Case No. D33/13

Salaries tax – settlement payment – whether capital in nature – whether legal fee deductible – sections 8, 9 and 12 of the Inland Revenue Ordinance ('IRO').

Panel: Kenneth Kwok Hing Wai SC (chairman), Diana Cheung and Mark Richard Charlton Sutherland.

Date of hearing: 4 November 2013.
Date of decision: 24 January 2014.

Pursuant to a Settlement Agreement with his employer and related companies, the Appellant received from his employer: (i) a lump sum payment of USD7.25 million; (ii) USD25,002 as reimbursement for certain repatriation moving and other expenses; and (iii) USD10,012 as reimbursement for COBRA Payments made by the Appellant. The Settlement Agreement was reached after an arbitration award was made in the Appellant's favour in respect of his claims against his employer and related companies in relation to the termination of his employment.

The Appellant claimed that these payments were capital in nature on the ground that they were paid to the Appellant for the purpose of relinquishing and settling all claims and counterclaims asserted.

The Appellant also argued that in the event that the payments were held to be taxable, the legal fee incurred by the Appellant in relation to the Arbitration proceeding should be tax deductible under section 12(1) of the IRO.

Held:

1. Each of the components of the sum of USD7,250,000 was offered and paid to the Appellant in return for his having acted as an employee. The Appellant's divers entitlements arose from various terms of his employment. The components were all derived 'from his employment'. The Appellant relinquished nothing and surrendered no rights. The payments arose from the employment and not from 'something else'. (Fuchs v Commissioner of Inland Revenue [2011] 14 HKCFAR 74 applied)

2. The sum of USD25,002 and the sum of USD10,012 also arose from employment in the sense that it was paid in return for the Appellant acting as

an employee. The Board does not see how these were for 'something else' on any reading.

3. The legal fee was not within the bare physical or temperal limits within which the Appellant performed his work or labour. More specifically, the legal fee was not incurred in the performance of the Appellant's employment duties and therefore are not deductible. The legal fee does not satisfy the stringent section 12(1) requirements under the IRO. (Commissioner of Inland Revenue v Robert P Burns 1 HKTC 1181 applied)

Appeal dismissed.

Cases referred to:

Fuchs v Commissioner of Inland Revenue [2011] 14 HKCFAR 74
Du Cros v Ryall 19 TC 444
Commissioner of Inland Revenue v Robert P Burns 1 HKTC 1181
Humbles v Brooks 40 TC 500
D91/03, IRBRD, vol 18, 870
Romanin v The Commissioner of Taxation [2008] 73 ATR 760

Wilson Hui instructed by Baker Tilly Hong Kong Limited for the Appellant.
Paul H M Leung instructed by Ms Ho Ng Wing Yee Winnie, Senior Government Counsel for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This is an appeal against the Determination of the Deputy Commissioner of Inland Revenue dated 1 February 2013 by which he:

(1) confirmed the additional salaries tax assessment for the year of assessment 1998/99 showing additional assessable income of $97,748 with additional tax payable thereon of $14,662;

(2) confirmed the additional salaries tax assessment for the year of assessment 1999/2000 showing additional assessable income of $3,088,672 with additional tax payable thereon of $463,301; and

(3) reduced the salaries tax assessment for the year of assessment 2000/2001 showing assessable income of $69,539,311 with tax payable thereon of

$10,430,896 to assessable income of $33,333,676 with tax payable of $5,000,051.

Grounds of appeal

2. The grounds of appeal given on the Appellant's behalf are that:

- 'the Determination is excessive and is not in accordance with our claim that the settlement payment pursuant to the Settlement Agreement in the amounts of

  (i) a lump sum payment of USD7.25 million

  (ii) USD25,002 as reimbursement for certain repatriation moving and other expenses and

  (iii) USD10,012 as reimbursement for COBRA Payments made by [the Appellant]

  ('Settlement Payment') are capital in nature and non taxable as they were paid to [the Appellant] for the purpose of relinquishing and settling all claims and counterclaims asserted. The payment was clearly not income from [the Appellant's] employment, hence it should not be subject to Hong Kong Salaries Tax' ('the first ground of appeal').

- 'in the event that the Settlement Payment is held to be taxable, the legal fee incurred by the [Appellant] in relation to the Arbitration proceeding (HK$7,316,961) should be tax deductible under section 12(1) of the Inland Revenue Ordinance' ('the second ground of appeal').

The agreed facts

3. The parties agreed the facts stated in the 'Statement of Agreed Facts' and we find them as facts.

4. A copy of the 'Statement of Agreed Facts' is annexed and marked 'Annexure A' which we incorporate by reference.

Charge of salaries tax

5. Section 8(1) of the Inland Revenue Ordinance ('the Ordinance') 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 …'

6. Section 8(1A) of the Ordinance provides that:

' For the purposes of this Part, income arising in or derived from Hong Kong from any employment-

(a) includes, without in any way limiting the meaning of the expression and subject to paragraph (b), all income derived from services rendered in Hong Kong including leave pay attributable to such services;

(b) excludes income derived from services rendered by a person who-

(i) …

(ii) renders outside Hong Kong all the services in connection with his employment;…'

7. Section 9 provides that:

'(1) Income from any office or employment includes-

(a) any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others …'

Fuchs v CIR

8. In Fuchs v Commissioner of Inland Revenue[1], the Court of Final Appeal gave clear, succinct and authoritative guidance on the applicable principles to decide whether a payment received by an employee on termination of his employment is taxable.

(1) It turns on the construction of section 8(1): Is such payment 'income ... from ... any office or employment of profit'? Since section 9 defines 'income' widely to include 'any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance', the key issue is whether those amounts constitute income 'from' the taxpayer's 'employment'.[2]

[1] (2011) 14 HKCFAR 74.
[2] §14.

(2) Income chargeable under that section is not confined to income earned in the course of employment but embraces payments made (in Lord Radcliffe's terms) 'in return for acting as or being an employee', or (in Lord Templeman's terms) 'as a reward for past services or as an inducement to enter into employment and provide future services'. If a payment, viewed as a matter of substance and not merely of form[3] and without being 'blinded by some formulae which the parties may have used',[4] is found to be derived from the taxpayer's employment in the abovementioned sense, it is assessable. This approach properly gives effect to the language of section 8(1).[5]

(3) It is worth emphasising that a payment which one concludes is 'for something else' and thus not assessable, must be a payment which does not come within the test. As Lord Templeman pointed out, it is only where 'an emolument is not paid as a reward for past services or as an inducement to enter into employment and provide future services but is paid for some other reason, [that] the emolument is not received "from the employment".'[6] Thus, where a payment falls within the test, it is assessable and the fact that, as a matter of language, it may also be possible to describe the purpose of that payment in some other terms, e.g., as 'compensation for loss of office', does not displace liability to tax. The applicable test gives effect to the statutory language and other possible characterisations of the payment are beside the point if, applying the test, the payment is 'from employment'.[7]

(4) 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 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. [8]

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3 Hochstrasser v Mayes [1960] AC 376 at 390.
4 Henley v Murray (1950) 31 TC 351 at 365.
5 §17.
6 Shilton v Wilmshurst [1991] 1 AC 684 at 689 (emphasis supplied). See also Henry v Foster (1931) 16 TC 605 at 634, per Romer LJ.
7 §18
8 §22.

(5) See also paragraphs 14 to 22 of the CFA judgment.

(6) The case of Du Cros v Ryall 19 TC 444 relied upon by the Appellant does not assist us as it was premised upon a different factual matrix and, in any event, we are not bound by it. We are, of course, bound by Fuchs.

Decision on the first ground of appeal

9. The settlement payment referred to in the first ground of appeal comprised the following sums:

(i) a lump sum payment of USD7.25 million;

(ii) USD25,002 as reimbursement for certain repatriation moving and other expenses; and

(iii) USD10,012 as reimbursement for COBRA Payments made by the Appellant.

