Case No. D31/10

Salaries tax – income from employment of profit – sections 8(1), 9(1)(a), 68(4) of Inland Revenue Ordinance ('IRO').

Panel: Colin Cohen (chairman), Edward Cheung Wing Yui and Patrick O'Neill.

Date of hearing: 21 September 2010.
Date of decision: 3 December 2010.

Upon the termination of her employment with Company F, the Taxpayer received, together with other termination payments, a sum of $7,410,000 ('Sum A1') and a sum of $3,370,106 ('Sum B') being the market value of shares vested to her. Sum A1, according to Company F, was the guaranteed bonus mentioned in the taxpayer's employment contract. Sum B was in respect of Company F agreeing that all shares allocated to the Taxpayer under the Company F Bonus Share Plan (Special Allocation) ('the Special Allocation of Shares'), as provided in the employment contract, would vest upon termination.

The Taxpayer claimed that the two sums were paid as compensation for her loss of employment with Company F and should be treated as non-taxable.

Held:

1. The true test for whether income is from an employment of services is whether the payment arose from employment for services past, present or future. Payments made under a contract of employment or as an inducement to enter into an employment are taxable.

2. On the evidence, Company F paid Sum A1 to the Taxpayer based on the terms and conditions of the employment contract. As to Sum B, it is unequivocal and clear that the Special Allocation of Shares was vested to the Taxpayer pursuant to her entitlement under her employment contract, which was a clear inducement for the Taxpayer to take up her employment with Company F. As such, both sums are taxable.

3. Sum A1 and Sum B were clearly not damages for the Taxpayer's forfeiture of her legal and contractual rights. The Taxpayer, while carrying the burden of proof, failed to point to any breach of her contractual rights.

4. One must look at Sum A1 and Sum B separately as being independent components of the relevant terminations payments and consider their

chargeability separately. It is up to the Board to look at the true nature of the relevant payments and the circumstances in which these were made.

Appeal dismissed.

Cases referred to:

Reed v Seymour 11 TC 625
CIR v Elliott [2007] 1 HKLR 297
D80/00, IRBRD, vol 15, 715
Comptroller-General of Inland Revenue v Knight [1986] STC 255
Fuchs v CIR (CACV 196/2008)
CIR v Yung Tse Kwong [2004] 3 HKLRD 192
Mairs v Haughey [1994] 1 AC 303
D87/01, IRBRD, vol 16, 725
D21/09, (2009-10) IRBRD, vol 24, 517
D88/00, IRBRD, vol 15, 771
Richardson (Inspector of Taxes) v Delaney [2001] STC 1328
Henley v Murray (Inspector of Taxes) [1950] 31 TC 351
Shilton v Wilmshurst [1991] 1 AC 684
D126/02, IRBRD, vol 18, 188
D70/01, IRBRD, vol 16, 595
D3/97, IRBRD, vol 12, 115
D13/94, IRBRD, vol 19, 136
D43/93, IRBRD, vol 8, 323
D79/88, IRBRD, vol 14, 160

Taxpayer represented by her tax representative.
Wong Ka Yee and Chan Wai Yee for the Commissioner of Inland Revenue.

Decision:

Introduction

1. The Taxpayer appeals against the determination by the Deputy Commissioner of Inland dated 23 February 2010 in respect of the salaries tax assessment raised on her for the year 2005/06 ('the Determination').

The Issue

2. The issue to be decided by the Board is whether the following sums and benefits the Taxpayer received from her ex-employer, Company F upon termination of employment should be chargeable to salaries tax:

(a) a sum of $7,410,000 referred to as Sum A1 in the Determination; and

(b) a sum of $3,370,106 referred to as Sum B in the Determination being the market value of shares vested to the Taxpayer.

3. The following facts were agreed by the parties and we find them as facts:

‘ (1) [The Taxpayer] has objected to the salaries tax assessment raised on her for the year of assessment 2005/06. The Taxpayer claims that certain payments made to her by her former employer upon termination of employment should not be chargeable to tax.

(2) By a letter dated 18 August 2004 (“the Employment Contract”), [Company F] offered, inter alia, the following terms and conditions to employ the Taxpayer as Managing Director and Head of Coverage, China, Wholesale Clients Strategic Business Unit:

(a) Guaranteed Bonus for 2005 (“the Guaranteed Bonus”)

“In early 2006, [the Taxpayer] will be awarded a one time guaranteed bonus of USD950,000, payable in the equivalent Hong Kong dollars.

No bonus will be awarded or paid if, at the time that the bonus is due to be awarded or paid, (1) [the Taxpayer is] no longer in employment with [Company F]; or (2) [the Taxpayer’s] employment has been terminated by [Company F] with cause …; or (3) [the Taxpayer has] given notice of termination of [her] employment to [Company F]; or (4) [the Taxpayer has] been disciplined under [Company F’s] Disciplinary Procedure and the disciplinary sanction is still current on [her] file.”

