Case No. D26/07

Salaries tax – sign-on bonus and settling-in allowance paid at the commencement of employment – upon early termination of the employment the following tax year part of the bonus and allowance refunded to employer – whether the entire bonus and allowance should be treated as income for the year of assessment in which it was paid – sections 8(1), 9(1), 11B, 12(1)(a) of the Inland Revenue Ordinance ('IRO').

Panel: Benjamin Yu SC (chairman), Leung Hing Fung and Keith Yeung Kar Hung.

Date of hearing: 12 December 2006.
Date of decision: 25 September 2007.

The appellant was employed by Bank A as from 21 February 2005. The employment terms provided, inter alia, that the appellant would receive a sign-on bonus of $390,000 payable with his first month's payroll and a settling-in allowance of $66,000. The employment terms further provided that if the appellant resigned within 12 months from his commencement of employment, he would be required to repay the sign-on bonus and the settling-in allowance on a pro rata basis.

In June 2005, the appellant gave notice of resignation, and his employment was terminated on 5 September 2005. The appellant refunded to the Bank a pro rata portion of the sign-on bonus and the settling-in allowance, amounting to $179,506.85 and $30,378.08 respectively.

In the appellant's tax return for the year of assessment 2004/05, the declared total income included the full amount of the sign-on bonus and of the settling-in allowance and the appellant was assessed accordingly. The appellant later wrote to the Commissioner asking for an adjustment of his 2004/05 salaries tax assessment to exclude the refund that he subsequently made to the Bank.

The assessor did not agree to the adjustment. That decision was confirmed by the Deputy Commissioner.

Held:

1. The issue is whether the whole of the sign-on bonus and the settling-in allowance should be treated as income, notwithstanding that the appellant had to refund part of these payments upon termination of his contract.

2. Section 8 of the IRO imposes a charge on a person's 'income' arising in or derived from Hong Kong. 'Income' means 'money received, especially on a regular basis, for work or through investments'. A person cannot be taxed for money that he has not received. This is not affected by the provisions of section 11D(b). This provides that *for the purpose of section 11B*, income accrues to a person when he becomes entitled to claim payment thereof. The purpose of that provision is to assist in determining *when* that is, in which year of assessment should an item of income be taxed. It does not mean that a person who is entitled to receive income but has never received it can be taxed under section 8 (D15/88, IRBRD, vol 3, 223 distinguished).

3. The employment contract should be construed as stating in effect that the appellant was only entitled to receive the full sign-on bonus and settling-in allowance contingent on his having served the full 12 months from the date of employment. He did not, and was thus not entitled to the full sign-on bonus or the full settling-in allowance. As a matter of fact, he did not receive the full sign-on bonus and the full settling-in allowance.

Appeal allowed.

Cases referred to:

D24/05, IRBRD, vol 20, 382
D15/88, IRBRD, vol 3, 223

Taxpayer in person.
Tsui Nin Mei and Fung Chi Keung for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This appeal raises an interesting question of law. The facts are not in issue. We summarise them below.

The Facts

2. The taxpayer ('the Appellant') was employed by Bank A ('the Bank') as a

Vice-President upon the terms of a letter dated 21 January 2005. These terms provided, inter alia, that the Appellant would receive a sign-on bonus of $390,000 payable with his first month's payroll and a settling-in allowance of $66,000. These were one-off payments.

3. In respect of the sign-on bonus, the employment letter went on to provide:

> 'In the event you voluntarily resign or give notice of termination of employment within 12 months from the date on which you join (the Bank), any amount of Joining Bonus paid to you will be immediately payable by you to (the Bank) on a pro-rata basis according to the total number of calendar days you have not worked within 12 months from your employment date. Further, you authorize (the Bank) to make such deductions from any remuneration or compensation accrued and due to you under the terms of this agreement or from any pay in lieu of notice or otherwise, as may be necessary to repay any such sums due to (the Bank).'

4. In respect of the settling-in allowance, the employment letter stated:

> 'Please note that you are required to repay any costs associated with the initial relocation on a pro-rata basis in the event that you resigned or are terminated for cause within the first 12 months from your commencement of employment with (the Bank).'