10. ***USD7.25 million:***

A total of US$7,950,940.50 was awarded under the Arbitration Award[9]:

Item	Source	Amount [US$]	Interest [US$]	Total [US$]	
Severance	[EmployerCo]	$1,087,500.00[10]	$138,656.25	$1,226,156.25	
Severance	[Company F1]	$1,200,000.00[11]	$153,000.00	$1,353,000.00	*
COBRA	[EmployerCo/ Company F1]	$9,060.69[12]	$951.37	$10,012.06	**
Repatriation	[EmployerCo/ Company F1]	$22,625.77[13]	$2,375.71	$25,001.48	**
Evict'n defense	[Company F1]	$9,234.62[14]	$969.64	$10,204.26	
1998 Award	[EmployerCo]	$125,670.00[15]	$16,022.93	$141,692.93	
1999 Award	[EmployerCo]	$1,080,912.00[16]	$152,003.25	$1,232,915.25	
Buy-Out	[Company F1]	$600,000.00[17]	$76,500.00	$676,500.00	

[9] §6 K (1) of the Statement of Agreed Facts.
[10] As severance compensation under section 7(a) of the Employment Agreement, with pre-award interest.
[11] Under Section 3(a) of [the Severance Agreement], with Pre-Award Interest.
[12] Under Section 3(a)(ii) of the Severance Agreement and the Employment Agreement under 5(e)(f)(g)(h) and 7(a)(ii) with Pre-Award interest.
[13] Under Section 3(a)(iv) of the Severance Agreement and the Employment Agreement under 5(e)(f)(g)(h) and 7(a)(ii) with Pre-Award interest.
[14] Pursuant to Section 3(a)(iii)(A) of the Severance Agreement.
[15] Under the 1998 Award Agreement, with Pre-Award interest.
[16] Under the 1999 Award Agreement, with Pre-Award interest.

Item	Source	Amount [US$]	Interest [US$]	Total [US$]
EPI	[EmployerCo]	$4,098,253.00[18]	$245,895.18	$4,344,148.18
Salary	[EmployerCo]	$138,456.00[19]	$19,010.34	$157,466.34

TOTAL PAYMENTS (incl. [US$1,226,156.25] severance credit maximum) [US$7,950,940.50]

11. In a document entitled 'Non-Taxability Claim on Share Option Gains' dated 16 January 2004 submitted by the Representative to the Revenue, the Representative informed the Revenue that:

> '*The difference between USD7,950,940 and USD7,250,000 is USD700,940 (HKD5,447,487), is due to the [Employer] Group's undertaking to bear the Hong Kong salaries tax payments of [the Appellant] under various assessments as listed in Exhibit A to the confidential settlement agreement (total Hong Kong salaries tax liabilities of [the Appellant] under those assessments is … HKD5,447,487).*'

12. Each of the components of the sum of USD7,250,000 was offered and paid to the Appellant in return for his having acted as an employee. The Appellant's divers entitlements arose from various terms of his employment. The components were all derived 'from his employment'. The Appellant relinquished nothing and surrendered no rights. The payments arose from the employment and not from 'something else'.

13. We asked Mr Wilson Hui to identify the provisions in the Confidential Settlement Agreement relied upon in support of the first ground of appeal. He relied on the following 2 provisions:

- The last Recital: '*WHEREAS, the Parties now wish to compromise and settle all claims and counterclaims asserted, which could have been asserted, or relate to the Arbitration, the Counterclaims, the Award, the Hong Kong Action and the Tax Assessments. '*

- Clause 10: '*This Settlement Agreement embodies the entire agreement and understanding between the Parties with respect to the subject matter hereof, and may be changed, waived, discharged or terminated only by an instrument in writing signed by all the Parties.*'

14. These 2 provisions cannot and do not change the fact that USD7.25 million was 'from employment'.

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[17] Under the Buy-Out Agreement.
[18] Pursuant to Section 5(c)(ii)(C)(y) of the Employment Agreement and the Amendment Agreement.
[19] Salary.

15. ***USD25,002:***

This sum was paid as reimbursement for certain repatriation moving and other expenses. We find that such sum also arose from employment in the sense that it was paid in return for the Appellant acting as an employee. We do not see how this was for 'something else' on any reading.

16. ***USD10,012:***

This sum was paid as reimbursement for COBRA Payments made by the Appellant. We find that such sum also arose from employment in the sense that it was paid in return for the Appellant acting as an employee. We do not see how this was for 'something else' on any reading.

17. For these reasons, the Appellant fails on the first ground of appeal.

Deduction of expenses under section 12

18. Section 12(1) provides that:

> '*In ascertaining the net assessable income of a person for any year of assessment, there shall be deducted from the assessable income of that person-*
>
> *(a) all outgoings and expenses, other than expenses of a domestic or private nature and capital expenditure, wholly, exclusively and necessarily incurred in the production of the assessable income ….*'

19. The expenses must be:

(1) other than expenses of a domestic or private nature;

(2) other than capital expenditure;

(3) wholly, exclusively and necessarily incurred;

(4) incurred in the production of the assessable income.

20. Commissioner of Inland Revenue v Robert P Burns[20] was a case where the Respondent was a racehorse trainer employed by the Royal Hong Kong Jockey Club. On 26th February 1977 he was charged before the Stewards with contravening one of the Rules of Racing and was disqualified for six months. He appealed against this decision and was successful in having the disqualification set aside. In prosecuting that appeal, however, he incurred legal expenses amounting to $40,000 and the issue on appeal before the Court of

[20] 1 HKTC 1181.

Appeal was whether he was entitled to deduct from his assessable income. Huggins JA said in his leading judgment that[21]:

> ' *As I understand the approach of McTiernan, J. in Lunney's Case it was that he was prepared to recognise a looser "perceived connection" between the expenditure and the assessable income than were the other judges, for he said at p.490:*
>
> > *"In my opinion it is an unduly narrow construction of the initial part of s. 51(1), in the case of an employment, to confine its operation to expenditure made by the taxpayer within the bare physical or temperal limits within which he performs his work or labour and to disregard any expenditure made outside those limits even though it has a necessary relation to the purpose of earning income for which the taxpayer carries on the employment. It is shown by the stated case that the taxpayer could not in the circumstances under which he was situated earn any assessable income by his employment without incurring the cost of travelling which he claims to be an allowable deduction. I cannot see the difference in principle between an expense incurred in gaining income and one incurred necessarily for the purpose of gaining it."*
>
> *That is an approach which has much to be said for it, but I think the weight of authority is against it. Thus the expense of a baby-sitter was disallowed in Lodge v Federal Commissioner of Taxation (1972) A.T.R. 251, legal expenses to recover remuneration under a service agreement were disallowed in Eagles v Levy (1934) 19 R.T.C. 23 and legal expenses incurred by a solicitor in defending an action brought against him by a former employer on the ground that he had committed a breach of his duty of good faith under the contract of employment and that he had solicited one of the employer's clients were disallowed in Knight v Parry (1972) 48 T.C. 580. In the last of these cases the judge found for the plaintiff on the first ground but for the defendant on the second. Upon these findings the Law Society declined to take any proceedings against the defendant for unprofessional conduct, the Society having previously said that it would not decide whether to institute disciplinary proceedings until the employer had brought a civil action in the courts. The judge gave as his first reason for his decision that the expenses were not deductible that*
>
> > *"even the purpose of protecting himself professionally was not a purpose wholly and exclusively referable to the carrying on of his practice as a solicitor, but for the purpose of seeing that he was not precluded from doing so." (sic)*

[21] At pages 1190 to 1191.

Although some may regard this as an artificial distinction, there is weighty authority for drawing it and I think that authority ought to be followed.'

21. In Humbles v Brooks , Ungoed-Thomas J amplified that [22]:

> *'"In the performance of the said duties" means in the course of their performance ... It means "in doing the work of the office, in doing the things which it is his duty to do while doing the work of the office. It does not include qualifying initially to perform the duties of the office, or even keeping qualified to perform them ... it does not mean adding to the taxpayer's usefulness in performing his duties. The requirement of the employer that the expenditure shall be incurred does not, of itself, bring the expense within the Rule, nor does the absence of such a requirement exclude it from the application of the Rule...".'*

22. See also D91/03, IRBRD, vol 18, 870 on the deductibility of professional indemnity premium incurred by a solicitor.

23. We are bound by Robert P Burns. The legal fee was not within the bare physical or temperal limits within which the Appellant performed his work or labour. More specifically, we find that the legal fee was not incurred in the performance of the Appellant's employment duties and therefore are not deductible. The legal fee does not satisfy the stringent section 12(1) requirements.

24. We are not assisted, nor are we bound, by the Australian case of Romanin v The Commissioner of Taxation [2008] 73 ATR 760 upon which the Appellant relied to support his case.

25. For these reasons, the Appellant fails also on the second ground of appeal.

Disposition

26. We dismiss this appeal and uphold the assessments appealed against as confirmed or reduced by the Acting Deputy Commissioner.

[22] 40 TC 500 at page 502.

Annexure A
D33/13

BOARD OF REVIEW

Appeal by Mr A

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Statement of Agreed Facts

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ANNEXURE A

STATEMENT OF AGREED FACTS

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(1) The Appellant has objected to the additional Salaries Tax Assessments for the years of assessment 1998/99 and 1999/2000 and the Salaries Tax Assessment for the year of assessment 2000/01 raised on him. The Appellant claims that certain sums received by him upon termination of employment should not be chargeable to tax.