(b) Buy-out

“[The Taxpayer] will receive a Special Allocation of Shares in [Company F]. The value of that Special Allocation will be based on the 30 working day (prior to and inclusive of the day of joining [Company F]) average price of the stock and options of [her] previous employer and the number of stock and options forfeited. …

This Special Allocation is subject to [the Taxpayer’s] providing original documentation regarding [her] deferred compensation from [her] previous employer confirming details of vesting dates,

amount awarded, and amount forfeited, and any other scheme rules as applicable.

… That Special Allocation of Shares will be held under the terms of the [Company F] Bonus Share Plan, subject to special vesting conditions depending on [the Taxpayer's] being in service with [Company F] at the time of vesting. …

Any unvested shares will be forfeited should [the Taxpayer] resign to join a competitor or [her] employment is terminated for cause within 12 months from [her] commencement date."

(c) Notice of Termination

"[The Employment Contract] may be terminated during the period of employment:

a) By either party giving 6 weeks' notice in writing or payment in lieu of notice.

b) …."

(3) The Taxpayer accepted the offer and the employment commenced on 27 September 2004.

(4) By a letter dated 10 August 2005 ("the Termination Letter"), [Company F] informed the Taxpayer that her employment with the company would be terminated on the even date by reason of redundancy. The Termination Letter provided, inter alia, the following terms:

(a) Payment in lieu of notice (Clause 2)

"[The Taxpayer] will receive a payment in lieu of 6 weeks' notice including both [her] base salary and housing allowance in [her] final payment."

(b) Termination payment (Clause 3)

"[The Taxpayer] will receive the following termination payments provided that [she accepts] the terms and conditions set out in [the Termination Letter] and sign below to indicate [her] agreement:

i) HK$7,410,000 (USD950,000);
ii) 12 weeks' base salary and housing allowance; and
iii) All shares allocated to [the Taxpayer] under the [Company F] Bonus Share Plan (Special Allocation) ("the Share Plan")

will vest immediately. …

These payments will be included in [the Taxpayer's] final payment."

(c) Final payment (Clause 13)

"The receipt acknowledges that the final payment is paid to [the Taxpayer] in full and final settlement of all [her] entitlements, contractual, statutory or otherwise, on termination, and that [the Taxpayer has] no claims against [Company F] or any of its associated companies or any of [its] or their employees or officers relating to [her] employment, the termination of [her] employment or any other matter including without limitation any contractual claims or statutory claims under Hong Kong law."

The Taxpayer signed on the Termination Letter to signify her acceptance of the terms of the termination of her employment.

(5) In a statement of final payment ("the Statement of Final Payment"), it was showed that the following payments were made to the Taxpayer upon her termination of employment with [Company F]:

		$	
(a)	Salary for 1 August to 10 August 2005 [$227,500 / 31 x 10]	73,387.10	
(b)	Housing allowance for 1 August to 10 August 2005 [$115,000 / 31 x 10]	37,096.77	
(c)	Payment in lieu of unused annual leave [$342,500[1] x 12 / 260 x 17]	268,730.77	
(d)	Payment in lieu of notice for 11 August to 21 September 2005 [$342,500[1] / 31 x 21 + $342,500[1] / 30 x 21]	471,766.13	
(e)	Termination payment including:		
	(i) USD950,000 x 7.8	7,410,000.00	("Sum A1")

	(ii)	12 weeks' base salary and housing allowance [$342,500[1] / 31 x 21 + $342,500[1] x 2 + $342,500[1] / 30 x 2]	939,849.46 ("Sum A2")
			8,349,849.46 ("Sum A")
(f)		Relocation expenses	100,000.00
		Total	9,300,830.23

Note:
(1) $227,500 (basic salary) + $115,000 (housing allowance) = $342,500

(6) The Taxpayer started employment with [Company C] on 1 October 2005.

(7) The Taxpayer's employers filed employer's returns and notifications in respect of the Taxpayer and reported, inter alia, the following particulars for the year of assessment 2005/06:

			[Company F]		[Company C]
(a)	Date of employer's return / notification	:	14-11-2005	16-5-2006	19-6-2006
(b)	Period covered	:	1-4-2005 – 10-8-2005		1-10-2005 – 31-3-2006

(c)	Income particulars	:			
			$	$	$
	Salary		983,387	--	682,499
	Leave pay		268,731	--	--
	Bonus		--	--	1,366,395
	Other reward, allowances or perquisites				
	Termination payment		8,349,849 (i.e. Sum A)	--	--
	Others		159,614	--	32,578
	Dividends		--	125,951	--
	Total		9,761,581	125,951	2,081,472
(d)	Particulars of place of residence provided	:			
	Nature		Flat	[Blank]	Flat
	Period covered		1-4-2005 –	[Blank]	1-10-2005 –

	10-8-2005		31-3-2006
Rent paid by employee	$437,483	[Blank]	$404,786
Rent refunded to employee	$437,483	[Blank]	$354,000

(8) In her 2005/06 Tax Return – Individuals, the Taxpayer declared the same income particulars as per Fact (7) except that she did not include Sum A in her assessable income for the reason that it was a compensation for loss of employment with [Company F].

