Case No. D32/04

Salaries tax – gain on share option – Hong Kong sourced vs non-Hong Kong sourced employment – vesting period – services rendered in Hong Kong during non-Hong Kong sourced employment – time apportionment basis – severance payment – whether tax-exempt or not depends not on the label but on all the circumstances in which the payment was made – sections 8 and 9 of the Inland Revenue Ordinance ('IRO').

Panel: Anna Chow Suk Han (chairman), Benny Kwok Kai Bun and David Yip Sai On.

Date of hearing: 17 March 2004.
Date of decision: 20 August 2004.

On 27 September 1995, the Taxpayer, whilst having a non-HK employment with Company C (the predecessor of Company B), was granted a 5-year share option to subscribe for shares in Company B under Company C's stock option plan ('the Plan').

On 15 May 1996:

- Pursuant to the amendment of option agreement, should the taxpayer's employment with Company B be terminated without cause, his option granted under the Plan would be 100% vested and exercisable in full at the time of such termination.

- The taxpayer entered into a written employment agreement ('the Agreement') with and was appointed by Company B as its Vice Chairman - Executive Director for a period of two years from 1 July 1996 to 30 June 1998.

- The Agreement provided that should the taxpayer's employment be terminated without cause by Company B, Company B would pay the taxpayer his base salary (US$330,000 for the first year and US$360,000 for the second year) through the end of the then current term.

In March 1997, there was a change in control of Company B.

The taxpayer objected to the salaries tax assessment for the year of assessment 1997/98 raised on him in respect of the followings:

Share Option Gain

On 2 April 1997, the taxpayer exercised the option and made a gain of HK$20,816,189.

The Revenue contended that since the taxpayer spent numerous days in Hong Kong during the non-HK employment with Company C, time apportionment basis which was proper and appropriate should be adopted for computing the taxable share option gain.

The taxpayer contended that:

- Only the portion of the share option gain which was accrued to him when he had a HK employment with Company B which commenced on 1 July 1996 would be taxable.

- The vesting period should end on the date when the option was exercised on 2 April 1997 and not when the employment was terminated on 31 August 1997.

Severance Payment

On 8 May 1997, Company B served the taxpayer the notice of termination of his employment to be effective on 31 August 1997.

On 7 July, 1997, Company B agreed to bring forward the taxpayer's last date on the payroll to 31 July 1997.

Company B reported in the employer's return of the year ended 31 March 1998, a lump sum of US$363,000 (HK$2,811,435 – base salary for the period from 1 July 1997 to 30 June 1998) as severance payment ('the Sum') to the taxpayer.

The Revenue's case was that the Sum was not compensation in nature. The taxpayer surrendered no rights and received exactly what he was entitled to receive under the Agreement.

The taxpayer contended that:

- The Sum was a compensation for loss of office even though it was a pre-negotiated settlement.

- His employment with Company B was terminated with cause which was by reason of a change in control in which Company B was prevented from performing its contractual obligations.

Held:

Share Option Gain

1. 80% of the share option gain which was derived from the taxpayer's HK-employment with Company B would be fully assessable to salaries tax.

2. For the 20% share option gain which was derived from the non-HK employment with Company C:

   2.1 The vesting period should be the period from 27 September 1995, the date of the grant, to 30 June 1996, the date of termination of the taxpayer's employment with Company C.

   2.2 Section 8(1A)(a) extends the basic charge to salaries tax to include all income derived from services rendered in Hong Kong even when the employment is non-Hong Kong sourced.

   2.3 The taxpayer spent numerous days in Hong Kong during the vesting period from 27 September 1995 to 30 June 1996, thus, subject to the 60 days rule, the portion of the share option gain attributable to the taxpayer's services rendered in Hong Kong was assessable to salaries tax.

Severance Payment

3. The label placed upon a payment is not decisive of its character, all the circumstances in which it was paid have to be examined carefully to determine whether or not it was tax-exempt.

4. The Sum paid by Company B to the taxpayer was in discharge of Company B's obligation under the Agreement which was distinguishable from a payment of damages or compensation for loss of office.

5. The taxpayer's right to the Sum was part and parcel of and derived from the Agreement with Company B rendering the payment an income derived from the taxpayer's employment and was thus taxable.

Appeal allowed in part.

Cases referred to:

Dale v de Soissons 32 TC 118
Williams v Simmonds 55 TC 17
D19/92, IRBRD, vol 7, 156
D90/96, IRBRD, vol 11, 727
D24/97, IRBRD, vol 12, 195
D43/93, IRBRD, vol 8, 323
D16/95, IRBRD, vol 10, 144

Yeung Siu Fai for the Commissioner of Inland Revenue.
Elina Hung of Messrs Elina Hung & Co, Certified Public Accountants, for the taxpayer.