(2) EmployerCo is a foreign corporation. Since January 1994, the Appellant was employed as a member of the key management team for the Asian operations of EmployerCo. He was relocated to Hong Kong in early 1998 and entered into an employment agreement dated 1 January 1998 ('the Employment Agreement') with EmployerCo. The Employment Agreement contained the following terms:

> 2. Employment.
>
> (a) [EmployerCo] shall employ [the Appellant] and [the Appellant] shall enter the employ of [EmployerCo], for the period set forth in this Section 2, in the positions set forth in Section 3 and upon the other terms and conditions herein provided. The initial term of employment under this Agreement (the 'Initial Term') shall be for the period beginning on [1 January 1998] and ending on the later of (x) the third anniversary thereof and (y) the date which is the second anniversary of an Initial Public Offering, unless earlier terminated as provided in Section 6.
> …
>
> 3. Position and Duties.
>
> (a) [The Appellant] shall serve in a senior position with [EmployerCo] with such title, responsibilities, duties and authority as may from time to time be assigned to [the Appellant] by the Chief Executive Officer. [The Appellant] shall report directly to the Chief Executive Officer, and, in term of position, shall report functionally to the President of [Company F1]. [The Appellant] shall devote substantially all his working time and efforts to the business and affairs of [EmployerCo]. [The Appellant's] title shall be President of [Company F2]. [The Appellant] also shall hold the title of Executive Vice President of [Company F1].
> …

4. Place of Performance. In connection with his employment during the Term, [the Appellant] shall initially be based in [a named country], except for necessary travel on [EmployerCo's] business. Subject to Section 2(b), [EmployerCo] may assign the [the Appellant] to another location if, in the reasonable good faith determination of the Chief Executive Officer, [the Appellant's] services to [EmployerCo] will be of greatest value if rendered in such location …

5. Compensation and Related Matters.

   (a) Annual Base Salary. …

   (b) Discretionary Bonus. For each Contract Year, or part thereof, during the Term, [the Appellant] shall be eligible to receive a Discretionary Bonus in such amount, if any, as the Chief Executive Officer determines, in his sole discretion, to be appropriate …

   (c) Equity Participation.

      (i) [EmployerCo] acknowledges that [the Appellant] has made substantial contributions to the business of [EmployerCo] and [Company F2]. In view of the foregoing and [EmployerCo's] intention to consummate an Initial Public Offering as soon as commercially practicable in light of market conditions, [EmployerCo] hereby grants to [the Appellant] the Equity Participation Interest ('EPI'). The [EPI] shall be payable in cash in U.S. dollars (or, at the election of [the Appellant], by delivery of freely transferable equity securities of the kind sold in the Initial Public Offering ('IPO Securities')) by [EmployerCo] to [the Appellant] immediately upon (x) the closing of the Initial Public Offering, or (y) at [the Appellant's] election, commencing on the fourth anniversary of the Effective Date, any anniversary of the Effective Date if an Initial Public Offering has not been consummated by such date (the 'Trigger Date'). In the case of a Trigger Date described in clause (y) of the preceding sentence, [the Appellant] shall provide 30 days prior written notice to [EmployerCo] of his intention to elect to receive the [EPI] on any such Trigger Date.

      (ii) For the purposes hereof:

         (A) the [EPI] means an amount equal to the sum of: (x) the product of (1) three and three-quarters percent (3.75%) and (2) the [Company F2] Valuation Amount, plus (y) the product of (1) one and one-quarter percent (1.25%) and (2)

the [Company F1] Valuation Amount.

…

(d) Existing Equity Participation. [EmployerCo] acknowledges that prior to the date hereof [the Appellant] has been granted options to purchase common stock of [Company F2] which are fully vested. Such options shall remain valid and in full force and effect in accordance with their terms.

…

6. Termination. [The Appellant's] employment hereunder may be terminated by [EmployerCo] or [the Appellant], as applicable, without any breach of this Agreement only under the following circumstances:

(a) (i) Death. …

(ii) Disability. …

(iii) Cause. [EmployerCo] may terminate [the Appellant's] employment hereunder for Cause.

(iv) Good Reason. [The Appellant] may terminate his employment for Good Reason.

(v) Without Cause. [EmployerCo] may terminate [the Appellant's] employment hereunder without Cause.

(vi) Resignation without Good Reason. [The Appellant] may resign his employment without Good Reason upon 90 days written notice to [EmployerCo].

…

7. Severance Payments.

(a) Termination other than for Cause or Without Good Reason: If [the Appellant's] employment shall terminate for any reason (other than (x) for Cause pursuant to Section 6(a)(iii) or (y) without Good Reason pursuant to Section 6(a)(vi)), [EmployerCo] shall

(i) pay to [the Appellant], in a lump sum cash payment as soon as practicable following the effective date of the termination …

(ii) continue for the remainder of the Term [the Appellant's] coverage under all [EmployerCo] welfare benefit plans and programs in which [the Appellant] was entitled to participate immediately prior

> to the Date of Termination, to the extent permitted thereunder …
>
> (b) Survival. The expiration or termination of the Term of Employment shall not impair the rights or obligations of any party hereto which shall have accrued hereunder prior to such expiration. In addition, Section 5(c) shall survive any termination of this Agreement for whatever reason, other than a termination for Cause pursuant to Section 6(a)(iii) if 'Cause' is a non-appealable conviction of fraud involving [EmployerCo's] assets.
>
> …
>
> 20. Arbitration. Any dispute or controversy arising under or in connection with this Agreement shall be settled exclusively by arbitration, conducted before a panel of three arbitrators in [name of place omitted here], in accordance with the rules of the [name of arbitration association omitted here] then in effect ...

(3) The Appellant subsequently signed an executive severance agreement dated 20 December 1999 ('the Severance Agreement') with Company F1 on terms governing the termination of his employment. The Severance Agreement contained the following terms:

> WHEREAS, 'Shareholder' is the principal shareholder of [EmployerCo] and [EmployerCo] is the indirect controlling shareholder of [Company F1]; and
>
> WHEREAS, Shareholder and certain other shareholders of [EmployerCo] intend to dispose of all or a substantial portion of their respective interests in [EmployerCo] and / or [EmployerCo] intends to dispose of all or a substantial portion of its interest in [Company F1]; and
>
> WHEREAS, [the Appellant] is a senior officer of [Company F1]; and
>
> WHEREAS, [Company F1] believes it is important that [Company F1] be able to rely upon [the Appellant] to continue in his position until after consummation of the proposed sale …
>
> NOW, THEREFORE, in order to provide an incentive to [the Appellant] for the continued dedication of [the Appellant] and his advice and counsel notwithstanding the possibility of a sale of [Company F1] and to encourage [the Appellant] to remain in the employ of [Company F1], and for other good and valuable consideration, [Company F1] and [the Appellant] hereby agree as follows:
> …
>
> 2. Termination of Employment of [the Appellant] During the Contract Period.

(a) At all times, each of [Company F1] and [the Appellant] shall have the right by written notice to terminate [the Appellant's] employment with [Company F1] for any reason …

(b) In the event that the employment of [the Appellant] with [Company F1] is terminated by [Company F1] during the Contract Period Without Cause or by [the Appellant] during the Contract Period for Good Reason, [the Appellant] shall be entitled to receive the benefits provided in Section 3 hereof. Upon a termination of [the Appellant's] employment by [Company F1] during the Contract Period for Cause or by [the Appellant] during the Contract Period without Good Reason and upon a termination of [the Appellant's] employment for any reason other than during the Contract Period, [the Appellant] shall have the right to receive only the benefit provided for in subsection 3(a)(iv) hereof, the benefit provided in subsection 3(a)(ii) hereof to the extent legally required and the benefit provided in subsection 3(a)(v) hereof to the extent theretofore paid.

3. Benefits Upon Termination in Certain Circumstances

(a) Upon termination of the employment of [the Appellant] under circumstances entitling him to the benefits of this Section 3:

(i) [The Appellant] shall be entitled to a lump sum cash payment equal to his base salary for the remainder of the Contract Period …

(ii) For a period of 18 months after the termination date, [Company F1] shall continue [the Appellant's] coverage under all [Company F1] health and welfare benefit plans and programs in which [the Appellant] was entitled to participate immediately prior to the termination date to the extent permitted thereunder …

(iii) [Company F1] shall continue to pay or reimburse [the Appellant] for the expenses of tuition for his children and housing expenses or provide [Company F1] paid housing or a housing allowance …

(iv) [Company F1] shall provide [the Appellant], his spouse and any dependent children resident with him with business class air passage from the location of his residence on the date of termination to his home country and shall reimburse [the Appellant] for his moving expenses for household furnishings and other belongings …

(v) All stock options granted to [the Appellant] pursuant to the Plan shall vest as of the Closing and shall be payable as specified in the Plan and/or in the relevant stock option agreement.