(9) In reply to the Assessor's enquiry, [Company F] provided the following information in relation to the Taxpayer's termination of employment:

(a) The Taxpayer was made redundant as a result of the internal corporate restructuring of the company and a termination payment was paid by the company to compensate her for the loss of employment.

(b) The payment of USD950,000 (i.e. Sum A1) was the Guaranteed Bonus mentioned in the Employment Contract.

(c) The amount of the Taxpayer's termination payment was calculated in accordance with the company's practice. As such, there was no correspondence in relation to the negotiation of the quantum of the severance payment.

(10) The Assessor considered that the Sum was taxable and raised on the Taxpayer the following 2005/06 Salaries Tax assessment:

	$
Income	
[Company F]	9,887,532 [1]
[Company C] [Fact (7)(c)]	2,081,472
	11,969,004
Add: Value of residence provided	
[Company F]	988,753 [2]
[Company C]	157,361 [3]
	1,146,114
Assessable Income	13,115,118
Tax payable thereon at standard rate of 16% without granting any allowances	2,098,418

Notes:

(1) The amount of income from [Company F] was computed as follows:

$9,761,581 [Fact (7)(c)] + $125,951 [Fact (7)(c)] = $9,887,532

(2) The rental value in respect of place of residence at [Property A] provided by [Company F] was computed as follows:

$9,887,532 [Note (1)] x 10% = $988,753

(3) [Company C] provided to the Taxpayer Property A as her place of residence for the period from 1 October 2005 to 31 January 2006 and [Property D] for the period from 1 February 2006 to 31 March 2006. Hence, the rental value was computed as follows:

$2,081,472 [Fact (7)(c)] x 10% - ($404,786 [Fact (7)(c)] - $354,000 [Fact (7)(c)]) = $157,361

(11) The Taxpayer, through [her former representative] ("the Former Representative"), objected to the assessment in Fact (10) on the grounds that Sum A was a compensation for loss of employment and that it was not related to past, present and future services rendered or to be rendered. Thus, Sum A should be treated as non-taxable.

(12) The Former Representative relied on the following legal principles:

(a) In determining whether a payment was caught by sections 8 and 9(1)(a) of the Inland Revenue Ordinance ("IRO"), one should look at the true nature of the payment. The label of the payment was not determinative.

(b) In Reed v Seymour 11 TC 625, it was determined that payments to be brought into account must arise as a reward for the services, either in the past, present or to be rendered in the future, and not for some other consideration.

(c) In determining the taxability of payment made on termination of employment, the courts had referenced the well-established proposition that a "payment as consideration for the abrogation of a contract of employment, or as damages for it, is not taxable". The court in CIR v Elliott [2007] 1 HKLR 297 supported this proposition.

(d) In the Board of Review Decision D80/00, IRBRD, vol 15, 715, the Board determined that a payment made on account of compensation for loss of employment, or a payment in lieu of or on account of severance pay was not taxable.

(13) In relation to Sum A, the Former Representative asserted that:

(a) The Taxpayer's employment with [Company F] was terminated by reason of redundancy. Thus, Sum A should be regarded as a consideration for the abrogation of a contract of employment, which was outside the scope of Hong Kong Salaries Tax as supported by Elliott.

(b) Sum A was made per clause 13 of the Termination Letter for full and final settlement of all the Taxpayer's entitlements, contractual, statutory or otherwise, on termination.

(c) Sum A was not referenced as a gratuity in any documents.

(d) There was no requirement for the Taxpayer to render any services to [Company F] to receive Sum A.

(e) Sum A was not made on account of any services to [Company F].

(f) Sum A was not paid pursuant to the Employment Contract. Company F was not contractually obligated to pay Sum A and the Taxpayer had no legal right to claim the sum.

(g) The true nature of Sum A was that it was made purely to compensate the Taxpayer for the loss of her employment and its quantum reflected the seniority of the Taxpayer's position.

(14) In relation to Sum A1, the Former Representative asserted that:

(a) The Guaranteed Bonus was forfeited upon the Taxpayer's termination on 10 August 2005. The payment was guaranteed in the sense that the amount was pre-determined in the event the conditions for payment were met. It was not guaranteed in the sense that the Taxpayer was entitled to payment if she was no long working for [Company F].

(b) It was stated in the Statement of Final Payment that Sum A1 was one component of a termination payment and not the Guaranteed Bonus.

(c) Having sought legal advice, the Taxpayer was orally advised that she had no legal entitlement to the Guaranteed Bonus.

(d) The Taxpayer had a series of three discussions with [Mr E], Coverage Head of Asia Pacific for [Company F], during which she negotiated her entire termination payment and USD950,000 was addressed. During the discussions, the Taxpayer was advised that

Company F was not legally obligated to make the USD950,000 payment but it was willing to pay more than the Taxpayer's minimum legal entitlement. [Mr E] acknowledged that the Taxpayer needed to be treated fairly and properly compensated for the loss of her employment.