Decision:

The appeal

1. Mr A ('the Taxpayer') objects to the salaries tax assessment for the year of assessment 1997/98 raised on him in respect of the gain realized under the share option scheme and the sum of $2,811,435 being the 'severance payment' ('the Sum') paid to him under his contract of employment with Company B.

The background facts

2. In December 1989, the Taxpayer was employed by Company C, a predecessor of Company B, as Vice Chairman.

3. In January 1993, the Taxpayer was appointed as Company C's President.

4. Company B, a limited liability company incorporated under the laws of Country D, was formed in June 1995. On 26 September 1995, through an initial public offering, Company B was listed on the Stock Exchange in Country E.

5. On 27 September 1995, the Taxpayer was granted an option to subscribe for 200,000 shares in Company B under Company C's 1995 stock option plan ('the Plan'). The option would be vested in the Taxpayer over a period of five years from the date of grant.

6. Pursuant to the amendment of option agreement dated 15 May 1996, should the Taxpayer's employment with Company B be terminated without cause, the Taxpayer's option granted under the Plan would become 100% vested and exercisable in full at the time of such termination.

7. On 15 May 1996, the Taxpayer entered into a written employment agreement ('the Agreement') with Company B. He was appointed Vice Chairman-Executive Director for a period of two years from 1 July 1996 to 30 June 1998.

8. The Agreement provided for the payment, inter alia, of base salary of US$330,000 for the first year commencing 1 July 1996 and US$360,000 for the second year commencing 1 July 1997.

9. The Agreement also provided that the Taxpayer's employment might be terminated without cause by Company B giving the Taxpayer 90 days' notice of termination and in such event, Company B would pay the Taxpayer, inter alia, his base salary through the end of the then current term.

10. The Agreement further provided that the Taxpayer might terminate his employment at any time during the one year period commencing on the date of a change in control as defined in the Agreement and upon termination, the Taxpayer would be entitled to severance benefits equalled to the benefits entitled by the Taxpayer upon termination by employment without cause.

11. In March 1997, there was a change in control of Company B.

12. In April 1997, payment of the share option gain was made to the Taxpayer's designated bank account.

13. By a letter of 8 May 1997 from Company B to the Taxpayer which, as stated by Company B, was served pursuant to the Agreement as the Taxpayer's notice of termination of his employment effective on 31 August 1997, Company B notified the Taxpayer that he would be paid, inter alia, his base salary for the remainder of his current term of the Agreement, that is, 30 June 1998.

14. By a letter dated 7 July 1997, Company B agreed to bring forward the Taxpayer's last date on the payroll to 31 July 1997.

15. In an employer's return in respect of the Taxpayer of the year ended 31 March 1998, Company B reported a lump sum of US$363,000 (HK$2,811,435) representing the Taxpayer's base salary for the period from 1 July 1997 to 30 June 1998 as severance payment.

The statutory provisions

16. The relevant provisions in the Inland Revenue Ordinance ('IRO') are stated below.

17. Section 8

'*(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; and

(b) any pension.

(1A) 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;

…'

18. Section 9

'*(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 ...

...

(d) any gain realized by the exercise of, or by the assignment or release of, a right to acquire shares or stock in a corporation obtained by a person as the holder of any office in or an employee of that or any other corporation.'

19. Section 68(4)

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

The Taxpayer's case

20. The Taxpayer's stance is that he had a non-Hong Kong employment with Company C and a Hong Kong employment with Company B. The Taxpayer's representative ('the

Representative') pleads that the portion of the share option gain which is taxable was the part accrued to the Taxpayer when he had a Hong Kong employment with Company B and not the part accrued while he had a non-Hong Kong employment with Company C. The Representative stressed that the Taxpayer was employed by an overseas company and was assigned to oversee the operation of Hong Kong, and, as such, the Taxpayer should not be subject to Hong Kong salaries tax.

21. Initially, the Taxpayer only objected to the 'numerator' of the formula adopted by the Revenue for the computation of the amount of the share option gain that should be assessable to salaries tax, but now the Taxpayer also objects to the 'denominator' of the formula. It is proposed that the final vesting period of the share option gain should end on the date when the option was exercised, that is, 2 April 1997 and not on 31 August 1997 when the employment terminated.

