Case No. D139/02

Salaries tax – whether income derived from services rendered in Hong Kong – sum paid in consideration of a restrictive covenant – section 8(1) and 8(1A)(a) of the Inland Revenue Ordinance ('IRO').

Panel: Ronny Wong Fook Hum SC (chairman), Chan Koon Hung and Choi Kin.

Date of hearing: 6 February 2003.
Date of decision: 24 March 2003.

Company A, a company incorporated in Hong Kong and a subsidiary of Corporation A, engaged the appellant as its regional managing director. The letter of appointment provided that 'if [the appellant] should be terminated from his assignment ... for other than "cause", [Corporation A] would reassign [the appellant] to another [company under Group A] ... or offer [the appellant] severance pay for 12 months equal to [the appellant's] base salary at the time in accordance with [Corporation A's] Career Transition Plan'.

By a letter of termination, Corporation A informed the appellant that his position was being eliminated and in accordance with the letter of appointment he would normally be provided with severance pay equal to 12 months base salary in accordance with its Career Transition Plan. Corporation A had agreed to provide the appellant with a 13th month of base salary, subject to the condition that the appellant would agree to provide Corporation A with up to twenty days of consulting services. As part of the Career Transition Plan, the appellant was asked to sign a severance agreement and release. Sum A, being the sum total of 12 months' base salary and Sum B, being the additional one month base salary, were paid by Corporation A to the appellant.

The Revenue conceded that the appellant's case did not fall within the basic charge of section 8(1) but fell to be considered under section 8(1A)(a). The issue before the Board was whether the sum in question was 'income derived from services rendered in Hong Kong'. The appellant contended that he did not render any service in Hong Kong.

Held:

1. The Board is divided as to whether Sum A is 'income derived from services rendered in Hong Kong'. The majority of the Board takes the view that under the letter of appointment, Sum A is only payable if two conditions are satisfied. First,

there must be a termination of the appellant's assignment. Secondly, there must not be any reassignment of the appellant within Group A. The entitlement to Sum A is therefore wholly dependent on cessation of the appellant's connection with Group A. Whilst these are conditions precedent leading to the entitlement of Sum A, they do not suggest that services rendered in the past formed part of the consideration for Sum A. The letter of appointment further provides that Sum A is to be paid 'in accordance with our Career Transition Plan'. As indicated by the letter of termination, the severance agreement and release is 'part of the Career Transition Plan'. It follows that the covenants in the severance agreement and release formed part of the bargain in return for Sum A. The relevant covenants restrict the activities of the appellant and prevent him from instituting proceedings against Group A. They do not impose any obligation on the part of the appellant to render any service in favour of Group A. The majority of the Board therefore finds in favour of the appellant.

2. The minority of the Board takes the view that three reasons led to the payment of Sum A: satisfactory services rendered by the appellant resulting in the absence of any termination of cause; the lack of alternative employment and the entry into the restrictive covenants. Sum A should be divided into three parts with a third thereof being allocated to services rendered.

Appeal allowed.

Cases referred to:

Commissioner of Inland Revenue v Goepfert (1989) 1 HKRC 90-003
D24/97, IRBRD, vol 12, 195
Beak v Robson [1943] 1 All ER 46

Tang Hing Kwan for the Commissioner of Inland Revenue.
Ho Chi Ming Counsel instructed by Messrs Mok Wai Kwong & Co for the taxpayer.

Decision:

The facts

1. Company A is a company incorporated in Hong Kong. At all material times, it was a subsidiary of Corporation A, a company incorporated in the United States.

2. On or about 7 August 1996, Company A engaged the Appellant as its regional managing director, North Asia.

3. By letter dated 15 February 1999 ('the Letter of Appointment'), Corporation A confirmed the Appellant's appointment as 'President - [A] Media International and Managing Director - Regional Client Development for Asia Pacific' with effect from 1 April 1999. The Letter of Appointment provided that:

> ' Finally, as an "insurance policy for peace-of-mind" if you should be terminated from your assignment as President - [A] Media International for other than "cause", we will reassign you to another [company under Group A] opportunity or offer you severance pay for 12 months equal to your base salary at the time in accordance with our Career Transition Plan'.

4. By letter dated 12 January 2001 ('the Letter of Termination'), Corporation A informed the Appellant that the position of president, A Media International 'is being eliminated effective as of February 28, 2001'. The Appellant was told that:

> ' In accordance with [the Letter of Appointment], you would normally be provided with severance pay equal to 12 months base salary in accordance with our Career Transition Plan. We have agreed to provide you with a 13th month of base salary, subject to the condition that you agree to provide us with up to twenty (20) days of consulting during 2001 ... Assuming you are willing to provide these additional consulting services, you would therefore receive 13 monthly payments (commencing in March 2001 and concluding with a payment in March 2002) of HK$173,250 (reflecting your annual base salary of HK$2,079,000)'.

As part of the requirements of the Career Transition Plan, the Appellant was asked to sign a 'Severance Agreement and Release'.

5. The Severance Agreement and Release provided as follows:

(a) By clause 1 that the Appellant's employment with Corporation A be terminated as from 28 February 2001.

(b) By clause 3 that up to 31 March 2002, '[the Appellant] will be reasonably available to consult on matters and will cooperate fully with respect to any claims, litigations or investigations relating to [Corporation A] (and as part of this agreement and as partial consideration for the sums to be paid hereunder, [the Appellant] specifically agrees to provide up to twenty (20) days of consulting services during 2001 ...'

