CACV 94/2016
[2018] HKCA 297

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF APPEAL
CIVIL APPEAL NO 94 OF 2016
(ON APPEAL FROM INLAND REVENUE APPEAL NO 2 OF 2015)

BETWEEN

POON CHO-MING, JOHN	Appellant
and	
COMMISSIONER OF INLAND REVENUE	Respondent

Before: Hon Macrae VP, Yuen and Kwan JJA in Court
Date of Hearing: 16 May 2017
Date of Judgment: 1 June 2018

J U D G M E N T

Hon Macrae VP:

1. I agree with the judgment of Yuen JA.

Hon Yuen JA:

2. This is an appeal from a Judgment of Anthony Chan J given on 24 March 2016 in which he dismissed the appeal of the Appellant (**"the Taxpayer"**) from a decision of the Inland Revenue Board of Review ("**BoR**") given on 16 June 2015 in which it was held that the Taxpayer was chargeable to salaries tax for:

(1) a sum described as "payment in lieu of discretionary bonus" in a Separation Agreement between the Taxpayer and his employer (**"Sum D"**), and

(2) a notional gain derived from certain share options, the vesting of which was accelerated under the Separation Agreement ("**the Share Option Gain**").

3.1. The case stated (with the italicized words below added by the judge) was as follows:

> "Did the Board of Review err in law in failing to conclude, upon the true construction of the 20 July 2008 Separation Agreement and the 20 October 1999 Service Agreement *and in the relevant circumstances of the termination* that all of the Sum D payment in lieu of a discretionary bonus plus the notional Share Option Gain, were in the nature of payments of compensation for the Employer's abrogation of the Service Agreement and for the Taxpayer's agreement to the additional covenants in the Separation Agreement and therefore they are not chargeable to salaries tax under Part 3 of the Inland Revenue Ordinance (Cap.112)?"

3.2. Despite the rolled-up language, the parties approached the matter before the judge[1] on the basis that the case stated challenged the conclusion of the BoR that neither the Sum D payment, nor the Share Option Gain, was:

(a) compensation for the Employer's abrogation of the Service Agreement ("**issue (A)**"), or

(b) compensation for the Taxpayer's agreement to the Separation Agreement ("**issue (B)**"),

and thus both Sum D and the Share Option Gain were chargeable to salaries tax.

4.1. Salaries tax is chargeable under Part 3 as follows:

> "8(1). 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 the following sources:
>
> (a) any office or employment of profit ...".

4.2. Section 9 defines "income from any office or employment" to include

> "(a) any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others ...;
>
> ...
>
> (d) any gain realized by the exercise 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 ... corporation".

[1] §21, Judgment.

Background

5. Before discussing the arguments on appeal, it is necessary in the present case to set out the facts in some detail.

6. Pursuant to a Service Agreement dated 20 October 1999, the Taxpayer was employed as Group Chief Financial Officer and executive director of a large "brand name" clothing company incorporated in Bermuda and listed in Hong Kong ("**the Employer**") with subsidiaries worldwide. He commenced employment on 3 December 1999[2].

- The Service Agreement

7. The Service Agreement contained the following provisions which are material to this appeal:

> 2.2. The Taxpayer's employment will begin on or before 1 February 2000 and will continue, subject to the terms of the Agreement, for a term of 2 years and thereafter until terminated by either party giving to the other not less than 6 months' written notice;
>
> 4.3. In addition to the Salary, the Taxpayer will be eligible to participate in the Senior Management bonus scheme ("Annual Bonus") on such terms and at such level as the board of directors of the Employer may from time to time determine;
>
> 5.2. The Employer will, in accordance with its employees' share options scheme, grant to the Taxpayer, within 14 days after his date of commencement of employment, share options at an exercise price to be set with a discount of 20% permitted under such share option scheme;
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> 11.2. During his appointment and until the expiration of 3 months from the Date of Termination[3], the Taxpayer will not directly or indirectly (among other things):-
>
> > (A) carry on, be interested or employed in a restricted business [defined[4] as the business of selling, marketing or producing restricted goods in countries in which any member of the Group carries on business];

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2 §12, BoR Decision.

3 Defined in clause 1(C) of the Service Agreement as the date on which the employment of the Taxpayer terminates save pursuant to an assignment.

4 In clause 11.1 of the Service Agreement.

(B) assist or provide any entity with technical, commercial or professional advice relating to the restricted goods [defined[5] as goods of the same or similar design ... as distributed or produced by any member of the Group at any time during his appointment or at the Date of Termination];

14.6 On the Date of Termination (for whatever reason) the Taxpayer will promptly:-

a) at the request of the Employer resign (if he has not already done so) from all offices held by him in the Group ...

and the Taxpayer irrevocably authorises the Employer in his name and on his behalf to execute all documents and do all things necessary to effect the resignations referred to above, in the event of his failure to do so.

- Employment

8. During the 8 years that followed his appointment as Group CFO and executive director, the Taxpayer became the Deputy Chairman as well as Company Secretary of the Employer, and a director of 34 subsidiary companies in 15 jurisdictions. He also had a public profile through appointments to public bodies. His evidence (which was accepted by the BoR) was that by reason of impressive financial results achieved during his tenure as Group CFO, he was highly regarded by the Employer's investors and shareholders.