(4) On 2 June 2000, the Appellant and EmployerCo executed an agreement to amend the Employment Agreement ('the Amendment Agreement'), which contained the following terms:

> 2. Section 5(c)(i) of the Employment Agreement is amended to read in its entirety as follows:
>
> (c) Equity Participation (i) [EmployerCo] acknowledges that [the Appellant] has made substantial contributions to the business of [EmployerCo] and [Company F2]. In view of the foregoing and [EmployerCo's] intention to consummate an Initial Public Offering as soon as commercially practicable in light of market conditions, [EmployerCo] hereby grants to [the Appellant] the [EPI]. The [EPI] shall be payable in cash in U.S. dollars (or, at the election of [the Appellant], by delivery of freely transferable equity securities of the kind sold in the Initial Public Offering ('IPO Securities')) by [EmployerCo] to [the Appellant] (x) immediately upon the closing of the Initial Public Offering, (y) immediately upon [the Appellant's] election, commencing on the fourth anniversary of the Effective Date, any anniversary of the Effective Date if an Initial Public Offering has not been consummated by such date or (z) subject to the last sentence of this section 5(c)(i), at [the Appellant's] election delivered to [EmployerCo] immediately following the occurrence of a Change of Control (the 'Trigger Date'). In the case of a Trigger Date described in clause (y) of the preceding sentence, [the Appellant] shall provide 30 days prior written notice to [EmployerCo] of his intention to elect to receive the [EPI] on any such Trigger Date. In the case of a Trigger Date described in clause (z) above, the amount payable to [the Appellant] in respect of the [EPI] shall equal 95% of the amount calculated in accordance with Sections 5(c)(ii) and 5(c)(iii) below, [the Appellant's] entitlement to such payment is contingent upon [the Appellant's] continuing to perform the duties of his employment for [Company F1] or [EmployerCo] (as directed by [name omitted here]) for a period of up to three months following a Change in Control (the 'Transition Period') if and to the extent requested by [name omitted here] and such payment shall be made to [the Appellant] upon the expiration of any Transition Period.

(5) By a letter dated 2 March 2001, EmployerCo and Company F1 confirmed the Appellant's resignation from employment with them and their affiliated companies. The letter read:

> [Employer] waives the ninety-day notice period set forth in paragraph 6(a)(vi) of your [Employment Agreement, as amended]. [Employer] deems your resignation to be without 'Good Reason' as that term is defined in the Employment Agreement and to be effective as of the time set forth in your resignation letter dated October 23, 2000.
> In addition to your resignation without 'Good Reason', [Employer] believes that your employment termination is justified by other grounds, including termination for 'Cause' as that term is defined in the various agreements between you and [Employer] …

(6) The Appellant made claims against EmployerCo, Company F1 and Company F2 in relation to the termination of his employment by arbitration. International Arbitration Tribunal of [name of arbitration association omitted here], [name of place omitted here] made an Interim Findings and Award dated 29 August 2002 ('the Interim Findings'), which contained the following terms:

> In his statement of claim, [the Appellant] asserts the following claims against [Company F1]: (1) for severance pay compensation in the amount of [US$1.2 million] and other severance benefits including repatriation expenses and housing and living expenses under [the Severance Agreement]; and (2) claims under a stock option buy-out agreement dated November 16, 2000 ('the Buy-Out Agreement') in the amount of [US$600,000], together with pre- and post-award interest.
>
> Against [EmployerCo] [the Appellant] also asserts claims under the Employment Agreement, as amended, for: (1) severance compensation in the amount of [US$900,000], to the extent such compensation has not been paid by [Company F1] under the Severance Agreement; (2) severance benefits, including repatriation expenses, to the extent such benefits and expenses have not been paid by [Company F1] under the Severance Agreement; (3) a discretionary bonus for the calendar year 1999; and (4) an [EPI] payment under Section 5 of the Employment Agreement … together with pre- and post-award interest.
>
> Under the Restricted Stock Award Agreement dated June 24, 1999 ('the 1998 Award Agreement') and the Restricted Stock Award Agreement dated July 15, 1999 ('the 1999 Award Agreement'), [the Appellant] asserts claims in the amount of [US$125,165 and US$1,060,900] respectively, together with pre- and post-award interest.
>
> Finally, [the Appellant] claims the right to full indemnification for his defense expenses from [EmployerCo] … and from [Company F2] … and from [Company F1] …

FINDINGS AND AWARD

[The Appellant's] Termination

The date and circumstances under which [the Appellant's] employment ended is of singular significance to both sides. It determines whether or not [the Appellant] is entitled to certain financial benefits.

… We … find that [the Appellant] was always free to leave his employment whether or not an IPO ever occurred. Of course, depending on the circumstances of his departure, he may or may not have been entitled to certain financial benefits.

… We find … that the March 2, 2001 writing constitutes clear and conclusive documentary evidence that [EmployerCo] intended to, and did in fact with this letter, terminate [the Appellant] …

However, we find as a matter of fact that [EmployerCo] failed to meet its burden of establishing that the termination met the 'for Cause' standard. Accordingly, we find that [the Appellant] was terminated without Cause on March 2, 2001.

… we find that the March 2, 2001 termination without Cause was effective April 1, 2001. Based upon the foregoing [the Appellant] is entitled to the employment benefits set forth below.

[The Appellant's] Entitlements and Recoveries

A. Severance Payments

1. [The Appellant] shall recover from [EmployerCo] a lump sum cash payment of [US$1,087,500] … as severance compensation under section 7(a) of the Employment Agreement, with pre-award interest …

2. We find that because [EmployerCo, Company F1 and Company F2] treated other key executives 'as though there was a change in control' upon the … Sale … [the Appellant] is entitled to this severance benefit, and shall recover from [Company F1] [US$1.2 million] under Section 3(a) of [the Severance Agreement], with Pre-Award Interest … To the extent that [EmployerCo] pays the amount set forth in paragraph 1 immediately above, then [Company F1] shall be entitled to claim a credit for the amount paid.

3. [The Appellant] shall recover jointly and severally from [Company F1] and [EmployerCo] his COBRA payments in the amount of [US$9,060.69] under Section 3(a)(ii) of the Severance Agreement and the Employment Agreement under 5(e)(f)(g)(h) and 7(a)(ii) with Pre-Award interest …

4. [The Appellant] shall recover jointly and severally from [Company F1] and [EmployerCo] his repatriation expenses in the amount of [US$22,625.77] under Section 3(a)(iv) of the Severance Agreement and the Employment Agreement under 5(e)(f)(g)(h) and 7(a)(ii) with Pre-Award interest …

5. [The Appellant] shall recover from [Company F1] Alone another [US$9,234.62] with Pre-Award interest … as compensation for his defense expenses in connection with the eviction proceeding brought against him by [Company F1] and [Employer] Hong Kong with respect to the … house during the time that [the Appellant] was entitled to be in possession thereof pursuant to Section 3(a)(iii)(A) of the Severance Agreement.

B. The 1999 Discretionary Bonus

We find that [the Appellant] failed to meet his burden of proving that he was entitled to a discretionary bonus for 1999, and therefore this claim is denied.

C. Recoveries Under the 1998 and 1999 Award Agreements

Under the 1998 Award Agreement, [EmployerCo] awarded [the Appellant US$100,000] which was notionally invested in 71.429 shares of the common stock of [Company F1] …; these shares were valued by [EmployerCo] at [US$1,759.37] per share or [US$125,670] … Pursuant to Section 5(b)(i) of the 1998 Award Agreement, [the Appellant's] interest was 100% vested when his employment terminated without Cause effective April 1, 2001. Accordingly, [the Appellant] shall recover from [EmployerCo] the amount of [US$125,670.00] under the 1998 Award Agreement, with Pre-Award interest … Under the 1999 Award Agreement [EmployerCo] awarded [the Appellant] 614.375 shares of its common stock subject to vesting as provided therein … Under Section 2(e) of the Employment agreement, one half vested upon the [Company G] Sale and the other half upon the termination of [the Appellant's] employment, effective April 1, 2001. Accordingly, [the Appellant] shall also recover from [EmployerCo] the amount of [US$1,080,912.00] under the 1999 Award Agreement, with … Pre-Award interest …

D. [The Appellant's] Recovery Under the Buy-Out Agreement

Pursuant to the [Buy-Out Agreement] [Company F1] agreed to buy out [the Appellant's] [Company F1] options for 100,000 shares at [US$3] per share and to pay [the Appellant] a retention bonus of 50% of his annual base salary or [US$300,000]. These payments were due upon [the Appellant's] termination from [Company F1], effective April 1, 2001. Accordingly, [the Appellant] shall recover from [Company F1] the amount of [US$600,000] pursuant to the Buy-Out Agreement with Pre-Award interest …