5. The Appellant commenced his employment on 21 February 2005. In June 2005, the Appellant gave notice of resignation, and his employment was terminated on 5 September 2005. The Appellant came under a duty to repay to the Bank a pro rata portion of the sign-on bonus and the settling-in allowance. This he did by drawing a cheque in the sum of $260,578.40 in favour of the Bank, of which $179,506.85 was the refund of the sign-on bonus, $30,378.08 was the refund of the settling-in allowance and $5,063.01 related to refund for temporary accommodation.

6. In the Bank's initial employer's return to the Commissioner of Inland Revenue in May 2005, the whole amount of sign-on bonus and settling-in allowance were included. In December 2005, the Bank revised the amount to take account of the pro rata repayments made by the Appellant. In its letter accompanying the revised employer's return, the Bank stated:

> 'The return was revised because (the Appellant) was subsequently refunded part of the bonus and allowance (bonus: HKD179,506.85, allowance: HKD30,378.08) to us upon his termination of employment.'

Such revisions were accepted by the Commissioner.

7. In the Appellant's tax return for the year of assessment 2004/05, the Appellant declared his total income for the period from 21 February 2005 to 31 March 2005 to be $540,857.

This sum included the full amount of sign-on bonus and of the settling-in allowance and the Appellant was assessed accordingly. The Appellant later wrote to the Commissioner to ask for an adjustment of his 2004/05 salaries tax assessment. He wrote:

> ' On 9 June 2005, my last day of employment with (the Bank), I returned part of the sign-on bonus, settle-in allowance and temporary accommodation to (the Bank) … In my tax return, I followed (the Bank' s) original employer' s return because I was told that they would not revise the 2004/2005 numbers. After I filed (m)y tax return, I received (the Bank' s) revised Employer' s return for 2004/2005…'

8. The assessor did not agree to adjust assessable income by excluding the amount of sign-on bonus and settling-in allowance which the Appellant repaid the Bank. The Appellant persisted in his objection but his objection was overruled by the Deputy Commissioner in a determination dated 29 September 2006. He now appeals to the Board.

9. The issue before us is whether the whole of the sign-on bonus and settling-in allowance should be treated as the Appellant' s income for the year of assessment 2004/05 notwithstanding that he was obliged to and did repay the sum of $179,506.85 + $30,378.08 = $209,884.93.

Relevant Provisions

10. Section 8(1) is the charging provisions for salaries tax. This reads:

> *'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; and (b) any pension.'*

11. Section 9(1) defines *'income from any office or employment to include any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others …'* There is no dispute that the sign-on bonus and the settling-in allowance come within this definition.

12. Section 11B provides that the assessable income of a person in any year of assessment shall be the aggregate amount of income accruing to him from all sources in that year of assessment. Section 11D(b) provides that 'for the purpose of section 11B', income accrues to a person when he becomes entitled to claim payment thereof.

13. Section 12(1)(a) of the Ordinance makes provisions for deduction of outgoings and expenses (other than expenses of a domestic or private nature and capital expenditure) which are wholly, exclusively and necessarily incurred in the production of the assessable income.

14. We have also been referred to section 68(4) of the Ordinance which places the burden of showing the assessment is wrong or excessive on the taxpayer. We do not think this assists. The appeal does not turn on who has the burden of proof. As indicated above, the question raised in this appeal is one of law.

Discussion

15. The issue in this case is not whether a sign-on bonus is taxable as income. It plainly is, being income derived from an employment of profit. If authority is required for this proposition, it can be found in Case No D24/05, IRBRD, vol 20, 382 and the authorities cited therein.

16. The issue is whether the whole of the sign-on bonus and the settling-in allowance should be treated as income, notwithstanding that the Appellant had to refund part of these payments upon termination of his contract.