(c) By clause 4 that until 31 March 2002, the Appellant 'will not become a stockholder' of various rival companies of Corporation A and 'will not recruit or solicit any customers of [Corporation A] ... or solicit any employee of [Corporation A] ...'

(d) By clause 9 for the release of Corporation A and its associates by the Appellant from all claims.

(e) By clause 11 that 'the consideration hereunder is given in exchange for all of the provisions hereof'.

6. Corporation A paid the Appellant the following sums:

(a) $2,079,000 ('Sum A') being the sum total of 12 months' base salary at $173,250 per month.

(b) $173,250 ('Sum B') being the additional one month base salary.

7. The issue before us is whether the Appellant is liable for salaries tax in respect of Sum A.

The relevant statutory provisions

8. Section 8(1) of the IRO provides that:

'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 ...'

9. Section 8(1A)(a) of the IRO provides that:

'For the purposes of this Part, income arising in or derived from Hong Kong from any employment includes ... all income derived from services rendered in Hong Kong ...'

10. The interrelationship between these subsections was fully explained by Macdougall J (as he then was) in Commissioner of Inland Revenue v Goepfert (1989) 1 HKRC 90-003:

'As a matter of statutory interpretation I am unable to escape the conclusion that, although sec. 8(1) must be construed in the light of and in conjunction

with sec. 8(1A), sec. 8(1A)(a) creates a liability to tax additional to that which arises under sec. 8(1) ...'.

'*If during a year of assessment a person's income falls within the basic charge to salaries tax under sec. 8(1), his entire salary is subject to salaries tax wherever his services may have been rendered, subject only to the so-called "60 days rule"...'.*

'*On the other hand, if a person, whose income does not fall within the basic charge to salaries tax under sec. 8(1), derives income from employment in respect of which he rendered services in Hong Kong, only that income derived from the services he actually rendered in Hong Kong is chargeable to salaries tax ...'*

11. The Revenue conceded that the Appellant's case does not fall within the basic charge of section 8(1) but falls to be considered under section 8(1A)(a). We are of the view that this is a crucial concession. Sum A is only taxable if it constitutes 'income derived from services rendered in Hong Kong'.

Case of the Revenue

12. In paragraph 4.2 of her closing submissions, Ms Tang for the Revenue submitted that 'The question to be asked is whether the sum in question is an income from employment'. Our attention was drawn to various authorities on that question. Those authorities are illustrative of the 'wider approach' (looking at the *source* of payment) and the narrower approach (looking at the reasons for the payment to see whether the same was in return for services) in determining whether the payment in question is income from employment (see D24/97, IRBRD, vol 12, 195).

13. With respect, that is not the issue under section 8(1A)(a). For the purpose of that subsection, it is insufficient if a sum is sourced from a taxpayer's employment. The sum in question must be 'income derived from services rendered in Hong Kong'.

Case of the Appellant

14. The Appellant gave evidence on oath. He told us that he did not render any service in Hong Kong since 1 March 2001. Despite his agreement to provide 20 days of consulting during 2001, he was not called upon to render any service pursuant to such agreement.

15. Mr Ho, Counsel for the Appellant, placed particular reliance on Beak v Robson [1943] 1 All ER 46. In that case the House of Lords held that a sum paid in consideration of a restrictive covenant is not a 'profit from the office' of a director and manager within Schedule E of the Income Tax Act, 1918. Viscount Simon LC pointed out that:

> *'In the agreement before us, the obligations flowing from the contract of service and the remuneration to be received by the respondent in respect of that service are entirely separate from the restrictive covenant and the consideration which is given for it. The sum £7,000 is not paid for anything done in performing the services in respect of which Robson is chargeable under Sched. E. The consideration which he has to give under the covenant is to be given not during the period of his employment, but after its termination'.*

Our decision

16. Sum A must be clearly distinguished from Sum B. It is clear from the Letter of Termination that the consideration for Sum B was the undertaking of the Appellant to provide 20 days of consulting during 2001. That undertaking has nothing to do with Sum A.

17. The Board is however divided as to whether Sum A is 'income derived from services rendered in Hong Kong'. The majority of the Board takes the view that under the Letter of Appointment, Sum A is only payable if two conditions are satisfied. First, there must be a termination of the Appellant's assignment as president of A Media International. Secondly, there must not be any reassignment of the Appellant within Group A. The entitlement to Sum A is therefore wholly dependent on cessation of the Appellant's connection with Group A. Whilst these are conditions precedent leading to the entitlement of Sum A, they do not suggest that services rendered in the past formed part of the consideration for Sum A. The Letter of Appointment further provides that Sum A is to be paid 'in accordance with our Career Transition Plan'. As indicated by the Letter of Termination, the Severance Agreement and Release is 'part of the Career Transition Plan'. It follows that the covenants in the Severance Agreement and Release formed part of the bargain in return for Sum A. The relevant covenants restrict the activities of the Appellant and prevent him from instituting proceedings against Group A. They do not impose any obligation on the part of the Appellant to render any service in favour of Group A. The majority of the Board therefore finds in favour of the Appellant.

18. The minority of the Board takes the view that three reasons led to the payment of Sum A: satisfactory services rendered by the Appellant resulting in the absence of any termination for cause; the lack of alternative employment and the entry into the restrictive covenants. The minority therefore reckons that Sum A should be divided into three parts with a third thereof being allocated to services rendered. The minority would have directed that the Appellant be taxed on such part of the aliquot third that is attributable to the days that he rendered services in Hong Kong prior to the termination of the Appellant's employment.

19. For these reasons, we allow the appeal and set aside the assessment in respect of Sum A.