German law are misplaced. Evidence of German law has not been adduced by any expert witness, it is therefore inadmissible and, in any event, irrelevant.

COSTS

47. The taxpayer has had to come to court to improve his position. He is therefore entitled to some of his costs. He has lost on Sum C, won on Sum B and lost on the apportionment argument. In all the circumstances I award the appellant, on a *nisi* basis, half of his costs.

(M.P. Burrell)
Judge of the Court of First Instance
High Court

Mr Barrie Barlow, SC, instructed by Messrs Laracy Gall, for the Appellant

Ms Yvonne Cheng, instructed by the Department of Justice, for the Respondent