- Discretionary Bonus

9.1. In respect of the Annual Bonus referred to in the Service Agreement (which was referred to in the Judgment as "the discretionary bonus"), the Employer did not have a formal bonus scheme with rules governing it[6].

9.2. However the undisputed evidence before the BoR was that the normal procedure involved 3 stages of decision-making[7]. After every financial year-end on 30 June, audited accounts would be provided to executives of the Employer. At the first stage, these executives would make suggestions to the remuneration committee in August[8]. At the second stage, the remuneration committee would make a recommendation to the Board. At the third stage, the Board would make the final decision on the discretionary

[5] See fn 4.

[6] Employer's letter to IRD dated 10 July 2012, §3(a).

[7] §48, BoR Decision.

[8] §23, Judgment.

bonus to be awarded, which would normally be in September. As is usually the case, the award of a bonus would depend on various considerations including the Employer's results and the individual's performance.

9.3. For every year of his employment up to and including the financial year ended 30 June 2007, the Taxpayer had been awarded a bonus.

9.4. However when the Taxpayer's employment terminated in July 2008, not even the first of the 3-stage process (which normally took place in August) had been completed. According to the written response from the Employer to the IRD[9], the Taxpayer was not awarded any bonus for the financial year ended 30 June 2008. An "entirely arbitrary amount mutually agreed by [the Taxpayer] and [the chairman]" in lieu of discretionary bonus was paid "to eliminate any claim for unpaid bonus" for the financial year ended 30 June 2008.

- The Employer's Share Option Scheme

10.1. Returning to pre-termination events, by letters dated 26 November 2003, 27 November 2004 and 7 February 2007 respectively ("**the Grant Letters**"[10]), the Employer offered the Taxpayer options to subscribe for its shares, subject to the terms of a share option scheme adopted by the Employer in 2001. The Taxpayer accepted the terms of the offers by signing the respective Grant Letters.

10.2. It was a term and condition of the 2003 and 2004 Grant Letters that:

> "Unless otherwise agreed by the Board in its absolute discretion (and approved by independent non-executive directors of the Company), the Option will only be granted to you in your capacity as Group Chief Financial Officer in the Group ("the Position") and may lapse if you cease to be in the Position".

The 2007 Grant Letter had a similar term and condition couched in stricter terms, but it is not material to the issues before this court.

10.3. The subscription prices and vesting dates under the respective Grant Letters are summarized below[11]:

Grant Letter	Price	No of Shares	Vesting Date
2003	$24.20	360,000	26 November 2004
		360,000	26 November 2005
		360,000	26 November 2006

9 Employer's letter to IRD dated 18 March 2011.

10 §14, BoR Decision.

11 §15, BoR Decision.

Grant Letter	Price	No of Shares	Vesting Date	
		360,000	26 November 2007	
		360,000	26 November 2008	(“**tranche A**”)
		1,800,000		
2004	$42.58	360,000	27 November 2005	
		360,000	27 November 2006	
		360,000	27 November 2007	
		360,000	27 November 2008	(“**tranche B**”)
		360,000	27 November 2009	(“**tranche C**”)
		1,800,000		
2007	$83.00	160,000	7 February 2008	(“**tranche D**”)
		160,000	7 February 2009	
		160,000	7 February 2010	
		160,000	7 February 2011	
		160,000	7 February 2012	
		800,000		

10.4. It can therefore be seen that as at July 2008, tranche A under the 2003 Grant Letter, and tranches B and C under the 2004 Grant Letter had not yet vested. (Tranche D under the 2007 Grant Letter *had* vested, although the option had not been exercised as at July 2008. Tranche D is not material to this appeal as it is *not* within the subject Share Option Gain).

- Acceleration of Vesting Period

11.1. The terms of the Grant Letters provided however that in the event that the Taxpayer’s employment is terminated and salary is paid in lieu of notice by the Employer, the Board may “at its absolute discretion” accelerate the vesting period by allowing the Taxpayer to exercise all or such part of any unvested option that would have vested *during the notice period.*

11.2. Accordingly, for a 6-month notice period commencing in July 2008 (expiring in January 2009), the Board would have had a discretion under the terms of the Grant Letters to accelerate vesting of *only 2 tranches*, i.e. tranche A under the 2003 Grant Letter and tranche B under the 2004 Grant Letter, both of which would have vested in November 2008.

- Period for exercise of vested option

12. The terms of the Grant Letters provided that the period for the exercise of vested options was within 6 years from the respective dates of the Grant Letters. However the rules of the 2001 scheme provided that upon cessation of employment, an

employee grantee may only exercise a vested option within 3 months following cessation[12].