22. As to the 'severance payment', it is contended that it was a compensation for loss of office and was not a deferred wage nor an income from the Taxpayer's employment and the nature of this payment could not be changed just because it was a pre-negotiated settlement. It is disputed that the Taxpayer's employment was terminated without cause by virtue of clause 8(b) of the Agreement, as contended by the Revenue. The Representative maintains that it was terminated by reason of a change in control under clause 8(e) which prevented the employer from performing its contractual obligations.

The Revenue's case

23. Initially the Revenue contended that the Taxpayer's employment with Company C was a Hong Kong employment. Only at a later stage of the investigation, the Revenue agreed with the Taxpayer that the Taxpayer was having a non-Hong Kong employment when the share option was granted to him on 27 September 1995. Since the Taxpayer spent numerous days in Hong Kong during the period from 27 September 1995 to 30 June 1996, that is, the date before the Agreement became effective; the Taxpayer was the second highest executive of Company C; and Company B, the successor of Company C, maintained its principal executive office in Hong Kong, the Revenue contends that it is reasonable to presume that the Taxpayer did perform duties while he was in Hong Kong and thus the share option gain could be partly attributed to the Taxpayer's services rendered in Hong Kong. It is asserted that the time apportionment basis as adopted in the determination is proper and appropriate for computing the taxable share option gain. However, in view of the new evidence submitted by the Representative that the share option gain was valued on 2 April 1997, the Revenue is prepared to re-compute the Taxpayer's taxable share option gain by adopting the value date of 2 April 1997 instead of 31 August 1997 as the option's final vesting date.

24. It is submitted that the 'severance payment' of $2,811,435 was not compensation in nature. It is argued that for something to be a compensation, it must be shown that there is a loss or surrender of right on the one side and a legal liability on the other to make the payment. As to the Taxpayer's claim that he had the right to an employment which he had to give up on the change in

control of the employer, it is contended that since clause 8(b) provided that Company B was entitled to terminate the Agreement without cause by giving 90 days prior notice, the Taxpayer could not be said to have the right to be employed for a term of two years the termination of which rendered him losing rights and being entitled to compensation.

25. It is asserted that on the authority of 'Dale v de Soissons 32 TC 118' and 'Williams v Simmonds 55 TC 17', the payment under clause 8(b) or clause 8(e) of the Agreement was income from the employment and is taxable. It was a sum agreed to be paid in consideration of the Taxpayer accepting and serving as Vice-Chairman-Executive Director and consequently it was a sum paid by way of remuneration for his services as director. The Taxpayer surrendered no rights and he received exactly what he was entitled to receive under the Agreement. As professed by the Representative, that the provisions of clause 8(e) did induce the Taxpayer to enter into the employment contract, thus the payment under this provision is to be made in the nature of a reward for services to be rendered and not in the nature of compensation.

26. In the event that the Board finds that the 'severance payment' was compensation in nature, it is submitted that 1/12 of the amount should represent the Taxpayer's base salary for the month of July 1997 and is chargeable to tax, since it is clear that the Taxpayer had rendered services to Company B up to 31 July 1997 and he had only reported salary and pro-rata bonus up to June 1997.

The issues for the Board's decision

27. The portion of the share option gain of $20,816,189 which should be chargeable to salaries tax, and

28. Whether the sum of $2,811,435 which was labelled as 'severance payment' received by the Taxpayer upon his termination of employment should be chargeable to salaries tax.

Conclusion

29. The Taxpayer appeared at the hearing of the appeal but chose not to give evidence on his own behalf. He said he had nothing further to add to the evidence given in the course of the investigation. Thus, in considering the issues in this appeal, we mostly rely on the documentary evidence before us.

Share option gain

30. Section 8(1)(a) of the IRO is the basic charging section for salaries tax which provides that salaries tax should be charged on every person in respect of 'his income arising in or derived from Hong Kong' 'from any office or employment'. The expression 'income arising in or derived from Hong Kong' in section 8(1)(a) is referrable to the locality of the source of income and

not the place where the duties of the employee are performed. The place where the services are rendered is not relevant to the inquiry under section 8(1)(a) as to whether income arises in or is derived from Hong Kong from any employment and should be ignored. Hence, if the locality of the source of income is Hong Kong, salaries tax is payable on the whole of the income arising from this employment even if some of the duties of this employment were performed outside Hong Kong. There is no apportionment in this case. Nonetheless, if no services were performed in Hong Kong in respect of an employment, liability to salaries tax does not arise. However, by virtue of section 8(1A)(a), the basic charge to salaries tax is specifically extended to include all income derived from services rendered in Hong Kong, including leave pay attributable to those services. As a consequence, when a person provides services in Hong Kong subject to the 60 days rule, he or she will be liable to salaries tax even though the source of his or her employment is not located in Hong Kong. At the hearing, the Revenue submitted that since the Taxpayer had agreed that he had derived a share option gain of $20,816,189 and that a portion of it should be chargeable to salaries tax, the issue on the share option gain only hinged on the method of apportionment. In this regard, the Representative maintains on behalf of the Taxpayer that the portion of the share option gain which is liable to salaries tax is the portion arisen during the period when the Taxpayer had a Hong Kong employment commencing on 1 July 1996, and not the portion arisen during the period before the Hong Kong employment.