E. [The Appellant's] EPI

Pursuant to Section 5(c)(ii)(C)(y) of the Employment Agreement, [the Appellant] was entitled to a 3.75% [EPI] in [Company F2] and a 1.25% EPI in [Company F1], due at the closing of an IPO, or if an IPO did not occur, at [the Appellant's] election, on January 1, 2002 … or any future anniversary date. By [the Amendment Agreement, the Appellant's] EPI entitlement would also be triggered by a 'change of control' defined in Section 1(d)(i) thereof … We find that the sale of the 49.9% interest in [EmployerCo] on December 18, 2000, did not constitute a change of control within the meaning of Section 1(d)(i) of the Employment Agreement, as amended, and that [the Appellant] became entitled to his EPI on January 1, 2002. Accordingly, based upon the valuation put forth by Respondents' experts, which we find is the appropriate valuation, and pursuant to [the Amendment Agreement, the Appellant] shall recover from [EmployerCo] the amount of [US$4,098,253.00], together with Pre-Award Interest …
…

K. Award Summary

1. Within thirty (30) days from the date of transmittal of this Award to the Parties, [EmployerCo and Company F1] shall pay to [the Appellant] the following amounts as indicated:

Item	Source	Amount [US$]	Interest [US$]	Total [US$]	
Severance	[EmployerCo]	$1,087,500.00	$138,656.25	$1,226,156.25	
Severance	[Company F1]	$1,200,000.00	$153,000.00	$1,353,000.00	*
COBRA	[EmployerCo/ Company F1]	$9,060.69	$951.37	$10,012.06	**
Repatriation	[EmployerCo/ Company F1]	$22,625.77	$2,375.71	$25,001.48	**
Evict'n defense	[Company F1]	$9,234.62	$969.64	$10,204.26	
1998 Award	[EmployerCo]	$125,670.00	$16,022.93	$141,692.93	
1999 Award	[EmployerCo]	$1,080,912.00	$152,003.25	$1,232,915.25	
Buy-Out	[Company F1]	$600,000.00	$76,500.00	$676,500.00	
EPI	[EmployerCo]	$4,098,253.00	$245,895.18	$4,344,148.18	
Salary	[EmployerCo]	$138,456.00	$19,010.34	$157,466.34	

TOTAL PAYMENTS (incl. [US$1,226,156.25] severance credit maximum) [US$7,950,940.50]

* [EmployerCo's] severance payment is to be credited against this amount
** [EmployerCo] and [Company F1] are jointly and severally liable to pay

> 2. Within thirty (30) days from the date of transmittal of this Award to the Parties, [the Appellant] shall pay to [EmployerCo] the sum of [US$200,000] as a loan repayment, plus [US$32,580] interest, for a total of [US$232,580.00].
>
> L. Costs and Fees
>
> [The Appellant] is awarded 100% of the costs of this proceeding …
>
> … this Award is in full settlement of all claims and counterclaims submitted to this Arbitration.

(7) On 21 November 2002, EmployerCo, Company F1, Company F2 and 'HKCo' entered into a confidential settlement agreement ('the Settlement Agreement') with the Appellant. The Settlement Agreement contained the following terms:

> WHEREAS, [the Appellant] commenced an arbitration [particulars of arbitration agreement omitted here] (the 'Arbitration');
>
> WHEREAS, [EmployerCo], [Company F1] and [Company F2] asserted counterclaims against [the Appellant] in the Arbitration, as well as in a First Amended and Supplemental Counterclaim, dated July 23, 2001 (the 'Counterclaims');
>
> WHEREAS, in response to [Employer's] Counterclaims, [the Appellant] asserted counterclaims for contribution and indemnification;
>
> WHEREAS, hearings in the Arbitration were held and [the Interim Findings] dated August 29, 2002 was issued by the panel as modified, the 'Interim Award' and on November 11, 2002, a second and final award for costs and fees was issued (with the Interim Award, collectively the 'Awards');
>
> WHEREAS, [HKCo], [Company F2] and [Company F1] filed an action against [the Appellant] with the High Court of the Hong Kong Special Administration Region, Court of First Instance, [action number omitted here] (the 'Hong Kong Action');
>
> WHEREAS, with respect to [the Appellant's] employment with Employer certain issues have arisen concerning certain tax assessments made by the Hong Kong Inland Revenue Department specified more fully below (the 'Tax Assessments');
>
> WHEREAS, the Parties now wish to compromise and settle all claims and counterclaims asserted, which could have been asserted, or relate to the Arbitration, the Counterclaims, the Awards, the Hong Kong Action and the Tax Assessment; and

NOW, THEREFORE, in consideration of the mutual promises herein contained, the undertakings herein set forth, and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the Parties agree as follows:

1. [EmployerCo] agrees to make payment to [the Appellant] in the following amounts within three (3) business days of the execution of this Agreement:

   (a) [US$7,250,000.00];

   (b) [US$25,001], as reimbursement for certain repatriation moving and other expenses; and

   (c) [US$10,012], as reimbursement for COBRA Payments made by [the Appellant].

   …

2. [EmployerCo], within three (3) business days of the execution of this Agreement, will deliver to [name omitted here] a good and certified check (or wire transfer, upon receipt of appropriate instructions) in the amount of [US$822,876] payable to [name omitted here] …

3. [EmployerCo] agrees to indemnify and hold [the Appellant] harmless for any and all amounts demanded by the Hong Kong Inland tax authorities pursuant to the assessments listed on Exhibit A attached hereto (the 'Tax Assessments') and to resolve the Tax Assessments with reasonable dispatch …

…

6. Simultaneously with the execution of this Settlement Agreement, the attorneys for the Parties shall execute and deliver: (a) to counsel for [the Appellant], a stipulation dismissing the Hong Kong Action (with prejudice) and (b) to counsel for Employer, a stipulation dismissing the Arbitration and Counterclaims (with prejudice) the Arbitration in the forms annexed hereto as Exhibit B and C (the 'Stipulations') …

7. Simultaneously with the execution of this Settlement Agreement, the Parties shall each respectively execute two copies of the releases (the 'Releases') in the forms attached hereto as Exhibits D and E. An original of each release shall then be delivered to counsel for the parties to be held in escrow until such time as the payments set forth in paragraphs 1 and 2 are made.

8. [The Appellant] and his counsel shall, within twenty (20) days of the date that the payments under paragraphs 1 and 2 are made, either certify the destruction of, or deliver or cause to be delivered to counsel for Employer, all original of the 'sealed' transcripts prepared in the Arbitration as well as all documents marked

> 'Confidential' or 'Highly Confidential', together with any duplicates thereof (including those in electronic format). [The Appellant] further agrees that nothing herein or in the Release shall be constructed to release, modify or discharge the obligations set forth in the terms of paragraph 9 of his Employment Agreement ...

(8) Company F2 filed a notification by an employer of an employee who is about to cease to be employed in respect of the Appellant for the period ended 31 July 1998 and declared the following particulars:

(a)	Capacity in which employed	:	Senior Vice President / Director
(b)	Period of employment	:	01-04-1998 to 31-07-1998
(c)	Reason for cessation	:	Transferred
(d)	Details of emoluments -		HK$
	(i) Salary / Wages	:	982,098
	(ii) Gain realized under share option scheme	:	218,339
	Total	:	1,200,437
(e)	Place of residence provided by employer	:	Yes

(9) On divers dates, HKCo filed employer's returns/notification in respect of the Appellant for the period/years ended 31 March 1999 to 2001 and declared the following particulars:

	Period/Year ended		31-03-1999	31-03-2000	31-03-2001
(a)	Capacity in which employed	:	Senior Vice President / Director		
(b)	Period of employment	:	01-08-1998 to 31-03-1999	01-04-1999 to 31-03-2000	01-04-2000 to 31-03-2001
(c)	Details of emoluments –		HK$	US$	HK$
	(i) Salary / Wages	:	1,964,212	391,040	3,506,363
	(ii) Bonus	:	926,508	--	--
	(iii) Gain realized under share option scheme	:	27,602	--	15,946,546
	(iv) US tax payments	:	1,466,971	218,000	--
	(v) Hong Kong Salaries Tax paid by employer	:	--	--	2,930,376
	(vi) Other rewards, allowance or perquisites	:	40,388	80,614	42,283,957
	Total	:	4,425,681	689,654*	64,667,242
(d)	Place of residence provided	:	Yes	Yes	Yes

* Equivalent to HK$5,330,404 (US$689,654 x 7.7291)

(10) The notification for the year ended 31 March 2001 contained the following information:

(a) A breakdown of 'Gain realized under share option scheme' of HK$15,946,546:

			HK$	Equivalent US$
(i)	1998 Award Agreement	:	1,101,606	141,693
(ii)	1999 Award Agreement	:	9,585,423	1,232,915
(iii)	Buy-Out Agreement	:	5,259,517	676,500
	Total	:	15,946,546	

(b) A breakdown of 'Other rewards, allowance or perquisites' of HK$42,283,957:

			HK$	Equivalent US$
(i)	COBRA	:	77,840	10,012
(ii)	Repatriation	:	194,377	25,001
(iii)	Eviction defense	:	79,334	10,204
(iv)	EPI	:	33,774,014	4,344,148
(v)	Recoverable expenses	:	6,337,185 ('the Recoverable Expenses')	815,114
(vi)	FICA & Medicare gross up	:	64,661	8,317
(vii)	US tax payment	:	1,756,546	225,934
	Total	:	42,283,957	

(c) The appendix to the notification included the following statement:

> ' Upon redundancy and subsequent to an arbitration between [the Appellant] and Employer, [the Appellant] received US$694,834.5 as severance payment which is in the nature of compensation for loss of office. As the amount does [not] relate to his services rendered / to be rendered in the past, present or future, it should not be considered as taxable.'