- *Circumstances of Termination of Employment*

13. The BoR found that the Taxpayer and his solicitor (both of whom gave evidence before it) were truthful witnesses. In summary, the evidence was to the effect that the chairman of the board (to whose position the Taxpayer had expected to succeed) informed him that the Employer was preparing to terminate his employment immediately and remove him from the offices he was holding. The Taxpayer was taken aback. In his solicitor's words, he was in a "combative mood"[13] and refused to "go quietly". First, he proposed to challenge the chairman's plans to remove him from his directorships by taking the matter to the shareholders, with a view to delaying his departure from the board, contrary to the wishes of the chairman and a majority of the board. Secondly, he was also prepared to take his claims to court, which would attract interest from the media, with consequential market reaction. The parties were in an acrimonious relationship, but after a weekend of negotiations involving lawyers on both sides, they eventually agreed the terms of the Separation Agreement.

14.1. The material facts accepted by the BoR were as follows.

14.2. On Friday afternoon, 18 July 2008, the chairman who was also the Group CEO informed the Taxpayer that the Employer was going to terminate his employment immediately and remove him from his directorship positions. No written notice was served or payment in lieu of notice was made then.

14.3. The chairman told the Taxpayer that he wished him to leave with immediate effect, that it would be better for both parties if they could come to terms to avoid adverse publicity, but that even if no agreement could be reached, the Employer would remove him anyway.

14.4. The chairman showed the Taxpayer a notice of a board meeting called for Sunday evening, 20 July 2008 for a resolution to the above effect to be passed. The notice referred to a Separation Agreement but the Taxpayer was not provided with a draft.

14.5. The chairman told him he would be given payment in lieu of notice and for accrued and unused annual leave. When the Taxpayer mentioned the unvested share options, the chairman said they could consider them if the parties could come to an agreed settlement. The matter of discretionary bonus was not mentioned.

15.1. The Taxpayer was aggrieved by the Employer's action which he attributed to the chairman's refusal to implement a "handshake deal" in respect of his

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[12] §§5.2(b), Agreed Facts.

[13] Fiona Mary Loughrey Witness Statement §13.

succession to the chairman's position, as well as disagreements over corporate governance and business strategy[14].

15.2. The Taxpayer did not take the Employer's decision "sitting down". He was of the view that even though the Employer could terminate his employment as Group CFO, that was not the case with his position as executive director. He sought legal advice immediately[15].

15.3. The Taxpayer considered that even though the chairman appeared to have the majority of the board, he was confident that he (the Taxpayer) had the support of the shareholders due to favourable financial results during his tenure as Group CFO. He took the view that the shareholders were "likely to regard my sudden dismissal unfavourably, particularly if I were to challenge the Board before a meeting of the shareholders (who, absent my consent, held the right to decide the matter)"[16].

15.4. This reference to his consent was in respect of his directorships. The Taxpayer's position was that he was not going to co-operate with the Employer by *resigning* his directorships.

15.5. What the Taxpayer had in mind was bye-law 86(4) of the Employer under which a director may be *removed* by resolution at a general meeting of shareholders, but 14 days notice would have to be given to convene the meeting, at which the director would be entitled to be heard. In the Taxpayer's view, the requirement of notice for the general meeting and the opportunity for him to address shareholders "would not avail [the Employer] of an easy solution to secure my speedy removal on 20 July 2008"[17].

15.6. In other words, the Taxpayer sought to delay his departure from the board, and to create negative shareholder reaction to the chairman's action. He informed the chairman of his position. It is apparent that at that time, the Taxpayer did not consider that under cl.14.6 of the Service Agreement, he was obliged at the request of the Employer to resign from his offices upon termination of employment, and the Employer was authorized to execute on his behalf documents to effect his resignation. But it is notable that the BoR did not doubt his *bona fides* when he challenged the Employer's plans and countered them with his proposed two-pronged course of action, which was supported by the legal advice he received at the time.

15.7. Apart from the directorship issue, the Taxpayer also challenged the validity of the restraint of trade clauses in the Service Agreement.

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[14] Taxpayer's Witness Statement §7.

[15] Ms Loughrey's Witness Statement §3.

[16] Taxpayer's Witness Statement §11.

[17] Taxpayer's Witness Statement §18(c) but see §20.4 below on bye-law 90.

16. There were contentious negotiations over the weekend between the parties and their legal advisers. Eventually on Sunday 20 July 2008, the Separation Agreement was signed.

- Separation Agreement

17.1. The material provisions included the following.

17.2. The Taxpayer's employment terminated on the date of the Separation Agreement, ie 20 July 2008.

17.3. Under "Severance Compensation",

4.1 The Employer on behalf of itself and officers, employees and agents, without admission of liability, agreed to pay the Taxpayer the sums specified below as "compensation in respect of possible claims of the type" referred to as "Settlement and Waiver" in clause 6 of the Separation Agreement:-

4.1.1. payment in lieu of 6 months notice;

4.1.2 statutory long service pay;

4.1.3 payment in lieu of leave;

4.1.4 payment in lieu of discretionary bonus for the financial year ending 30 June 2008 - 500,000 euros [Sum D]; and

4.1.5 a payment of 1.5 m euros in consideration of covenants given by the Taxpayer not to challenge the restraint of trade clauses.