31. It has all along been the Taxpayer's case that the Taxpayer had a non-Hong Kong employment with Company C prior to 1 July 1996 and a Hong Kong employment with Company B commencing on 1 July 1996. The Taxpayer declared his salary, leave pay and bonus received from Company B in his 1997/98 salaries tax return [fact 1(11) in the determination] and the assessor accordingly raised salaries tax assessment on the Taxpayer in respect of these three items of income [fact 1(19)(c) in the determination]. By assessing the Taxpayer fully on these three items of income, the Revenue had accepted that the Taxpayer's employment with Company B was a Hong Kong employment. In the Revenue's written submission, no denial was made in this respect. It is also our observation from the documents supplied for this appeal that throughout the investigation and in the correspondence between the Representative and the assessor, the assessor had never denied the Taxpayer's claim of having a Hong Kong employment with Company B. The assessor only asserted that the Taxpayer had a Hong Kong employment with Company C even before his entering into an employment agreement with Company B. Only in the response to the questions from the Board during the hearing, the Revenue for the first time took the stance that since Company C and Company B belonged to the same group and the Taxpayer's employment with Company C was a non-Hong Kong employment, the Taxpayer's employment with Company B was thus a non-Hong Kong employment. However, we cannot agree to this stance of the Revenue. Notwithstanding the fact that Company C and Company B belonged to the same group, it does not follow that because the Taxpayer's employment with Company C was a non-Hong Kong employment, his employment with Company B should remain a non-Hong Kong employment. We would say that it all depends on the facts of the case. Thus, as opposed to the Revenue's submission that the issue of the share option gain only hinges on the method of apportionment, there

is also the question of whether the Taxpayer's employment with Company B was a non-Hong Kong employment or a Hong Kong employment to decide.

32. Having perused the documentary evidence before us, apart from the aforesaid facts, we have also found the following additional facts upon which we come to the conclusion that the Taxpayer's employment with Company B was a Hong Kong employment:

(a) It is provided under clause 3(a) of the Agreement that the Taxpayer was to report to the Chairman of the Board of managing director and to the Board [B1-page 46]. The Chairman of the Board of managing directors was Mr F. It is a known fact that Mr F lives and stations in Hong Kong. The Revenue also accepts the fact that Mr F's family is in Hong Kong [R1-page 14].

(b) Clause 7(b) of the Agreement provides that the Taxpayer was entitled to the use of an automobile in Hong Kong [B1-page 48].

(c) Clause 19 of the Agreement provides that any dispute or controversy arising from or in connection with the Agreement should be submitted to binding arbitration in Hong Kong [B1-page 55].

(d) Clause 20 of the Agreement provides that notices to the Taxpayer were to be sent to the Taxpayer at the company's address or at his last known residence in Hong Kong. The company's address was also in Hong Kong [B1-page 55]. The Taxpayer was working and residing in Hong Kong at the material times.

(e) In the amendment of option agreement, the Taxpayer was described as a resident of Hong Kong [B1-page 43].

(f) The Revenue was informed by the Representative that the Taxpayer did not become an employee of Company B until 1 July 1996 when he took up the position of 'Vice-Chairman-Executive Director' of a subsidiary 'Company G' in Hong Kong [R1-page 1].

(g) The Taxpayer's employment was to manage the operation of the hotel under Company G in Hong Kong [R1-page 6].

(h) The Taxpayer was relocated to Hong Kong since his employment with Company B on 1 July 1996 [R1-page 9].

(i) By his letter of 6 July 2000 to the Representative, the assessor took the stance that the Taxpayer had taken up a Hong Kong employment since 22 September 1995 [R1-page 14]. Only in his letter of 4 September 2003, the assessor

accepted that the Taxpayer was having an offshore employment when the share option was granted [R1-page 38].