(11) The Appellant failed to file his tax returns for the years of assessment 1998/99, 1999/2000 and 2000/01 within the stipulated time. The Assessor raised on the Appellant the following estimated Salaries Tax Assessments for the years of assessment 1998/99 to 2000/01 pursuant to section 59(3) of the Inland Revenue Ordinance ('the Ordinance'):

	1998/99	1999/2000	2000/01
	HK$	HK$	HK$
Income	5,626,118[(1)]	5,330,404[(2)]	64,667,242[(3)]
Residence	538,017	533,040	4,872,069
Total Assessable Income	6,164,135	5,863,444	69,539,311
Tax Payable thereon	924,620	879,516	10,430,896

Notes
(1) HK$1,200,437 [Fact (8)(d)] + HK$4,425,681 [Fact (9)(c)]
(2) Fact (9)(c)
(3) Fact (9)(c)

(12) On behalf of the Appellant, Messrs Deloitte Touche Tohmatsu ('Deloitte') objected against the estimated Salaries Tax Assessment for the year of assessment 1998/99 on the ground that the Appellant's income received from Company F2 should be assessed in accordance with section 8(1A)(a) of the Ordinance. The Appellant filed his tax return to validate the objection. The Assessor accepted the claim and the objection was settled as follows:

	HK$
Income	5,124,296
Residence	496,961
Total Assessable Income	5,621,257
Tax Payable thereon	843,188

(13) On behalf of the Appellant, Deloitte objected against the estimated Salaries Tax Assessment for the year of assessment 1999/2000 on the ground that the assessment was excessive. The Appellant filed his tax return to validate the objection, in which he declared the same amount of income as that assessed. Accordingly, no revision to the assessment was required.

(14) On behalf of the Appellant, Baker Tilly Business Services Limited ('the Representative') objected against the estimated Salaries Tax Assessment for the year of assessment 2000/01 on the ground that the assessment was excessive.

(15) The Appellant filed his 2000/01 tax return to validate the objection. In an appendix to the return, he claimed that the assessable income should be computed as follows:

		HK$	Onshore & taxable portion HK$
(a)	Salary	3,506,363	2,382,405
(b)	Salaries tax paid by employer	2,930,376	1,991,050

		HK$	Onshore & taxable portion HK$
(c)	Gain on stock option under:		
	- The 1998 Award Agreement	1,101,606	676,054
	- The 1999 Award Agreement	9,585,423	4,884,626
	- The Buy-Out Agreement	5,259,517	4,185,039
(d)	US tax payments	1,756,546	1,193,488
(e)	Compensation for EPI	33,774,014	11,473,912
(f)	The Recoverable Expenses	6,337,185	-
(g)	Others (COBRA HK$77,840, Repatriation HK$194,376, and FICA & Medicare HK$64,662)	336,878	228,892
(h)	Reimbursement of eviction defense	79,334	-
	Total [Fact (9)(c)]	64,667,242	27,015,466

The Representative provided an analysis in support of the claim that only part of the compensation for EPI ascertained on a time-apportionment basis should be chargeable to tax.

(16) The Representative put forward the following assertions:

EPI

(a) '[EPI] was granted by [EmployerCo] in January 1998 as per the Employment Agreement dated 1st January 1998. Amount was in substance a compensation to [the Appellant] for release of certain share option right he possessed under the EPI. Accordingly, the amount should be subject to time apportionment based on days in and days out in the year of assessment 1997/98. EPI apportioned as onshore:

> [HK$33,774,014] x 124/365 (per time apportionment basis agreed by the IRD for 1997/98) = [HK$11,473,912]'

(b) 'Kindly note that the amount of HKD33,774,014 being Compensation for [EPI] reported in the Composite Tax Return of [the Appellant] for the year of assessment 2000/01 … is a lump sum compensation for depriving [the Appellant] of his right to certain equity share option gain upon termination of his employment in March 2001.'

Deduction in respect of the Recoverable Expenses and the Legal Fees

(c) The Appellant's employment with EmployerCo was terminated on 2 March 2001 without cause.

(d) '[The Appellant] was awarded reimbursement of all legal costs of the arbitration proceeding in respect of his employment dispute with the Employer Group. As [the Appellant] had actually incurred the same amount of legal fees of HKD6,337,185, after setting off of this expense, the net amount assessable should be nil.'

(e) '[The Appellant] also spent legal fees on the Arbitration case … of USD938,072 or HKD7,316,961 ('the Legal Fees') which were not reimbursed by the Employer Group. Hence, this amount should be an allowable deduction for Hong Kong salaries tax purposes.'

(f) '[The Appellant] commenced an arbitration … Pursuant to [the Interim Findings] delivered by [name of arbitration association omitted here] on 29th August 2002 …[the Appellant] was awarded entitlements to lump sum severance payments, share options under the 1998 and 1999 Award Agreements with [EmployerCo], stock options under the Buy-Out Agreement with [Company F1], and compensation for [EPI] in [Company F2] and [Company F1], totaling USD7,950,940. [The Appellant] was also entitled to recover all legal costs from [Company F1] and [EmployerCo]. The total legal cost incurred by [the Appellant] was USD1,450,000 payable to … [the Appellant's] legal counsel for the Arbitration.'

(g) 'On 21st November 2002, the Employer Group and [the Appellant] compromised and settled all the claims related to the Arbitration. [The Appellant] signed [the Settlement Agreement] with [EmployerCo], [Company F1], [Company F2] and [HKCo], largely adopting the conclusions reached by the [name of arbitration association omitted here] in [the Interim Findings].'

(h) '[EmployerCo] agreed to pay [the Appellant] a total amount of USD7,285,013 …'

(i) '[EmployerCo] also agreed to reimburse part of the legal cost incurred by [the Appellant] in the amount of USD822,876 (i.e. HKD6,337,185). This amount was paid directly by [EmployerCo] to [Name of lawyer omitted here] …This amount was duly reported and included as taxable in the Employer's Return and was shown as [the Recoverable Expenses] in [the Appendix] to the Composite Tax Return of [the Appellant] for 2000/01 … Since this amount was fully reimbursed by [EmployerCo], the net assessable or taxable amount has been reported as "nil" …'

(j) '[The Appellant] has also claimed a tax deduction on an additional legal fee deduction of USD938,072 (i.e. HKD7,316,961). The breakdown of this amount is as follows:

	USD	
[Name of lawyer omitted here] legal fees paid by [the Appellant]	627,124	(Note 1)
Fees paid to the [name of arbitration association omitted here] (and [Name of lawyer omitted here])	183,425	--
Expert Witness Fees	41,742	--
Stenographic Fees	31,305	--
Photographic Fees	5,990	--
Other Legal Fees	48,486	(Note 6)
	938,072	

Note:

1. The amount of USD627,124 is the balance of the legal fees paid by [the Appellant] to [Name of lawyer omitted here] after being reimbursed of USD822,876 by [EmployerCo]. Total amount to [Name of lawyer omitted here] thus amounts to USD1,450,000. The amount of USD627,124 has been allocated from the Escrow Account to [Name of lawyer omitted here] …

…

6. The 'Other Legal Fee' of USD48,486 was the USD19,241.82 payable by [the Appellant] to [Name of lawyer omitted here] and USD29,243.82 to [Name of lawyer omitted here] for legal advice on the Arbitration …'

(k) 'This additional legal fee deduction of USD938,072 in total was not reimbursed by the Employer Group. It was incurred by [the Appellant] wholly, exclusively and necessarily in the production of his gain on stock option, EPI compensation and other perquisites awarded as a result of the Arbitration proceeding. This legal fee was so essential that without incurring it, it would not have been possible for [the Appellant] to generate the relevant income in question. These assessable incomes have been duly offered to salaries tax in Hong Kong. Hence, the additional legal fee should be deductible.'