(e) In the context of a negotiated settlement agreed upon termination of employment, it was uncommon for the parties to determine if there had been an actual breach of employment terms unless a settlement could not be agreed. Such settlement was generally used to avoid further disputes and to draw a line under the issue in as swift a way as possible. A settlement was generally agreed on the basis that it precluded the ex-employee from further action against the employer based on a potential or a contended breach. The purpose of the settlement was to achieve a level of compensation for loss of employment agreeable to the parties without the need to take legal action to determine the existence of a breach.

(f) Sum A1 was proposed by [Company F]. [Company F] took the position that the offer of an amount that exceeded the Taxpayer's legal entitlement and matched the amount she would ultimately have received had her employment not been terminated would possibly exceed her expectations and, depending on the other terms of the termination, avoid a protracted dispute.

(15) [Company F] filed two additional notifications and reported the following remunerations made to the Taxpayer:

Date of Notification	Amount
	$
31-8-2007	1,313,369
14-4-2008	2,005,091
	3,318,460

The Taxpayer agreed to the amounts reported in the additional notifications.

(16) In reply to the Assessor's enquiry, the Taxpayer provided the following information and documents in relation to the shares allocated to her, upon her termination of employment, under the Share Plan (see Fact (4)(b)):

(a) A copy of the terms of issue dated 11 March 2005 ("the Terms of Issue") of the Share Plan which showed, inter alia, the following

terms and details in relation to the allotment of 17,985 shares in [Company F] ("the Shares") to the Taxpayer:

"1. The entitlement of [the Taxpayer] to [the Shares] issued under this Special Allocation will vest in [the Taxpayer] on the following basis:

Date of Vesting	**Proportion of Shares Vesting**
1st September 2005	23% [or equiv. 4,211 shares]
1st September 2006	53% [or equiv. 9,481 shares]
1st March 2007	24% [or equiv. 4,293 shares]

…

4. If a Trigger Event (as defined in clause 5 below) occurs before [the Shares] to which these terms of issue apply have vested in [the Taxpayer], [the Taxpayer] will have no entitlement to [the Shares].

5. Trigger Event means [the Taxpayer] ceasing to be an employee of [Company F] except where an employee resigns from [Company F], in which case the Trigger Event will be the notice of resignation itself, unless the Board in its discretion decides in a particular case that the person's ceasing to be an employee of [Company F] or notice of resignation is not be treated as a Trigger Event for this purpose.

6. If a Trigger Event occurs, entitlements to [the Shares] that have not vested in [the Taxpayer] will lapse and [the Shares] will be treated as forfeited shares for the purposes of the Plan Rules.

…

Value of Special Allocation: [EUR]317,958 [or equiv. 17,985 shares]
Special Allocation Date: 11 March 2005"

(b) A copy of the letter of 1 June 2005 entitled "[Company F] Bonus Share Plan (Special Allocation) Notification of Entitlement" informing the Taxpayer of her entitlement to the Shares.

(c) The Shares were vested and transferred to her on 28 September 2005.

(d) The market value of the Shares on the vesting date was HKD3,370,106 ("Sum B") which was computed with reference to the closing share price of EUR20.10 on the vesting date and the applicable EUR/HKD exchange rate at 9.3226.

(e) She did not pay any consideration for the Shares.

(f) According to the Former Representative, being part of the termination package, the vesting of the Shares was outside the scope of the Hong Kong salaries tax. The terms of issue explained that as a result of her termination, she had no entitlement to any shares under the Share Plan.

(g) [Company F] decided to vest the Shares as part of the termination payment as consideration for the abrogation of her contract of employment.

(17) The Assessor was of the view that Sum A2 was an extra payment in addition to the payment in lieu of notice. She wrote to the Taxpayer to explain her views and proposed to revise the 2005/06 salaries tax assessment to exclude Sum A2 and to include the income of $3,318,460 shown in Fact (15) and Sum B.

(18) The Taxpayer did not accept the Assessor's proposal. She asserted that:

(a) Her termination payment comprised three components, namely Sum A1, Sum A2 and Sum B (collectively referred to "the Sums").

(b) The Sums were non-contractual payments. According to the Employment Contract, she was not entitled to any of the Sums ultimately paid to her upon her termination.

(c) The Sums were negotiated by her during a series of three meetings in July and August 2005 as compensation for the abrogation of her employment contract as a result of being made redundant.

(d) The Termination Agreement clearly showed the terms on which she was willing to accept the Sums as consideration for abrogation of the Employment Contract. Such terms included the rights she surrendered. All her future rights and obligations came to an end.

(e) [Company F] referred to the Sums as a "Termination Payment".

(f) The Sums were not referable to work done.

(g) The Sums were not calculated by reference to work done under the Employment Contract.

(h) The Sums might be regarded as an arbitrary amount paid to her to soften the blow of premature unemployment.

(i) She was never entitled to the Guaranteed Bonus of $7,410,000, which comprised cash and shares, and never received it. She did however receive a separate all-cash termination of $7,410,000 (i.e. Sum A1). The coincidence of these total numbers caused some unnecessary confusion but it did not alter the true nature of the payment.