17.4. Under Stock Options,

5.1 The Employer and the Taxpayer agreed that, notwithstanding the cessation of employment and without any admission of liability, the Taxpayer would be entitled to exercise the stock options set out in Annexure 2 (viz. tranche A under the 2003 Grant Letter and tranches B and C under the 2004 Grant Letter) within 3 months from the Vesting Dates which were accelerated to Separation Date[18]. (As noted earlier[19], the original vesting dates of tranches A and B were within the notice period of 6 months,

[18] Defined in cl.1.1 of the Separation Agreement to mean 20 July 2008, being the date upon which the Taxpayer's employment with the Employer terminates.

[19] See §10.4 above.

but that of tranche C fell on 27 November 2009, outside the notice period).

5.2 The deadline for the exercise of tranche D under the 2007 Grant Letter (which had vested) was advanced to 19 October 2008.

5.3 For the avoidance of doubt, all other unvested options lapsed on Separation Date.

17.5. Under Settlement and Waiver,

6.1 The Taxpayer accepted the sums and benefits given to him under clauses 4 and 5 in full and final settlement of all claims and rights of action (whether under statute, common law or otherwise) in Hong Kong, Bermuda and any other jurisdiction in the world (including but not limited to breach of contract or tort, and any Statutory Employment Protection Claim[20] which could be brought) which the Taxpayer had or may have against the Employer or any other Protected Person[21] arising from or connected with his employment or holding of office or the termination thereof.

17.6. Under Directorship,

7.1 The Taxpayer agreed to resign with effect from the date of the agreement from all directorships which he held with the Employer, and he would sign all resignations the forms of which were reasonably acceptable to him.

17.7. Under Contract of Employment,

9. The Taxpayer confirmed acceptance that cl.11 of the Service Agreement[22] should remain in full force and effect, and that he would not take steps to challenge its validity.

17.8. Under the Taxpayer's Ongoing Obligations, the Taxpayer agreed:

10.1 not to challenge the validity of the restraint of trade clause;

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[20] Defined to mean any claim under the Employment Ordinance and other specified ordinances: cl.1.1, Separation Agreement.

[21] Defined to mean, amongst others, the Employer's officers: cl.1, Separation Agreement.

[22] The 3-month restraint of trade clause.

10.3 to assist the Employer in litigation;

10.4 not to make any critical comments or statements about the Employer or their officers;

10.5 not to disclose the contents of the Separation Agreement;

10.6 not to make any comments to investors, bankers, substantial shareholders[23] and the media concerning the termination of his employment and his resignation from his directorships.

17.9. Under Form of Announcements and Reference,

13.1 The parties agreed on the forms of an internal announcement, a public announcement and a reference letter. They were to the effect that the Taxpayer had resigned due to his intended pursuit of other interests and that he had no disagreement with the board.

- Events after the Separation Agreement

18. The Taxpayer exercised the options in tranches A to C (as well as tranche D, which as indicated earlier, is not within the subject Share Option Gain).

- Charge to Salaries Tax

19. In the Taxpayer's Salaries Tax assessment in the 2008/2009 year of assessment, various sums were charged to tax. By the time the matter went to the BoR, the remaining issues were whether Sum D and the Share Option Gain were taxable[24].

BoR Decision

20.1. As noted above, the BoR accepted that the Taxpayer was a truthful witness. (It also accepted that his solicitor was a truthful witness, but decided that her evidence was of limited assistance due to the application of legal professional privilege and to her acceptance that she did not have in-depth expertise in the area of company law relating to the Employer's constitution).

20.2. The BoR held correctly that the relevant test to be applied was that set out in *Fuchs v CIR* (2011) 14 HKCFAR 74, a judgment of the Court of Final Appeal. In summary, the CFA held that the key issue was whether the subject payment

[23] Defined in the Listing Rules.

[24] A third issue, viz. the relevant date for computation of the notional gain, was not in issue before the judge or this Court.

- constitutes income "from" the taxpayer's employment[25] - which would make the payment chargeable to salaries tax, or

- was a payment "for something else" (or put another way, "for some other reason")[26] - which would not be chargeable.

In other words, the relevant test is the purpose of the payment.

20.3. In *Fuchs* (which will be discussed in greater detail later in this Judgment), the CFA discussed various scenarios which might occur when payment is made when a contract of employment is terminated, particularly "abrogation examples", i.e. situations where a payment is made by an employer to an employee to compensate him for the abrogation of his rights as employee.

20.4. In the present case, the BoR held in respect of issue (A) that:

(1) neither s.93 Bermuda Companies Act 1981[27], nor bye-law 86 or 90 conferred a right on the Taxpayer to put the issue of his removal as director to the vote of the shareholders;

(2) under cl.14.6 of the Service Agreement, the Taxpayer was contractually obliged to resign from all offices held by him, and he did not have a right to put the issue of his removal to the vote of the shareholders.

Accordingly, as:

(i) the Taxpayer's employment as Group CFO could be lawfully terminated by payment in lieu of 6 months notice, and

(ii) he had no right to remain as a director,

he had not surrendered or foregone any rights under the Service Agreement, and so the payments were not compensation for the abrogation of his rights.

20.5. The BoR held in respect of issue (B) that:

(1) both Sum D and the Share Option Gain were "income from the Taxpayer's employment" for the following reasons:-

- in respect of Sum D,

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[25] §14, *Fuchs*.