(17) Company H, on behalf of HKCo, provided the following information:

EPI

(a) '[EPI] was paid out to [the Appellant] in accordance with clause 5(c) of [the Employment Agreement]. Based on the arbitration agreement … he became entitled to this interest on January 1, 2002.'

(b) Breakdown of the EPI-

	US$	HK$
EPI ('the EPI Payment')	4,098,253	31,862,278
Interest	245,895	1,911,736
Total	4,344,148	33,774,014

The Recoverable Expenses

(c) '[The Recoverable Expenses] were costs / fees incurred by [the Appellant] in relation to the arbitration including out of pocket arbitration costs and legal fees, which were reimbursed to him based upon the arbitration agreement …'

(d) '… the amount was paid based on actual costs borne by [EmployerCo and Company F1] and no negotiation of the amount was involved …'

(e) Breakdown of the Recoverable Expenses-

	US$	HK$
Recoverable costs	215,328	
Recoverable legal fees	599,786	
Total	815,114	6,337,185

Gain realized under share option scheme

(f) '100,000 options were granted to [the Appellant] as a further incentive for him to remain employed with the Company which were later bought out based upon the [Buy-Out Agreement].'

(g) Breakdown of the gain-

	Share value US$	Interest US$	Total US$	Total HK$
1998 Award Agreement	71.429 shares x $1,759.37/share = 125,670	16,023	141,693	1,101,606
1999 Award Agreement	614.375 shares x $1,759.37/share = $1,080,912	152,003	1,232,915	9,585,423
Buy-Out Agreement	[30,000 options (granted on July 15 1998) + 70,000 options (granted on July 1 1999)] x $3/share + retention bonus			

	Share value US$	Interest US$	Total US$	Total HK$
	[$600,000 (annual base salary) x 50%] = $600,000	76,500	676,500	5,259,517
Total			2,051,108	15,946,546

(h) The market value of the stock at the date of grant in respect of the 1998 restricted stock award (i.e. 1 January 1999) and the 1999 restricted stock award (i.e. 15 July 1999) were US$1,400 and US$2,000 per share respectively.

Severance payments

(i) 'Circumstances leading to the … payments

- Severance payments of US$1,226,156.25 and 126,843.75

  Based upon [the Severance Agreement, the Appellant] was entitled to a severance payment in the event of his termination after certain transactions occurring. One of the transactions is acquisition by a third party of more than 50% of the aggregate voting power of all the outstanding securities (of Employer). In this case, it was the sale to [Name omitted here]. Accordingly, he was entitled to a severance payment under clause 7(a)(i) of [the Employment Agreement] and Section 3(a) of [the Severance Agreement]. Pursuant to section 14 of [the Severance Agreement] which allowed [the Appellant] to be paid the greater of the severance benefits under both of the relevant agreements, [the Appellant] was entitled to US$1,200,000 plus interest of US$153,000 (per Section 3 of [the Severance Agreement]) instead of US$900,000 (per Clause 7(a)(i)(A)) of [the Employment Agreement]).

  Employer and [the Appellant] were unable to agree upon the amount of compensation due to [the Appellant] under his employment and other compensation agreements. As a consequence, [the Appellant] initiated an arbitration proceeding which concluded a mutually satisfactory settlement of all claims and final settlement payments including the severance payments.

  Per Section K of the arbitration agreement … [EmployerCo's] severance payment of US$1,226,156.25 (interest inclusive) is to be credited against [Company F1's] severance payment of US$1,353,000 (interest inclusive) and the excess of US$126,843.75 is to be paid to [the Appellant] on top of [US$1,226,156.25].

- Counterclaims of US$232,580

  This amount was an offset for a loan advanced to [the Appellant] together with the interest payment accrued on the loan.

- Additional counterclaims of US$425,585.50

  The amount represents a reduction in the final arbitration award in return for Employer, among other things, agreeing not to appeal the decision of the arbitration tribunal.'

(j) Breakdown of the severance payments-

Category I payment – EmployerCo's severance payment

	Per Employment Agreement	US$		US$
Severance payment	S7(a)(i)(A)	600,000.00 x 18/12	=	900,000.00
Severance payment	S7(a)(i)(B)	150,000.00 x 456.25/365	=	187,500.00
Interest				138,656.25
Total				1,226,156.25

Category II payment – Company F1's severance payment

			US$
Severance payment	Per Severance Agreement	Section 3(a)	1,200,000.00
Interest	Per Severance Agreement	Section 3(a)	153,000.00
			1,353,000.00
Less: Category I payment	Per the Interim Findings	Page 9, Section A 2	(1,226,156.25)
Excess			126,843.75

	US$
Category I severance payment	1,226,156.25
Category II severance payment	126,843.75
Counterclaims	(232,580.00)
Settled additional counterclaims	(425,585.50)

	US$
Net severance payment	694,834.50

(18) Having reviewed the available information, the Assessor was of the following views:

(a) The claim that the Appellant's income for the years of assessment 1998/99 to 2000/01 should be assessed to tax on a time-apportionment basis could be accepted.

(b) The claim that the Recoverable Expenses should not be chargeable to tax could be accepted.

(c) the Legal Fees could not be allowed for deduction under section 12(1)(a) of the Ordinance.

(d) The EPI Payment was part and parcel of the Appellant's remuneration package paid to him in accordance with the terms of the Employment Agreement and should be chargeable to tax.

(e) The following gains were part and parcel of the Appellant's remuneration package and should be chargeable to tax:

	Nature	Amount US$	Amount HK$	
1998/99	Gain under the 1998 Award Agreement (71.429 x US$1,400/share)	100,000	772,090	('the 1998 Award Payment')
1999/00	Gain under the 1999 Award Agreement (614.375 shares x US$2,000/share)	1,228,750	9,497,131	('the 1999 Award Payment')
2000/01	Gain under the Buy-Out Agreement	600,000	4,664,760	('the Buy-Out Payment')

(f) The following severance payments were made to the Appellant in accordance with the Employment Agreement and the Severance Agreement and should be chargeable to tax (could be related back and treated as income for the last 36 months under section 11D(b)(i) of the the Ordinance):

Employer	Severance payment	Interest	Total amount
	US$	US$	US$
EmployerCo	1,087,500	138,656	1,226,156
Company F1	112,500	14,344	126,844
	1,200,000	153,000	1,353,000
Less: Settlement on counterclaims as mutually agreed			(425,585)
			927,415
			('the Severance Payment')

(19) The Assessor proposed to revise the 2000/01 Salaries Tax Assessment as follows:

	US$	HK$
Salary	431,992	3,358,565
US tax payment	225,934	1,756,546
The Buy-Out Payment	600,000	4,664,760
The EPI Payment	4,098,253	31,862,278
Other perquisites	40,003	311,011
The Severance Payment after related back		2,401,233
[US$927,415 x 365/1,096]	308,856	
	5,705,038	44,354,393
Income after time-apportionment		
[HK$44,354,393 x 248/365]		30,136,683
Add: Hong Kong Salaries Tax paid by employer		
[No time apportionment]		2,930,376
		33,067,059
Add: Quarters value		
[HK$392,400 (rateable value) x 248/365]		266,617
Assessable Income		33,333,676
Tax Payable thereon (at standard rate)		5,000,051

(20) The Assessor raised on the Appellant the following additional Salaries Tax Assessments:

(a) Year of assessment 1998/99

	US$	HK$
Employment period: 1 April 1998 to 31 July 1998		
Salary	127,200	982,098
Stock option gain	28,279	218,339
The Severance Payment related back		
[US$927,415 x 122/1,096]	103,234	797,060
	258,713	1,997,497

	US$	HK$
Income after time-apportionment:		
[HK$1,997,497 x 71/122]		1,162,478
Add : Quarters value		
[HK$463,200 (rateable value) x 71/365]		90,102
Assessable Income (A)		1,252,580
Employment period: 1 August 1998 to 31 March 1999		
Salary	254,402	1,964,212
The 1998 Award Payment	100,000	772,090
Stock option gain	3,575	27,602
Bonus	120,000	926,508
US tax payment	190,000	1,466,971
Others	5,231	40,388
The Severance Payment related back		
[US$927,415 x 243/1,096]	205,622	1,587,587
	878,830	6,785,358
Income after time apportionment:		
[HK$6,785,358 x 153/243]		4,272,262
Add: Quarters value		
[HK$463,200 (rateable value) x 153/365]		194,163
Assessable Income (B)		4,466,425
Total Assessable Income [(A) + (B)]		5,719,005
Less: Assessable Income already assessed		5,621,257
Additional Assessable Income		97,748
Tax Payable thereon (at standard rate)		857,850
Less: Tax already charged		843,188
Additional Tax Payable thereon		14,662