(j) [Company F's] confirmation that Sum A1 was the Guaranteed Bonus referred to in the Employment Contract could not be relied on. There had been a number of personnel changes in [Company F's] human resources department since her termination and no one currently working there had any first-hand knowledge of her situation. The Sums were negotiated by her and agreed by [Mr E] after a series of discussions. Those who were involved in the discussions recorded and confirmed the outcome of those negotiations in writing as shown by the termination payment in the Termination Letter and the Statement of Final Payment. Those who were involved signed both documents. Besides, [Company F] recorded the payments as termination payment in the notification filed in 2005. The true nature of the payment was not the inconsistent label applied by [Company F's] human resources department.

(k) The Employment Contract stated that the Guaranteed Bonus was payable in early 2006 and subject to [Company F] [Program L] under which some of the amount would have been paid in [Company F] shares which would have vested in future years. The all-cash termination payment of Sum A1 was not subject to [Program L], thus it was clearly not the Guaranteed Bonus referred to in the Employment Contract.

(l) The fact that the Employment Contract contained a contingent "guaranteed bonus" and the fact that a portion of the agreed termination payment was the same amount did not mean the termination payment was therefore related to the employment. While the number was the same as the Guaranteed Bonus the true nature of the payment was very different.

(m) The points of laws determined in Elliott were applicable to her objection. The distinction that Elliott involved the premature

termination of a 5-year contract while her employment contract was of indeterminate length was not relevant in determining the true nature of the termination payments. There was nothing in the judgment (or related precedents – for example, Comptroller-General of Inland Revenue v Knight [1986] STC 255 involved a contract of indeterminate length) that stipulated that for consideration received for the abrogation of rights under an employment contract to fall outside the scope of Hong Kong salaries tax, it must arose from the termination of a fixed-terms contract. The abrogation of a contract of indeterminate length, like hers, might result in more significant consequences given the long-term view taken by both parties when entering into the contract.

(n) The fact that [Company F] had the right to terminate the contract did not mean that she had no contractual or other rights following termination. Nor was it required that specific contractual rights be established in order to receive a compensatory payment for the abrogation of all rights under a terminated contract.

(o) It was not known whether there was any contractual breach or the value of any specific damages to which she might have been entitled. However, she did give up all rights, contractual, statutory and otherwise in return for receiving the termination payment. It was not necessary for her to be entitled to damages under the Employment Contract for the termination payment stemming from her redundancy to be compensatory in nature.

(p) Clause 13 of the Termination Letter was written evidence that she gave up all her rights stemming from the Employment Contract.

(q) A compensatory payment related to the abrogation of an employment contract did not need to be paid in accordance with the Employment Ordinance.

(r) [Company F] wanted to encourage her to abandon her rights under the Employment Contract and leave the company on amicable terms without pursuing any sort of dispute. Given the seniority of her position the size of the Sums was entirely appropriate in the situation.

(19) As a counter offer to the Assessor's proposal, the Taxpayer offered Sum B, but not Sum A1, for assessment. Besides, she elected to compute her rental value of the place of residence provided by her employers with reference to the rateable value of the residence. The Taxpayer proposed that the assessable income for the year of assessment 2005/06 be revised

as follows:

		$	
Income from [Company F]			
Income assessed [Fact (10)]		9,887,532	
Additional income [Fact (15)]		3,318,460	
Share award under the Share Plan (i.e. Sum B)		3,370,106	
		16,576,098	
Less: Termination payment (i.e. Sum A)		(8,349,849)	
		8,226,249	
Add: Value of residence provided		322,051	[1]
	(I)	8,548,300	
Income from [Company C]			
Income assessed [Fact (10)]		2,081,472	
Add: Value of residence provided		363,325	[2]
	(II)	2,444,797	
Assessable Income [(I) + (II)]		10,993,097	

Notes:

(1) With reference to the rateable value of Property A, the value of residence provided by [Company F] to the Taxpayer was computed as follows:

$11,131.50 x 4/0.05 x 132/365 = $322,051

(2) With reference to the rateable value of Property A and [Property D], the value of residence provided by [Company C] to the Taxpayer was computed as follows:

	$
Rateable value of Property A for 1-10-2005 to 31-1-2006 ($11,131.50 x 4/0.05 x 123/365)	300,093
Less: Rent suffered	(50,786)
	249,307
Rateable value of [Property D] for 1-2-2006 to 31-3-2006 ($8,817 x 4/0.05 x 59/365)	114,018
	363,325

(20) The Assessor maintains the view that Sum A1 and Sum B are chargeable to tax. Taking into account the Taxpayer's election for substituting the rental value with the rateable value, the Assessor now considers that the 2005/06 salaries tax assessment should be revised as follows:

	$
Assessable Income from Company F	
Income per Fact (19)	16,576,098
Less: Sum A2 [Fact (5)(e)(ii)]	(939,850)
	15,636,248

Add: Value of residence provided [Fact (19)]		322,051
	(I)	15,958,299
Assessable Income from Company C		
Income per Fact (19)		2,081,472
Add: Value of residence provided [Fact (10)]		157,361 [1]
	(II)	2,238,833
Assessable Income [(I) + (II)]		18,197,132
Tax payable thereon at standard rate of 16% without granting any allowances		2,911,541

Note:

(1) Computation of value of residence provided with reference to the Taxpayer's assessable income is more advantageous to the Taxpayer than the adoption of the rateable value.'