[26] §18, *Fuchs*.

[27] §38, BoR Decision.

(i) its purpose was to buy from the Taxpayer the opportunity to be considered for a discretionary bonus, and since the opportunity "stemmed from the Service Agreement", Sum D was "also a sum [which] stemmed from the Service Agreement"[28];

(ii) if the Taxpayer had been paid a discretionary bonus for the financial year 2007/2008, that would have been taxable, and since Sum D was a payment in lieu, its character was the same, and it should be treated the same way[29];

- in respect of the Share Option Gain,

  (i) the options "stemmed from the Share Option Scheme"[30] which right was obtained by the Taxpayer as an employee;

  (ii) even though the options had not yet vested, the Grant Letters stated only that they "*may lapse* (not *shall lapse*)" on cessation of employment[31]. Unless the Employer "makes a decision that the unvested options shall lapse, the Taxpayer would still have that right after the termination of the employment"[32];

(2) even though the purpose of the Separation Agreement was to achieve a "clean break", for which the Employer gave the Taxpayer Sum D and accelerated the vesting dates of the options,

"... it cannot be said that since the purpose of the separation agreement is to achieve a clean break, the consideration paid by the employer to the employee under the separation agreement ... would not be taxable. ... [T]he crux is the substance of the payment made to the employee. If the payment in substance is

[28] §54, BoR Decision.

[29] §55, BoR Decision.

[30] §62, BoR Decision.

[31] §70, BoR Decision.

[32] §71(c), BoR Decision.

income from the employment, the payment would still be taxable"[33].

21. The Taxpayer appealed by way of case stated.

The judge's Judgment

22.1. Essentially for the same reasons as those set out by the BoR, the judge affirmed its decision.

22.2. In respect of Sum D, he held that:

- although the Taxpayer's employment was terminated before the completion of the 3-stage exercise for the financial year 2007/2008, "he had performed his duties as an employee of the Company for the year ended 30 June 2008. The entitlement to the discretionary bonus can be traced to clause 4.3 of the Service Agreement"[34];

- a payment in lieu of bonus should be treated in the same way as the bonus normally paid, applying a passage in *London and Thames Haven Oil Wharves Ltd v Attwoll*[35] (which was not a case concerning payment on termination of employment) to the effect that where compensation is received for a trader's failure to receive a sum of money which would be credited to profits, that compensation should be treated for income tax purposes in the same way;

- as the Taxpayer had no right to sue for wrongful dismissal, and resignation from directorships was provided for in the Service Agreement, no right could have been abrogated in respect of issue (A)[36];

- in respect of issue (B),

  "As regards the submission that Sum D was derived from the Separation Agreement, it may technically be right because the Service Agreement provided no right to such payment. However ... that is not the test prescribed by *Fuchs*. Bonuses and gratuities paid to employees are, more often than not, discretionary payments (and therefore not

33 §77, BoR Decision.

34 §24, Judgment.

35 [1967] 1 Ch 772, 815.

36 §31, Judgment.

entitled as of right), but they are clearly taxable under s.9(1)(a) of the Ordinance"[37].

22.3. In respect of the Share Option Gain, he held that:

- for tranches A and B, the court was not required to resolve legal technicalities as to whether the Taxpayer was entitled to the shares in July 2008, for the true nature of the notional gain was from the Taxpayer's employment[38];

- for tranche C, this was part of the share options granted to him in November 2004 as an incentive to continue service. "The fact that the Taxpayer was able to obtain the benefit of it prior to the original vesting date simply shows that he had managed, *probably after negotiations, to augment his lawful entitlements* upon termination of his employment"[39] (Emphasis added).

Appeal

23. The Taxpayer appealed.

Discussion

24. There is no dispute that the law is that set out by the CFA in *Fuchs*. The issue is really whether, in light of the relevant circumstances of termination (including the Employer's responses to the IRD and the finding by the BoR that the Taxpayer was a truthful witness), the BoR had erred in law in concluding that the payments were chargeable to salaries tax.

25. The following points are worth repeating.

(1) The vital question for the court is what is the *substance of the bargain* [40] made between the Employer and the Taxpayer for the payments in question. (I have used the word "payments" as shorthand for Sum D and the Share Option Gain). If the Taxpayer is entitled to the payments as "income *from* [his] office or employment", salaries tax would be payable.

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[37] §33, Judgment.

[38] §40, Judgment.

[39] §41, Judgment.

[40] *Henley v Murray (Inspector of Taxes)* (1950) 31 TC 351, 360.

(2) Thus if the bargain is that he receives the payments in return for his acting as or being an employee[41], or as a reward for his services past, present or future[42], such payments would be chargeable to salaries tax.

(3) However not every payment which an employee receives from his employer is "from [his] employment"[43]. If the payments are not "from" his office of employment but for *some other reason* (eg to relieve the employee's distress, or to help with his home purchase[44], or to relieve his personal embarrassment when he had to sell his house at a loss when required by his employer to work at another location[45]), such payments would not attract salaries tax.