33. It is clear from the above facts that the Taxpayer's employment with Company B was Hong Kong sourced. If the Taxpayer's employment with Company B was Hong Kong sourced, all his income arising from this employment would be subject to assessment of salaries tax. Consequently, if the share option gain or any portion of it did derive from the employment with Company B, such part of the share option gain so derived should be fully assessable to salaries tax. On the other hand, if the share option gain or any portion of it did not derive from the employment with Company B but from the employment with Company C, on the basis that the Taxpayer did perform duties in Hong Kong, subject to the 60 days rule, those days of services rendered by the Taxpayer in Hong Kong during his employment with Company C would be relevant for the purpose of assessing the Taxpayer's share option gain so derived from his employment with Company C but those days of services rendered by the Taxpayer in Hong Kong as from 1 July 1996 would not be relevant for the purpose of assessing the Taxpayer's share option gain so derived from the employment with Company C, because it would be logical to assume that the Taxpayer's services performed in Hong Kong as from 1 July 1996 were performed on account of his employment with Company B and not on account of his non-Hong Kong employment with Company C which had already ceased. Section 11C of the IRO provides that for the purpose of section 11B, a person shall be deemed to cease to derive income from a source whenever he ceases to hold any office or employment of profit. Following from the above, it is necessary for us to consider the source from which the share option gain derived, whether it from the employment with Company C or from the employment with Company B or partly from Company C and partly from Company B.

34. We have before us: the Taxpayer's Agreement with Company B of 15 May 1996, the 1995 stock option plan, unanimous written consent of the board of managing directors of Company B, a summary of the option agreement for the Company B's 1995 stock option plan and the amendment of 15 May 1996 of the option agreement.

35. The Taxpayer's Agreement with Company B of 15 May 1996 was an employment agreement for a term of two years commencing on 1 July 1996. There was the term that the Taxpayer should continue to own options to purchase 200,000 shares of common stock of Company B pursuant to and in accordance with the rules of Company B's 1995 stock option plan and as provided in the Taxpayer's option agreement with Company B dated 27 September 1995 as amended with effect on 1 July 1996.

36. Some relevant terms and conditions of the grant of options under the 1995 stock option plan of Company B are briefly as follows:

(a) the Company, that is, Company B will provide the optionee with a written option agreement in the form approved by the administrator which sets out the

type of option, the grant date, the number of shares of stock covered by the option, the exercise price and the terms and conditions of exercise of the option;

(b) Options granted under the plan are subject to the following terms and conditions and such other terms and conditions not inconsistent with the plan as the administrator may impose:

(i) type of option

(ii) exercise of option – 'In order to exercise all or any portion of any option granted under this plan, an optionee must remain as an officer, employee or director of the Company, or a subsidiary, until the Vesting Date. The option shall be exercisable on or after each Vesting Date in accordance with the terms set forth in the Option Agreement.'

(iii) option term

(iv) exercise price

(v) method of exercise – 'To the extent the right to purchase shares of stock has accrued, options may be exercised, in whole or in part, from time to time in accordance with their terms by written notice from the optionee to the Company.'

(vi) restriction on stock; option agreement

(vii) non assignability of option rights

(viii) exercise after termination of employment, death or disability.
'If an optionee ceases to be the employed by the Company, or a subsidiary, in the case of an incentive stock option, for a reason other than cause, options held at the date of such termination (to the extent then exercisable) and options that otherwise would become exercisable within one year after the date of such termination, may be exercised, in whole or in part, at any time within one year after the date of such termination,'

(ix) compliance with securities law

37. Under the unanimous written consent of the board of managing directors of Company B dated 22 September 1995, the Taxpayer was granted an option to purchase up to 200,000

shares at an exercise price equal to the initial public offering price per share in the offering and that the option will vest ratably over a period of five years from the date of the offering.

38. The amendment of 15 May 1996 amended the option agreement effective as of 27 September 1995 between Company B and the Taxpayer. The amendment provided that

(a) paragraph 2 (d)(i) of the option agreement was amended and restated in its entirety to read as follows:

' (i) Termination of Employment With Cause or Voluntarily
If Grantee' s services to the Company are terminated by the Company for Cause or if, prior to June 30, 1997, Grantee voluntarily ceases to be employed by or to be a consultant or director of the Company, or a Subsidiary, the Option (to the extent then vested and exercisable) may be exercised, in whole or in part, at any time within thirty days after the date of such termination (but in no event after ten years from the Grant Date). If from and after June 30, 1997, Grantee voluntarily ceases to be employed by or to be a consultant or director of the Company, or a Subsidiary, the Option shall become 100% vested and exercisable in full immediately and may be exercised, in whole or in part, at any time until ten years from the Grant Date.'