4. The Taxpayer was represented at the hearing by her husband, Mr G, and her grounds of appeal were set out in a notice to the Board dated 23 March 2010. They are as follows:

> ' 1. Neither Sum A1 nor Sum B constitute assessable income because they are part of a compensatory Termination Payment paid to [the Taxpayer] by [Company F] for the abrogation of her employment contract (and in any case are not income from employment).
>
> 2. The IRD arrived at the conclusion based on incorrect facts, analysis and application of the relevant statute and case law.'

The Evidence

The Taxpayer

5. The Taxpayer gave evidence before us. She is presently Vice-President of Investment Banking for Company C. She grew up in Beijing and she graduated from Beijing University and then went to study in the U.S.A. She obtained her first job in Wall Street in 1992. In October 1997, she obtained an offer from Company C and worked with them. She then followed her supervisor to Company H.

6. Whilst at Company H, she was head-hunted by Company F. In spring of 2004, she entered into negotiations with them in respect of an intended move.

7. This was not an easy decision for her to make since she had never worked for a European bank before. However, her discussions were successful and she signed an

agreement with Company F on 18 August 2004 whereby she would take up the post as Managing Director and Head of Coverage, China, Wholesale Clients Strategic and Business Unit. She confirmed that she commenced work with Company F in early 2004.

8. She thought her position with Company F would be a long term employment experience. She had been previously with Company C for twelve years before she went to Company H. She had never been laid off nor had she had any difficulties with her past employers. However, she told us that within Company F, there was a complicated structure and internally, there were various political issues which made it difficult for people who were junior to her to take instructions.

9. She also drew to our attention that she had a difficult relationship with an employee who she asserts had verbally abused her.

10. She drew our attention to various conversations she had at Hotel J, Hangzhou with Mr E. She was undoubtedly worried and concerned about her position with Company F and therefore she tape-recorded these conversations. She took the view that she needed to take such steps as may be open to her to ensure that her position was protected and to enable her to obtain the best termination package from Company F.

11. In cross-examination by Miss Wong, she accepted that her contract was not a fixed term contract. Her attention was drawn to the fact that the notice of termination provided that either party may terminate the agreement by giving the other party six weeks' notice or payment in lieu.

12. Her attention was also drawn to the relevant clauses in respect of the guaranteed bonuses for 2004 and 2005. The Taxpayer was asked in cross-examination by Miss Wong as to whether or not Company F had breached any of the terms of the contract of employment.

13. The Taxpayer's position was that she took the view that she was unfairly treated. She had obtained some advice from her then solicitors, but she could not identify nor draw to the Board's attention any causes of action that she had against Company F. All she told us was that she felt she should receive some compensation.

14. She drew to our attention the fact that due to the difficult relationship with a fellow employee who she asserted swore at her, she felt that she may have certain causes of action against Company F.

15. She felt upset as to the way in which she was treated. However, when asked by the Board as to exactly what causes of action she had, she confirmed that she was fully aware as to the terms of her contract, she accepted that she was only entitled to six weeks' notice as well as her holiday entitlement.

16. On 10 August 2005, the Taxpayer was provided with a notice of termination of employment which she accepted on 11 August 2005. Pursuant to the agreement reached

with Company F, she received various sums which are the subject matter of this appeal.

Mr E

17. Mr E provided a statement dated 23 March 2010. In that statement, Mr E stated as follows:

> '[The Taxpayer] received a Payment to compensate her for her loss of employment and in settlement of any claim she may have been able to allege against [Company F]. Whenever a departing employee is paid anything in excess of statutory or contractual entitlement, a requirement for an executed release of claims by the employee is standard. [Company F] never recognized that [the Taxpayer] had any claim whatsoever against them.'

18. Mr G also asked that the transcripts dated 28 July 2005 (the conversations that took place between Mr E and the Taxpayer at the Hotel J, Hangzhou) and a further transcript of a meeting at the offices of Company F on 5 August 2005 at which the Taxpayer, Mr E and Ms K were present be admitted into evidence. Miss Wong had no objections with these two transcripts being adduced.

The Relevant Legislation

19. Section 8(1) of the Inland Revenue Ordinance ('IRO') is the basic charging section for salaries tax. The Section reads as follows:

> '*(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;*
>
> …..'

20. Section 9(1)(a) of the IRO gives a non-exhaustive definition of the terms 'income from employment' as follows:

> '*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,*
>
> …..'