(4) In the context of payments when a contract of employment is terminated, the same consideration applies: viz. what was the substance of the bargain between the Employer and the Taxpayer for the payments in question? Or as put in *Fuchs,* what was the purpose of the payments? Was it a reward for services past present or future (in which case it was "from his employment or office"), or was it for some other reason (in which case it was not)?

26.1. In *Fuchs*, the taxpayer had a 3-year contract, under which it was expressly stipulated that if the contract was terminated by the employer during the term otherwise than by reason of the employee's serious breach of contract or misconduct or mental disorder, the employer "shall pay to [the employee] as agreed compensation or liquidated damages" certain sums (the precise modes of payment are not material to this discussion).

26.2. As a result of a takeover, the employer terminated the employee's contract at the end of the second year, and he was paid the sums referred to in the preceding paragraph, which was referred to in the termination agreement as "a one-time compensation for the loss of his position due to the termination of the employment relationship for operational reasons".

26.3. The CFA held that the fact that "as a matter of language, it may also be possible to describe the purpose of that payment in some other terms, eg as 'compensation for loss of office'[46] does not displace liability to tax". The payment was a sum stipulated

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41 *Hochstrasser (Inspector of Taxes) v Mayes* [1960] AC 376, quoted in *Fuchs,* §16(a).

42 *Hochstrasser*, quoted in *Fuchs*, §16(b).

43 §16, *Fuchs*.

44 *Shilton v Wilmshurst (Inspector of Taxes)* [1991] 1 AC 684, quoted in *Fuchs* §16(c).

45 *Hochstrasser*, quoted in *Fuchs*, §19.

46 As in *Fuchs*.

in the contract to be payable to the employee in those circumstances and thus it was "from his employment".

26.4. In *Fuchs*, the payment was clearly "from" employment, for his entitlement to the payment was from the contract of employment itself. The employer paid the sum in order to perform its obligations which had been set out in the contract to cater for those circumstances[47].

26.5. Pausing here, I note that even in the case of a gratuity, the payment would still be chargeable if it is a reward from the employer (eg for past services) - even though the employer was not obliged to pay it, and thus the employee has no legal entitlement to it. However there is no argument in the present case that the Employer had given the Taxpayer the payments as a gratuity.

26.6. On the other side of the line are cases where the payment is clearly not "from" employment, eg damages obtained in proceedings against the employer for wrongful dismissal[48], or payment in a settlement in such proceedings. The contract of employment did not provide for these types of payment. The employer only made the payment by reason of the litigation commenced against it, the payment having derived from a cause of action after the contract had been terminated[49].

26.7. The Court of Final Appeal then considered some "abrogation" examples, where cases fell on one side of the "chargeability line"[50] or the other[51], depending on whether the employee was entitled under the contract to the payment. Thus in *Hunter v Dewhurst* [52], three directors left their positions in a company. Two received payments under an express article in the articles of association. These were chargeable. The chairman would have been entitled to a particular sum if he resigned in stated circumstances. After negotiations, it was agreed that he would not resign but would receive a smaller salary and attend work occasionally as a director. The payment he received for this agreement was held by the House of Lords not to be chargeable. In

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47 §20, *Fuchs*.

48 *Cf London and Thames Haven Oil Wharves Ltd supra.* which was relied on by the Commissioner and accepted by the judge: §25, Judgment.

49 §19, *Fuchs*.

50 As in *Dale v de Soissons* [1950] 2 All ER 460, where the employee was paid a sum stipulated in the contract on the employer's exercise of an option to terminate his contract.

51 As in *Henley v Murray, supra*, where the employee was asked to leave the company before his term expired but was paid the equivalent of what he would have received at the expiry. Nevertheless as the payment was not provided for under the contract, it was not chargeable to salaries tax.

52 (1932) 16 TC 605, quoted in §21, *Fuchs*.

substance it was paid by the employer "to obtain a release from its contingent liability" (i.e. for the particular sum payable if he had resigned) under the contract[53].

26.8. At §22 of *Fuchs*, Ribeiro PJ said this:

> "22. In situations like those considered above, since the employment is brought to an end, it will often be plausible for an employee to assert that his employment rights have been 'abrogated' and for him to attribute the payment received to such 'abrogation', arguing for an exemption from tax. It may sometimes not be easy to decide whether such a submission should be accepted. However, the operative test must always be the test identified above, reflecting the statutory language: In the light of the terms on which the taxpayer was employed and the circumstances of the termination, is the sum in substance 'income from employment'? Was it paid in return for his acting as or being an employee? Was it an entitlement earned as a result of past services or an entitlement accorded to him as an inducement to enter into the employment? If the answer is 'Yes', the sum is taxable and it matters not that it might linguistically be acceptable also to refer to it as 'compensation for loss of office' or something similar. On the other hand, the amount is not taxable if on a proper analysis the answer is 'No'. As the 'abrogation' examples referred to above show, such a conclusion may be reached where the payment is not made pursuant to any entitlement under the employment contract but is made in consideration of the employee agreeing to surrender or forgo his pre-existing contractual rights. In the present appeal, the principal dispute between the taxpayer and the Revenue involves rival contentions along the aforesaid lines."