(b) paragraph 2(d)(ii) of the option agreement was amended and restated in its entirety to read as follows:

' (ii) Termination of Employment Without Cause
If Grantee' s services to the Company are terminated by the Company without Cause, the Option shall become 100% vested and exercisable in full at the time of such termination and may be exercised in whole or in part at any time until ten years from the Grant Date.'

39. The summary of the Stock Option Plan includes a summary of the material terms such as

(a) Grant date: September _____1995

(b) Expiration date

(c) Vesting : 20% per year from the grant date (that is, on June 30 1996, 20% of the option will be vested – on the fifth anniversary of the grant date the option will be fully vested) (may be accelerated due to termination)

(d) Purchase price

(e) Exercise of options

(f) Termination of employment

A. With cause or voluntarily:

i. Vested portion of option must be exercised within 30 days or surrendered

ii. All unvested portions of option are surrendered

B. Without cause:

i. Option fully vests upon termination

ii. Option must be exercised within one (1) year of termination or surrendered

C. Death or permanent or total disability

There is also a foot-note at the end of the summary which says that:

'This summary is not meant as a substitution for the Option Agreement itself and should not be relied upon as a definitive statement of the terms and conditions of the Option Agreement. Please review the terms of the Option Agreement itself for the definitive terms.'

40. We have not been provided with the Taxpayer's option agreement. The Representative informed the Revenue by her letter of 6 October 2001 that there was no 'Option Agreement' as such but the stock option plan was legitimized in the unanimous written consent of the board of managing directors of Company B. However, we are uncertain as to whether this representation was true. We take this view because in the amendment of 15 May 1996 of the option agreement, paragraphs 2(d)(i) and 2(d)(ii) of the option agreement were specifically mentioned and were amended and restated in their entireties in the amendment of 15 May 1996. The headings of those paragraphs '2(d)(i)' and '2(d)(ii)' referred to in the amendment did not appear in the stock option plan or the unanimous written consent of the board of managing directors of Company B. We also note that the legal counsel of the Company B group informed the Representative that they sent her all documents which they could locate. Among them, there was not an option agreement. This information from the legal counsel of the Company B group did not suggest that there was in fact no option agreement. It only said that all documents found were sent

to the Representative. Further, with the remark in the foot-note of the stock option plan summary, we believe it will be unsafe for us to apply the terms as summarized in the stock option plan summary as the terms of the Taxpayer's option agreement. Thus, on the basis of the aforesaid, we shall not apply the terms summarized in the stock option plan summary to the Taxpayer's employment with Company C. On the other hand, the 1995 stock option plan provided the terms and conditions subject to which the options were granted and the other terms and conditions imposed by the administrator must not be inconsistent with those in the plan.

41. A term in the 1995 stock option plan provides that if an optionee ceases to be employed by Company B or its subsidiary for a reason other than cause, options held at the date of termination (to the extent then exercisable) and options that otherwise would become exercisable within one year after the date of termination may be exercised, in whole or in part, at any time within one year after the date of termination. Under the unanimous written consent of the board of managing directors of Company B, the Taxpayer's options should vest ratably over a period of five years from the date of offering which was 27 September 1995. Thus, according to these provisions, upon the Taxpayer's termination of his employment with Company C on 30 June 1996, only 20% of the 200,000 shares became vested in the Taxpayer and exercisable by him within one year after the date of termination with Company C. However, the Taxpayer exercised 100% of the share option on 2 April 1997.

42. The Taxpayer's Agreement with Company B of 15 May 1996 provides that the Taxpayer shall continue to own options to purchase 200,000 shares pursuant to the rules of the 1995 stock option plan and as provided in the Taxpayer's option agreement dated 27 September 1995 as amended with effect on 1 July 1996. The amendment of 15 May 1996 provides that if the Taxpayer's services to Company B shall be terminated without cause, the option shall become 100% vested and exercisable in full at the time of such termination. As provided in the 1995 stock option plan, the terms in any option agreement should not be inconsistent with those in the plan. Thus, although we have not been provided with the Taxpayer's option agreement, we believe that those terms in it must be consistent with those in the plan. That being the case, upon the termination of the Taxpayer's employment with Company C, only 20% and not 100% of the option granted to the Taxpayer became vested and exercisable by the Taxpayer. If 100% of the share option were to be vested and exercisable by the Taxpayer upon the termination of his employment with Company C, the term in the Agreement with Company B that he would continue to own option to purchase 200,000 shares would be unnecessary and would not be so provided. Thus, if it was not for the Taxpayer's employment with Company B which granted him a right to continue to own options to acquire 200,000 shares, the Taxpayer would not have been entitled to exercise the remaining of the 100% of the share options after the termination of his employment with Company C. Consequently, we do not accept that the Taxpayer's share option gain wholly derived from his employment with Company C. In reaching this view, we have taken into account the facts that the amendment of the option agreement and the Agreement with Company B were both dated 15 May 1996 and the amendment came before the Agreement. However, notwithstanding the amendment came before the Agreement, these two documents were to take effect simultaneously on 1 July

1996 which was also the commencement date of the Taxpayer's employment with Company B. Hence with the amendment to take effect on 1 July 1996, there is no room for argument that the terms of the option agreement as amended on 15 May 1996 were applicable to the Taxpayer's employment with Company C because the Taxpayer's employment with Company C in fact ended on 30 June 1996.