21. The burden of proof is set out and provided for in section 68(4) of the IRO and it provides:

'*the onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.*'

The Relevant Legal Principles

22. Sum A1 is chargeable to salaries tax if it is income from employment of profits within the meaning of section 8(1) of the IRO. Miss Wong on behalf of the IRD submitted to us the relevant legal principles that are relevant to this appeal. We have no difficulties in accepting these:

'(a) Payment made under a contract of employment is taxable;

(a) Payment made as an inducement entered into an employment is taxable;

(b) Compensation for abrogation of employment contract or breach of it is not taxable;

(c) For a sum to be compensation, it must be shown that there is a loss or surrender of rights on the part of an employee and a legal liability on the part of the employer to pay compensation for the loss of rights;

(d) The mere fact that a sum was paid by an employer to an employee on the occasion of termination of employment is not conclusive of the sum being a compensation for loss of employment;

(e) For tax purposes, the substitute for a payment is treated in the same way as the payment itself.'

23. Our attention was drawn to the following authorities:

(a) Fuchs v CIR (CACV 196/2008);
(b) CIR v Yung Tse Kwong [2004] 3 HKLRD 192;
(c) Mairs v Haughey [1994] 1 AC 303;
(d) Board of Review Decision D87/01, IRBRD, vol 16, 725;
(e) Board of Review Decision D21/09, (2009-10) IRBRD, vol 24, 517; and
(f) Board of Review Decision D88/00, IRBRD, vol 15, 771.

24. Mr G again in the various papers he submitted at the hearing and in his subsequent written submissions provided after the hearing had been completed drew our attention to the following authorities:

(a) CIR v Elliott [2007] 1 HKLR 297;
(b) Comptroller-General of Inland Revenue v Knight [1973] AC 428;
(c) Richardson (Inspector of Taxes) v Delaney [2001] STC 1328;
(d) Henley v Murray (Inspector of Taxes) [1950] 31 TC 351;

(e) Seymour v Reed 11 TC 625;
(f) Shilton v Wilmshurst [1991] 1 AC 684;
(g) Board of Review Decision D126/02, IRBRD, vol 18, 188;
(h) Board of Review Decision D70/01, IRBRD, vol 16, 595;
(i) Board of Review Decision D80/00, IRBRD, vol 15, 715;
(j) Board of Review Decision D3/97, IRBRD, vol 12, 115;
(k) Board of Review Decision D13/94, IRBRD, vol 9, 136;
(l) Board of Review Decision D43/93, IRBRD, vol 8, 323; and
(m) Board of Review Decision D79/88, IRBRD, vol 4, 160.

Our Analysis

25. The Taxpayer was employed by Company F under a written agreement. She commenced her employment on 27 September 2004 and her employment was subsequently terminated with effect from 10 August 2005.

26. Upon termination, Company F made various payments which included Sum A1 (HK$7,410,000) and a further sum of HK$3,370,106 (Sum B).

27. Sum B was in respect of Company F agreeing that all shares allocated to the Taxpayer under the Company F Bonus Share Plan (Special Allocation) ('the Special Allocation of Shares') would vest upon termination. The market value of those shares on that date was the sum that was transferred to her, that is, Sum B.

28. Mr G in his submissions both orally and subsequently in writing asserts that the Taxpayer claims that Sum A1 and Sum B were compensation for her loss of employment and hence were not chargeable to salaries tax. He asserts that they were in essence an abrogation of the employment contract. He asserts that even though Company F were not in breach of the employment agreement, it does not mean there were not other breaches that she could have raised that would entitle her to compensation.

29. He also asserts that whatever the nature of the guaranteed bonus for 2005 and the Special Allocation of Shares, those in turn became in essence a compensatory payment upon termination. He also asserts that she had no legal entitlement to the 2005 bonus or the Special Allocation of Shares. He also concludes that the sum was part and parcel of a total amount of compensatory payment, the nature of which should be considered as a whole.

30. It is up to the Board to consider very carefully the true nature of the payments that were made. Hence, this will be a question of fact that needs to be determined under the circumstances and all available evidence before us.

31. The true test is whether the payment arose from employment for services past, present or future. Miss Wong submits that both Sum A1 and Sum B clearly represented income which arose from the Taxpayer's employment with Company F and were not paid as compensation for the Taxpayer to surrender any of her contractual or legal rights.

Sum A1

32. The Taxpayer contends that this sum was not paid by Company F as the 2005 bonus for services rendered by her in the past. She asserts as we have said above that she had no contractual entitlement to the 2005 bonus and was no longer an employee of Company F at the relevant time when the bonus was paid.

33. However, from the evidence we have heard and the documents we have considered, Company F paid Sum A1 to the Taxpayer based on the terms and conditions of the employment contract. We have no hesitation in concluding that Sum A1 was indeed the 2005 bonus or a substitute for it. Our reasons are as follows:

(a) We accept the submissions of Miss Wong that the Taxpayer ceased employment with Company H on 24 September 2004. In our view, it is quite clear that when Company F offered employment to her on 18 August 2004, it was obvious that the guaranteed bonus including the 2005 bonus provided in the employment contract was undoubtedly an inducement for her to leave her employment with Company H and join Company F. Indeed, this is supported by the transcript of 5 August 2005 meeting when she said:

> ' ….. the reason you give me the guarantee ….. because I'm taking a great risk from my previous job to this job ..…'.