27.1. It is clear from the above passage that the test, whether in a termination situation or not, is the purpose of the payment. Absent any argument that the payment was a gift, the question is: was it paid because the employee was being rewarded for services under the contract of employment? The "abrogation" examples illustrate the application of that test. Thus if a payment is made to an employee only in consideration of his agreeing to surrender or forgo his pre-existing contractual rights, that payment is not made pursuant to the employee's entitlement under the contract of employment.

27.2. However it is important to note that "abrogation examples" are just that - they are only examples, and "abrogation of contractual rights" is not itself the test of chargeability in every termination situation. The test is not whether the employer had acted in breach in terminating the contract. In every case, the test remains that of the purpose of the payment at the relevant time. If the employee was entitled to the payment

53 §21(a), *Fuchs.*

under the contract of employment, then the purpose of the payment was in order for the employer to perform its obligations under the contract, and it follows that the payment was income "from" the employment. But if the employee was not so entitled, then one must consider the purpose for which the employer made that payment.

28. In the present case, with respect to the BoR and the judge, I have come to the conclusion that, on the facts found by the BoR, Sum D and the Share Option Gain were not payments to which the Taxpayer was entitled at the relevant time under his contract of employment, and the purpose of the payments from the Employer was, not to perform its obligations under the contract or to reward the Taxpayer for past services, but to stave off the Taxpayer's threatened two-pronged course of action (to approach the shareholders and to take the matter to court) and get him to "go quietly" by entering into the Separation Agreement with him.

29.1. The BoR had accepted that "one may say that the benefits offered by the Company to the Taxpayer including Sum D and accelerating the vesting dates of the Relevant Options are consideration to make the Taxpayer go away quietly"[54]. However it concluded that the payments were nevertheless chargeable.

29.2. With respect I do not agree with the BoR (and the judge) in that conclusion.

30. First, in respect of Sum D, the judge accepted that the Taxpayer had no accrued right to a bonus[55]. However, with respect, he was in error in relying on the fact that "he had performed his duties as an employee of the Company for the year ended 30 June 2008". At the relevant time, the 3 stages for the exercise of discretion for the award of the discretionary bonus had not been undertaken. There was no evidence that the Group's results for that financial year had been considered for the purpose of deciding whether a bonus should be awarded to *any* of its staff. Nor was there evidence that the Taxpayer's performance during that financial year had been considered for the purpose of deciding whether a bonus should be awarded to *him*. There was no evidence that the quantum of Sum D was decided even on a "guesstimate" of what he might have received if a bonus were to be awarded to him.

31. On the contrary, the unchallenged evidence from the Employer was that the Taxpayer was *not* awarded any bonus for the financial year ended 30 June 2008[56]. An "*entirely arbitrary amount* mutually agreed by [the Taxpayer] and [the chairman]" was paid "to *eliminate any claim* for unpaid bonus". Applying the *Fuchs* test of purpose, the purpose of the payment has been clearly expressed there. It was to avoid *any* litigation from the Taxpayer (even if the Employer would have been successful at the end).

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[54] §76, BoR Decision.

[55] §33, Judgment.

[56] §8, Employer's letter to IRD dated 18 March 2011, and §3(c) Employer's letter to IRD dated 10 July 2012.

32.1. It is notable that in the course of arguments, the question was posed by the court to counsel for the Commissioner what would have been the situation if after the events on Friday, the Taxpayer had issued a writ on the Saturday, and the Separation Agreement was made on the Sunday. His answer was that the Commissioner would not have been able to argue that the payments were assessable.

32.2. Indeed the present case is similar to the payment in *Hunter v Dewhurst* where the sum in question was paid for the Employer "to obtain a release from its contingent liability". That sum was held by the House of Lords to be not chargeable to salaries tax.

33. With respect to the BoR and the judge, I do not agree that it is appropriate to refer to the purpose of the payment as the purchase by the Employer from the Taxpayer of the opportunity to be considered for a bonus. Even though the Taxpayer's solicitor had pitched his case to the Employer on the basis that he should be compensated for the loss of the opportunity, there was nothing akin to an assignment of a chose in action, and the Employer's clear response to the IRD was that the purpose of paying Sum D was only to avoid all litigation.

34.1. Nor, with respect, was it helpful to consider whether, had the contract not been terminated, the Taxpayer would have had to pay tax in the ordinary course on receiving a discretionary bonus. Of course payment made *in those circumstances* would be chargeable. But that was not the test set out in *Fuchs.* One must consider the actual facts surrounding the subject payment at the relevant time, and determine what was its purpose or nature.

34.2. Thus in *Henley v Murray* (which was quoted by the CFA in *Fuchs*), the managing director was paid the exact equivalent of the amount he would have received if his contract had not been terminated prematurely. But as that payment had *not* been provided for in his contract in the event of premature termination, it was held that the sum was not chargeable.

34.3. That demonstrates that it is not relevant whether the payment would have been chargeable *if* the contract had *not* been terminated. What is relevant is the purpose or nature of the subject payment at the relevant time. Here, in light of the facts found by the BoR, it is clear to me that Sum D was not income "from" the Taxpayer's employment, but a payment he obtained from the challenges he posed to the Employer which led to negotiations culminating in the Separation Agreement. It was the antithesis to a reward for his services under the contract of employment.