(b) Year of assessment 1999/2000

	US$	HK$
Salary	391,040	3,022,387
The 1999 Award Payment	1,228,750	9,497,131
US tax payment	218,000	1,684,944
Relocation allowance	29,573	228,573
Gross up	47,166	364,551
Others	3,875	29,950
The Severance Payment related back		
[US$927,415 x 366/1,096]	309,702	2,393,720
	2,228,106	17,221,256

	US$	HK$
Income after time-apportionment:		
[HK$17,221,256 x 186/366]		8,751,785
Add: Quarters value		
[HK$394,200 (rateable value) x 186/366]		200,331
Assessable Income		8,952,116
Less: Assessable Income already assessed		5,863,444
Additional Assessable Income		3,088,672
Tax Payable thereon (at standard rate)		1,342,817
Less: Tax already charged		879,516
Additional Tax Payable thereon		463,301

(21) The Representative advised the Assessor that the Appellant did not accept the proposed revised 2000/01 assessment as settlement of his objection. The Representative also lodged objections against the 1998/99 and 1999/2000 additional assessments on the ground that the additional assessments were excessive.

(22) The Representative put forward the following contentions:

The Legal Fees

(a) 'We advise that [the Legal Fees] incurred by [the Appellant] should be deductible under section 12(1) of [the Ordinance] … the legal fee was related to the arbitration proceeding in respect of [the Appellant's] employment with [EmployerCo]. [The Appellant] has duly offered the income awarded as a result of the arbitration proceeding to Hong Kong Salaries Tax. Without the said legal fee incurred, it would not have been possible for [the Appellant] to obtain the relevant compensation i.e. the assessable income. We are strongly of the view that [the Legal Fees] was "wholly, exclusively and necessarily incurred" by [the Appellant] in the generation of the taxable compensation in question from his ex-employer. As a result, we are strictly of the opinion that [the Legal Fees] incurred by [the Appellant] should be deductible.'

The EPI Payment

(b) '[the EPI Payment] received by [the Appellant] should not be treated plainly as cash allowances or perquisites and be assessed in the year of assessment 2000/01 …'

(c) '[The Appellant] was given a choice between cash and share option, the election of which shall be determined at [the Appellant's] free choice. This shows that [the Appellant] has a legally enforceable right to acquire in shares in [Company F2] and [Company F1].'

(d) 'The nature of [the EPI Payment] is clearly a compensation for [the Appellant] for taking away of his legal right to purchase at zero cost certain shares in [Company F2] and [Company F1] as explained above.'

(e) 'However, since [the Appellant] was terminated by [EmployerCo] without cause on 2nd March 2001 as found by [arbitration] … [the Appellant's] entitlement to the right to purchase 3.75% shares in [Company F2] and 1.25% shares in [Company F1] was therefore relinquished involuntarily i.e. he was deprived of the chance to exercise his right. In this respect, [the Appellant] was awarded an amount of USD4,344,148 (i.e. HKD33,774,014) for the legal discharge of the option, which constitutes release of share option within the context of section 9(4)(b) of [the Ordinance]. As a result, the consideration of USD4,344,148 should be assessed in accordance with section 9(1)(d) of [the Ordinance] as "gain realized by the release of the right to acquire shares" in [Company F2] and [Company F1] obtained by [the Appellant] as an employee of [EmployerCo].'

(f) 'Since the share option was granted to [the Appellant] on 1st January 1998 on an unconditional basis, the amount of HKD33,774,014 received by [the Appellant] should be subject to time apportionment in the year of assessment 1997/98 … and only HKD11,473,912 (being the onshore portion) should be taxable in the year of assessment 2000/01.'

(g) 'Kindly note that the amount of USD4,344,148 was only received by [the Appellant] upon the termination of employment by [EmployerCo] in the year of assessment 2000/01. It should therefore be related back for 36 months in accordance with section 11D(b) of [the Ordinance].'

(h) 'It is outrageous for your department to say that since the EPI was awarded in accordance with the terms and conditions of the employment contract, such amount formed part and parcel of the remuneration package and therefore, [the EPI Payment] should be assessed as salaries income. We advise that we must first ascertain the true nature of the payment of [the EPI Payment] and its related award interest of USD245,895. As we have established in the above that the payment represents a compensation to [the Appellant] for depriving him of his legal right to purchase at zero cost certain shares in [Company F2] and [Company F1], the taxability must then be governed by Section 9(1)(d) of [the Ordinance and DIPN 38]. Of course, any rights granted to an employee or a director to acquire shares in a company … would normally be contained in his employment contract, but the taxability of the relevant gain on exercise, release or assignment of right in such share option must be ascertained strictly in accordance with Section 9(1)(d) of [the Ordinance]!'

The Severance Payment

(i) '… the payment of [the Severance Payment] (after settlement on counter-claims as mutually agreed by [the Appellant] and his ex-employer) received by [the Appellant] should not be treated as part of the taxable income from his employment with [EmployerCo].'

(j) 'Whether the payment constitutes taxable income depends on the substance of the amount, not the label. Although the said payment was described as "severance payment", the true nature of this payment is in fact compensation for loss of office, which is capital in nature and not be assessable to salaries tax.'

(k) 'Kindly note that to qualify as a severance payment, there must have been, among other things, an actual dismissal by reason of redundancy or lay-off.'

(l) 'In [the Appellant's] situation, he was neither dismissed by reason of redundancy nor laid off. [EmployerCo's] business is still in operation and the positions previously held by [the Appellant] (i.e. former senior officer of [EmployerCo] (equivalent to the ranking of a director under the system in the United States of America) and former officer and director of [Company F1] and [Company F2]) still remains to be in existence. [The Appellant] was simply wrongly dismissed from his office (which is equivalent to that of a statutory director of a limited company under the UK system). In fact, [the Appellant] was terminated by [EmployerCo] without cause after a series of events have deteriorated the relationship between [the Appellant] and the Employer's group. [EmployerCo's] decision to sell 49.9% interest in the company on 18th December 2000 was the key event culminating the termination and hence the arbitration proceeding, pursuant [the Appellant] was entitled to the net sum of [the Severance Payment] as compensation for his wrongly dismissal. As this is in essence a compensation for infringement of his legal rights, the amount should be regarded as capital in nature and not taxable.'

(m) 'We are therefore of the opinion that the true nature of the payment of [the Severance Payment] … awarded by [name of arbitration association omitted here] was not severance payment, but in fact a compensation for [the Appellant's] loss of office without cause and thus should not be assessable to salaries tax in the year of assessment 2000/01.'

Initial public offering mentioned in the Employment Agreement

(n) '… at the time of the Employment Agreement and the later Amendment, there was only an intention of [EmployerCo] to consummate an Initial Public Offering ('IPO') as soon as commercially practicable in light of market

conditions. [The EPI] may be granted to [the Appellant], at the election of [the Appellant], in the form of "freely transferable equity securities" if, and only if, there was actually an IPO. If there was subsequently no IPO taking place, then the EPI may only be payable in cash subject to various events and conditions as specified in the Employment Agreement (as amended). In fact, please note that the envisaged IPO had never occurred during [the Appellant's] employment with [EmployerCo] or before the date of [the Settlement Agreement].'

(o) '… as no IPO had in fact been consummated, the so-called "securities" were merely hypothetical and not in existence at the relevant times.'

(23) The Representative subsequently provided a counsel opinion and claimed that:

(a) 'According to the counsel opinion, although the quantum of the settlement payment received by [the Appellant] largely reflects the award under the Arbitration, the lump sum payment was not made pursuant to the awards granted under the arbitration with the [name of arbitration association omitted here]. Instead, the payment was made pursuant to [the Settlement Agreement]. The Settlement Agreement does not to any extent purport to satisfy the Arbitration award or to settle any of [the Appellant's] claims under the Employment Agreement or other agreements. What the Settlement Agreement stipulates is that [the Appellant] forfeit all his right under the Arbitration award (by requiring him to execute a stipulation to dismiss the Arbitration), that he destroy the transcript and all confidential documents related to the Arbitration. In effect, [the Appellant] was required to treat the Arbitration as if it had never happened. In this connection, the sum paid pursuant to the Settlement Agreement should be capital in nature and hence not subject to Hong Kong Salaries Tax.'

(b) 'Adopting the counsel opinion, we hereby wish to claim that all the awards granted to [the Appellant] under the Arbitration proceedings with [name of arbitration association omitted here] are capital in nature and hence not subject to Hong Kong Salaries Tax.'

– END OF ANNEXURE A –