Hence, we have no hesitation in concluding on the relevant authorities that this payment was an inducement to enter into an employment and as such, is taxable.

(b) We also refer to Mr E's meeting with the Taxpayer held on 28 July 2005. At that meeting, Mr E clearly stated that Company F had certain obligations under the employment contract and would like to pay the Taxpayer the full amount of bonus. He stated as follows:

> ' ….. you have a contract, we have certain obligations under that contract which we will honour ….'

> ' ….. we have certain obligations under the contract to ….. you have a guaranteed bonus this year …..'

> ' ….. and our strict obligations under the contract are to prorate that bonus. Ok. Technically, we don't have the obligations to pay the full amount. ….. I would like to pay you the full amount of the bonus …..'

(c) In the August meeting, that followed Mr E also confirmed that Company F would pay the guaranteed bonus, that is, the 2005 bonus in full. He stated as follows:

‘ ….. you do get the guaranteed bonus ….’

‘ ….. the 950 bonus in full …..’

‘ ….. the fact is we are paying the guaranteed bonus …..’

‘ ….. given that we are paying the guaranteed bonus in full …..’

(d) It is also clear in the July meeting, the Taxpayer was aware as to the fact that Company F were going to fulfill the terms of the employment contract which included the payment of the 2005 bonus. Indeed, we accept that no doubt she was told by Mr E that she would obtain her bonus in full. She stated as follows:

‘ ….. so let me just, to be very, very clear, ….. you just told me, you are going to fulfill me contract …..’

Mr E replied:

‘ …. Well, yeah, we will …..’

(e) We also have had the opportunity to consider the letter dated 25 October 2006 from Company F addressed to the IRD. Again, this letter was in response to enquiries raised by the IRD by virtue of their letter dated 4 October 2006. In this letter, Company F confirmed that the payment received, that is, Sum A1 was ‘This was a Guaranteed Bonus for 2005, please refer to the attached employment contract for details’.

34. Therefore, having regard to the transcripts of the various conversations between Mr E and the Taxpayer and in particular, having regard to the correspondence addressed by Company F to the IRD, we have no hesitation in coming to the conclusion that Sum A in essence was the payment of the 2005 guaranteed bonus and this was the true nature of this payment.

35. We did not find the evidence of the Taxpayer convincing. Her assertions were that the monies received were in essence a payment for her not pursuing legal action against Company F. At no time could she coherently draw to our attention any cause of action that she would have other than the fact that she felt her feelings may have been hurt or injured. Indeed, she did take advice from her solicitors. If she did have a cause of action, no doubt she would have been in a position to put to us clearly what that cause of action was. Hence, this again reinforces our position that the payments received by the Taxpayer were derived from the terms of her employment contract, that is, the 2005 guaranteed bonus.

Sum B

36. This is the Special Allocation of Shares which was granted to the Taxpayer pursuant to the buy-out clauses provided in the employment contract. Again, we accept this was specifically mentioned in her employment contract and that the value of the Special Allocation of Shares was based on the average price of the stock and the option of the Taxpayer's previous employer that she forfeited upon joining Company F.

37. We have no hesitation in accepting that this clearly points to the fact that the grant of the Special Allocation of Shares was a clear inducement for the Taxpayer to take up her employment by Company F.

38. As such, we accept Miss Wong's submissions by applying Mairs v Haughey [1994] 1 AC 303 that this inducement was a taxable benefit. Again, in our view, it is unequivocal and clear that the Special Allocation of Shares was vested to the Taxpayer pursuant to her entitlement under her employment contract and as such, they are taxable.

39. There is no evidence before us to show that Company F was in breach of the contract of employment. The terms of the Taxpayer's employment were crystal clear. The employment contract was not a fixed term and notice could be given by either side giving six weeks' notice in writing or payment in lieu of notice. Again, we refer to Mr E's statement whereby he contests any suggestions of Company F being in breach of the contract or that the Taxpayer was entitled to any loss of damages or claims arising from her contractual rights against Company F. Indeed, we also accept there was not any evidence before us showing that she has surrendered or given up any rights for accepting the Sums.

40. We have also considered very carefully the oral submissions by Mr G on behalf of the Taxpayer and his further written submissions. We are of the view that none of these submissions are made out having regard to the facts that we have found.

41. Again, we emphasize that there was no evidence before us to support that Company F had breached any terms of the employment contract.

Conclusions

42. As we have previously indicated, the burden of proof is upon the shoulders of the Taxpayer and as such, Mr G on behalf of the Taxpayer failed to draw to our attention any facts that could suggest that there were any breach of her contractual rights. Hence, the Sum A1 and Sum B were clearly not damages for the Taxpayer's forfeiture of her legal and contractual rights. Again, we have no hesitation in concluding that one must look at Sum A1 and Sum B separately as being independent components of the relevant termination payments and hence, their chargeability needs to be considered separately. It is up to the Board to look at the true nature of the relevant payments and the circumstances in which these were made.

43. Hence, for the reasons given above and having reviewed the evidence and the documents and the transcripts, we come to the conclusion that this appeal must be dismissed.