35.1. As for the Share Option Gain, with respect to counsel for the Commissioner, it is irrelevant that the options were granted when the Taxpayer was employed. It is not the grant but the vesting that is of benefit to the employee. It is clear that at the time of termination, the Taxpayer did not have any accrued rights to the

share options of tranches A - C as they simply had not vested[57]. If the Employer had not accelerated the vesting date as part of the Separation Agreement, they would have lapsed. (The BoR's reliance on the words "may lapse" is, with respect, misplaced for these words cater for the possibility of acceleration). It was only as a result of the Employer's decision to accelerate the vesting dates to the Separation Date that the Taxpayer was able to take the benefit of those tranches.

35.2. Was the acceleration a benefit "from" the employment or office? It is correct that for tranches A and B, the Grant Letters did provide that the board may in its absolute discretion accelerate the vesting dates during the notice period. However it is notable that the board accelerated the vesting date for tranche C as well, which was *not* within the notice period and which was therefore not provided for under the Grant Letters. In this connection, the following questions from the IRD and answers provided by the Employer are material:

Questions from IRD dated 21 January 2011:

"(18) It is noted that the vesting dates of the 1,080,000 share options set out in Annexure 2 of the Separation Agreement were accelerated from 26 November 2008, 27 November 2008 or 27 November 2009. The first two dates were within 6 months from 20 July 2008 whilst the latter date was beyond 6 months from 20 July 2008 (6 months being the notice period prescribed in the Service Agreement). In this connection, advise with documentary support (if any):

(a) Why the vesting dates of the share options were allowed to be accelerated.

(b) The basis on which the 1,080,000 share options were determined.

(c) The reasons and justifications for allowing Mr Poon to exercise the share options within the accelerated vesting period".

Answers from the Employer dated 18 March 2011:

"(18)(a) The Company agreed to allow Mr Poon to exercise the share options immediately on the signing of the Separation Agreement as part of the terms of the cessation of Mr Poon's employment.

[57] Similar to the situation in *Commissioner of Inland Revenue v Elliott* [2007] 1 HKLRD 297, §§24-25, where the Taxpayer had no right to "cash-out" certain incentive units until a later date.

(b) *The number of share options with accelerated vesting was an entirely arbitrary number. No specific basis was adopted in determining such number.*

(c) The Company allowed an acceleration of vesting of the share options so with a view to *settling all outstanding matters* upon the cessation of Mr Poon's employment". (Emphasis added).

35.3. Although the language used by the Employer was not similar to that used for Sum D[58], the purpose of the acceleration was expressed as "to settle all outstanding matters upon the cessation of Mr Poon's employment". Whilst it may be said that this might have meant a settling of mutual rights and obligations *under* the contract, it is significant that in Answer §18(b), *no differentiation* was made between tranches A and B (which would have vested within the notice period and were therefore covered by the Grant Letters) and tranche C. For tranche C, accelerated vesting was out of the question.

35.4. In my view, this absence of differentiation is significant as it points to the purpose of the conferment of the benefit as a whole - as the BoR found, "the benefits offered by the Company to the Taxpayer including Sum D *and accelerating the vesting dates of the Relevant Options* are consideration to make the Taxpayer go away quietly". (Emphasis added). This finding of fact did not make any distinction between tranches A and B of the one part, and tranche C of the other.

35.5. The evidence in support of this finding includes not only the Employer's Answer §18(b), but also the evidence that on 18 July 2008 when the Taxpayer mentioned the unvested share options, the chairman said they could consider them if the parties could come to an agreed settlement. (In any event, even if I am wrong in relation to tranches A and B, given the judge's conclusion that the Taxpayer had managed to "augment his legal entitlements" by getting the Employer to accelerate the vesting of tranche C, this tranche would not be chargeable).

36. Therefore, with respect to the BoR and the judge, I take the view that the acceleration of vesting leading to the Share Option Gain was also not a benefit given for the purpose of rewarding the Taxpayer for services past present or future, but for another reason, viz. it was consideration for him to drop his proposed two-pronged course of action, and to agree to present a united front with the Employer (both internally and to the public) on the reason for his departure (as set out in the annexes to the Separation Agreement), amongst other additional covenants set out in that Agreement[59].

37. Applying the test in *Fuchs*, for the reasons set out above, I take the view that neither Sum D nor the Share Option Gain is chargeable to salaries tax, the answer to the case stated is yes, and the appeal should be allowed with costs.

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[58] "To eliminate any claims"

[59] Listed at p.13 of the Skeleton of the Appellant Taxpayer.

Hon Kwan JA:

38. I agree with the judgment of Yuen JA.

(Andrew Macrae) Vice President	(Maria Yuen) Justice of Appeal	(Susan Kwan) Justice of Appeal

Mr Adrian Huggins SC, instructed by King & Wood Mallesons, for the Appellant

Mr Stewart Wong SC, instructed by the Department of Justice, for the Respondent