43. The amendment of the option agreement of 15 May 1996 provides that if the Taxpayer's services to Company B shall be terminated without cause, the option shall become 100% vested and exercisable in full at the time of such termination. In this regard, we have not overlooked the fact that the value date was 2 April 1997, a date earlier than the date of the notice of termination given to the Taxpayer by Company B and the date of termination of the Taxpayer's employment with Company B. This earlier date might suggest that 100% of the share option gain could have derived from the first employment with Company C, otherwise, the Taxpayer would not be entitled to exercise all his entitlement prior to the termination of his employment with Company B. We do not believe it was the case. We were informed by the Representative through her letter to the Clerk of this Board of 24 December 2003 that the written notice of termination given in the letter by Company H for Company B to the Taxpayer of 8 May 1997 was not meant to be a notice since it was well understood by the parties that upon the change of control of Company B, the Taxpayer's employment with Company B would terminate, and thus, after the change of control which already took place before the written notice in the letter of 8 May 1997, the Taxpayer exercised the option on 2 April 1997. The change of control took place in March 1997. Under the 1995 stock option plan, clause 6(b)(v) provides that options may be exercised in whole or in part to the extent the right to purchase shares has accrued. By virtue of the said understanding between the parties, the parties had accepted that after the change of control of Company B, the Taxpayer's employment with Company B was to terminate and his right to acquire the shares had thus accrued. Accordingly, the right was so exercised by the Taxpayer on 2 April 1997. We find the Taxpayer's right to acquire the remaining shares derived from the Agreement and in accordance with the amendment of the option agreement, the right became vested and exercisable when the Taxpayer's services to Company B was to terminate.

44. We note that the Representative maintains on behalf of the Taxpayer that the portion of the share option gain that should be assessable to salaries tax is the portion derived during the period when the Taxpayer had a Hong Kong employment commencing on 1 July 1996 and not during the period when the Taxpayer had a non-Hong Kong employment with Company C. This claim is made by the Representative notwithstanding the fact that in the course of the investigation, she provided the information to the assessor that while the Taxpayer was an employee of Company C, he was working on the restructuring of the hotel under Company G, leading to the listing of Company B in the Country E Exchange and for this purpose the Taxpayer visited Hong Kong before and after the listing in September 1995. In this regard, in the absence of evidence to the contrary, we agree with the Revenue that it is reasonable to assume that the Taxpayer did perform duties under his employment with Company C while he was in Hong Kong. On the basis of the Representative's said contention, there is perhaps a misconception of law on the part of the

Representative. The Representative seems to have taken the view that a taxpayer is not liable to salaries tax for income derived from a non-Hong Kong employment. In this connection, she has seemingly overlooked section 8(1A)(a) of the IRO which extends the basic charge to salaries tax to include all income derived from services rendered in Hong Kong even when the employment is non-Hong Kong sourced. It is by reason of this subsection that the Taxpayer's services rendered in Hong Kong are relevant to the chargeability of the share option gain to salaries tax even though the Taxpayer's employment with Company C was a non-Hong Kong employment.

45. Following from the above findings, we conclude that 80% of the share option gain derived from the Taxpayer' s employment with Company B which was Hong Kong sourced and is thus fully assessable to salaries tax and 20% of the gain derived from the employment with Company C which was non-Hong Kong sourced. As to the said 20%, we do not intend to disturb the time apportionment basis adopted by the Revenue and as agreed by the Representative, which we also believe is a proper and appropriate method under the circumstances to calculate the portion of it which is assessable to salaries tax in Hong Kong. However, we find that the vesting period of these 20% gains should be the period from 27 September 1995, the date of the grant of the right, to 30 June 1996, the date of termination of the Taxpayer' s employment with Company C when 20% of the right became vested and exercisable within one year after the termination of employment with Company C pursuant to a term under the 1995 stock option plan. Accordingly, subject to the 60 days rule, the amount of this portion of the share option gain should be computed as follows:

$$\frac{\text{The number of days when the Taxpayer was in Hong Kong during the vesting period between 27-9-1995 and 30-6-1996}}{\text{The number of days during the vesting period between 27-9-1995 and 30-6-1996}} \times 20\% \text{ of the share option gain of } \$20,816,189.00$$