17. Ms Tsui, for the Commissioner, focused her submissions on whether the amount repaid by the Appellant to the Bank was a deductible expense under section 12(1)(a). She referred the Board to Case No D15/88, IRBRD, vol 3, 223. There, the taxpayer paid one month's salary to the employer in lieu of notice by returning her final month's salary to her employer. The question was whether her final month's salary was assessable to tax notwithstanding that she had refunded the amount to her employer. The Board held that it was. The Board rejected the argument that the month's salary was a deductible expense. It went on to say:

> *'We would add that in our view it matters not whether the amount paid in lieu of notice was actually paid by way of a physical "refund" after the salary was physically received by the taxpayer or whether, with the consent of the taxpayer and in accordance with the contract, there was a "set-off" and the taxpayer physically received one month's salary less than what he or she would have physically received had there been proper notice given to the employer … We do not, however, see why the mechanics of the payment in lieu of notice should make any difference. The "set-off" would implicitly involve receipt of the month's salary which should therefore be chargeable to tax.'*

18. The Commissioner's argument here was that the refund of $209,885 by the Appellant to the Bank was the price he had to pay for not having fulfilled his obligation to serve for 12 months, and is not an item of expense deductible under section 12(1)(a).

19. We agree that the amount refunded cannot be regarded as deductible expense under section 12(1)(a), although not for the reason advanced by Ms Tsui. In our view, the sum refunded was not paid wholly exclusively and necessarily incurred in the production of assessable income, and is in any event of a capital rather than recurrent nature.

20. This is however not the end of the matter. We have to determine whether, having regard to the facts now established, the Appellant's income in respect of sign-on bonus and settling-in allowance during the relevant year of assessment was the full sum of $456,000 or the sum of $246,115.07 (being the full sum of $456,000 less the amount of $209,884.93 he refunded to the Bank).

21. We have not been able to find any authority directly in point. We should go back to first principles.

22. We start with section 8 which imposes a charge on a person's 'income' arising in or derived from Hong Kong. 'Income' means 'money received, especially on a regular basis, for work or through investments' (see The New Oxford Dictionary of English). A person cannot be taxed for money that he has not received. We do not think this is affected by the provisions of section 11D(b). This provides that *for the purpose of section 11B,* income accrues to a person when he becomes entitled to claim payment thereof. The purpose of that provision is to assist in determining *when* that is, in which year of assessment should an item of income be taxed. It does not mean that a person who is entitled to receive income but has never received it can be taxed under section 8. Take the case of a person who has worked for three months with an employer but has never received any payment because the employer was bankrupt at the end of the three months. No doubt, that person is entitled to claim payment of his salary, but we would be very surprised if section 8 could be read as imposing a tax liability on him to pay salaries tax on income he has never received.

23. The present case is, in our view, distinguishable from the facts in Case No D15/88. There, the payment by the taxpayer of the one month's salary can properly be considered as the price or damages she had to pay for the termination of the contract. This had nothing to do with the fact that she was entitled to and must be taken to have received the last month's salary. As the Board pointed out, the fact that there was a 'set-off' implicitly involved the receipt of the last month's salary. There can therefore be no doubt that she received that income. Receipt can either be physically in the form of cash or be notionally in the form of credit.

24. In the present case, we are of the view that on the proper construction of the contract of employment, the amount that the Appellant had to refund to the Bank cannot be considered as damages for termination of contract. If it were so, it would most likely be unenforceable as a penalty. Rather, we consider that the contract should be construed as stating in effect that the Appellant was only entitled to receive the full sign-on bonus and settling-in allowance contingent on his having served the full 12 months from the date of employment.

25. He did not, and was thus not entitled to the full sign-on bonus or the full settling-in allowance. Did he then, as a matter of fact, receive the full sign-on bonus and the full settling-in allowance? In our view, the answer is no.

26. In the present case the Appellant filed his tax return on 7 November 2005. This was after the time when he refunded part of the sign-on bonus and settling-in allowance to the Bank. If he had stated in his return that the total amount of sign-on bonus and settling-in allowance he received during the relevant year of assessment was $246,115.07 instead of $456,000, we do not think he can be faulted. There is also the oddity in the present case that the Commissioner acceded to the request by the Bank for adjustment in the employer' s return to reduce the expenses the Bank paid on these items, but decided that she could not accept the Appellant' s request for adjustment.

Conclusion

27. In the circumstances, we allow the appeal and remit the assessment to the Commissioner with the opinion of the Board.