Severance payment

46. The Revenue has provided us with the following legal authorities on the issue of 'the severance payment':

1. Dale v de Soissons 32 TC 118
2. Williams v Simmonds 55 TC 17
3. Board of Review Decision D19/92, IRBRD, vol 7, 156
4. Board of Review Decision D90/96, IRBRD, vol 11, 727
5. Board of Review Decision D24/97, IRBRD, vol 12, 195
6. Board of Review Decision D43/93, IRBRD, vol 8, 323
7. Board of Review Decision D16/95, IRBRD, vol 10, 144

47. It is the Revenue's practice to exempt from salaries tax severance payments made in accordance with the Employment Ordinance. If the severance payment to an employee exceeds the employee's entitlements under the Employment Ordinance, the excess will be subject to tax. A payment made as compensation for the loss of employment or settlement of a claim for damages for wrongful dismissal is also not assessable to salaries tax. It is accepted that such payment does not arise from employment because the employment has been terminated. However, to determine whether a payment is indeed a severance payment or compensation for loss of office as opposed to a payment for services rendered, a gratuity or some other taxable sum the circumstances under which the payment is made must be carefully examined. It is important to ascertain the true nature of the payment. It is the real nature of the payment and not the label placed upon the payment that will determine whether or not it is exempt from tax.

48. In this appeal, the payment of $2,811,435 has been labeled as salary, severance payment and compensation. By a letter of 8 May 1997, Company B notified the Taxpayer that upon termination of his employment, he would be paid his salary and bonus for the remainder of the current term of his contract. In the employee's return in respect of the Taxpayer for the year ended 31 March 1998, the sum of $2,811,435 was described as 'severance payment'. Clause 8(f) of the Agreement stated that any amounts due under clause 8 were in the nature of severance payments. In response to the assessor' enquiries, Company H, the successor of Company B, informed the assessor that there was a change in control of Company B as a result of which the Taxpayer's employment was terminated and pursuant to clause 8(e) of the Agreement, the Taxpayer was entitled to a lump sum payment of US$363,000 (Hong Kong dollar equivalent $2,811,435) representing compensation for the rest of the contract term, that is, from 1 July 1997 through 30 June 1998. Thus, as can be seen, we cannot rely on the label placed upon a payment to decide its character. It is necessary to examine carefully the circumstances in which it was paid as to determine whether or not it is tax-exempt.

49. Clause 8(e) of the Agreement provides that if at any time during the one year period commencing on the date of a change in control the Taxpayer terminates his employment, the Taxpayer shall be entitled to severance benefits provided in clause 8(b) (i)(ii) and (iii). Clause 8(b)(i) provides payment to the Taxpayer of base salary and bonuses through the end of the then current term. Clause 8(b)(ii) provides the Taxpayer's entitlement to all medical, dental and life insurance coverage and all other welfare benefits until the end of the then current term. Clause 8(b)(iii) provides the Taxpayer's entitlement to any amounts owing to the Taxpayer but not paid, by way of reimbursement of business and other expenses or under any employee benefit programme participated by the Taxpayer. By reason of this provision, in the event that the Taxpayer's employment is terminated by reason of a change in control of the employer, the Taxpayer will be entitled to all payments of salary, bonuses and any other sums due to him and any other employee benefits which he would be entitled for the entire term of the employment contract as if his employment had not been terminated. In other words, the Taxpayer will be fully paid and will suffer no loss as a result of the early termination of his employment contract upon a change in control of the employer. These entitlements of the Taxpayer upon a change in control of the employer were

made a term of his employment agreement with Company B. The Taxpayer's right to the payment derived from the Agreement itself. The payment of $2,811,435 was a contractual obligation on the part of Company B. This payment was made by Company B in discharge of its contractual obligation under the Agreement. This payment is distinguishable from a payment of damages or compensation for loss of office. A payment of damages or compensation for loss of office is made not in compliance with a term of the employment contract. On the contrary, it is made as a result of non-compliance with a term of the employment contract. The natures of these two types of payment are totally different. One is contractual and the other is not. The provision for payment of $2,811,435 was part and parcel of the Agreement reached between the Taxpayer and Company B rendering the payment of an income derived from the Taxpayer's employment and is thus taxable. For the aforesaid reasons, the Taxpayer's appeal in relation to the 'severance payment' fails and is hereby dismissed.