Case No. D35/85

Board of Review:

H. F. G. Hobson, *Chairman*; Ella Shuk-ki Cheong and John C. Chan, *Members*.

8 January 1986.

Salaries Tax—bonus based on percentage of net profits—payment made in the following year—date of accrual—Section 11D of the Inland Revenue Ordinance.

The Appellant was a director of its employer, a company incorporated in Hong Kong as well as the managing director of its subsidiary in Mauritius. In 1980/81, the Appellant was not exigible to Hong Kong Salaries Tax as he had been working in Mauritius. He was assessed to tax in 1981/82. The employer's Articles of Association provided that director's remuneration should be determined by the company in general meetings. At the general meeting of the employer company held on 31 December 1980, it was resolved, inter alia, that in future a separate bonus be paid to the directors and staff at a rate of not more than 25% of the net profits before tax of the company. Accordingly, a separate bonus in respect of the year ended 31 March 1981 was paid on 23 May 1981 to the Appellant when the profit for that year was ascertained. The Assessor included the bonus as the assessable income for the year of assessment 1981/82; the Commissioner confirmed the assessment.

In an appeal to the Board of Review, it was common ground that Section 11D(*b*) of the Inland Revenue Ordinance provides that income accrues to a person when he becomes entitled to claim payment thereof. The Appellant, by reference to two English cases, argued that the employer had by its resolution on 31 December 1980 committed an obligation to pay the bonus; hence even though the amount was not yet quantified a legal claim arose on that date. The Commissioner contended that the existence of a profit at 31 March 1981 was a contingent condition to the payment of bonus; not until the fulfillment of the condition i.e. when the profit for the year ended 31 March 1981 was ascertained on 23 May 1981 was there any right of action for breach.

Held:

The obligation to pay the bonus by reference to a percentage of net profits could not arise until the profits were established. The English cases provided no assistance as the English laws differ materially from the Hong Kong law.

Appeal dismissed.

D. J. Gaskin for the Commissioner of Inland Revenue.
A. P. Robertson of Messrs. Robertson, Double & Boase for the Appellant.

Cases referred to:—

1. Board of Review Decision B/R 13/74.
2. Heasman v. Jordon, [1954] 3 LLR 432.

3. Dracup v. Radcliffe, [1946] 27 TC 188.

Reasons:

B (the "Taxpayer") is employed by C (the "Employer"), and has been a joint managing director of a subsidiary in D since October 1976. He received a special bonus of $800,000 from the Employer on the 23 May 1981. The Inland Revenue Department assessed him to tax under section 8 for the year 1981/82 in respect of his income arising in or derived from the Colony for that year of assessment and in so doing included the special bonus.

The Taxpayer objected to this treatment, arguing that the special bonus was attributable to the preceding year. The Revenue having accepted that his income for 1980/81 was not exigible to Hong Kong salaries tax as he had then been working in the D, it follows that if the Taxpayer's objection were to prevail the special bonus would also not be taxable. The Acting Deputy Commissioner of Inland Revenue however confirmed the assessments.

On the Taxpayer's appeal to this Board he was represented by Mr. A. P. Robertson, solicitor, whilst Mr. D. J. Gaskin appeared for the Revenue.

The following matters were not in contention:—

1. The Employer was incorporated in Hong Kong on the 8 May 1973.

2. Its Articles included certain provisions of Table A, including Article 65; in pari material the articles read as follows:—

   Article 65:

   "The remuneration of the directors shall from time to time be determined by the Company in general meeting."

   Article 17:

   "Without prejudice to the general powers conferred by the preceding Article and the other powers conferred by these Articles, it is hereby expressly agreed that the director shall have the following powers, that it to say, power:—

   (*k*) to give to any director, officer or other person employed by the Company a commission on the profits of any particular business or transaction and such commission shall be treated as part of the working expenses of the Company, and to pay commissions and make allowances (either by way of a share in the general profits of the Company or otherwise) to any person for introducing business to the Company or otherwise promoting or serving the interest thereof.".

3. At the Annual General Meeting of the Employer company held on the 31 December 1980 the accounts for the year ending 31 March 1980 were approved and it was also resolved:—

> "That a special bonous paid to the directors and staff at a rate of not more than 25% of the Net Profit before tax of the Company in the past years be hereby ratified and that in future a special bonus be paid to the directors and staff at a rate of not more than 25% of the Net Profit before tax of the Company be hereby approved.".

4. By a letter dated the 6 July 1983 the Employer advised the Commissioner of Inland Revenue "that special bonus in respect of the year ended 31 March 1981 was determined early May 1981 when the profit for the year from the 1 April 1980 to 31 March 1981 was ascertained and it was paid on the 23 May 1981".

5. By a letter dated the 8 November 1983 the Employer again wrote to the Commissioner of Inland Revenue and confirmed that "the special bonus payment was a contractual payment. There is no written contract for an executive director but it has been our corporate policy since the establishment of our Company that an executive director was entitled to a special bonus as long as the Company makes profit. We regarded it as part of B's remuneration package and as such a contractual entitlement. B's entitlement to a special bonus accrues throughout the year and it is entitled to claim payment of a special bonus as long as his name appeared on our payroll as at 31 December. Of course the exact amount of its payment must await calculation when the Company's results are known. The general formula is that 25% of the Company's Net Profit before tax is distributed to directors and other staff who are on the payroll on the preceding 31 December."

The Taxpayer became an executive director of the Employer company on the 1 April 1981.

Most of the foregoing matters were treated as facts by the Acting Deputy Commissioner though it is not clear whether he was aware of the resolution of the 31 December 1980. In his reasons for upholding the 1981/82 assessment the Acting Deputy Commissioner said "section 11D(*b*) of the Ordinance further provides that for the purpose of section 11B income accrues to a person when he becomes entitled to claim payment thereof".

Section 11B reads thus:—

> "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." (emphasis added by us).

Section 11D reads (with emphasis added by us) thus:—

> "For the purpose of section 11B—

(*a*) income which has *accrued* to a person during the basis period for a year of assessment but *which has not been received by him in such basis period* shall *not* be included in his assessable income *for that year of assessment* until such time as *he shall have received such income*, when notwithstanding anything contained in this Ordinance, an *additional assessment* shall be raised in respect of such income:
Provided that for the purposes of this paragraph income which has either been made available to the person to whom it has accrued or has been dealt with on his behalf for according to his directions shall be deemed to have been received by such person;

(*b*) income accrues to a person when he becomes entitled to claim payment thereof; …" (we have excluded the two provisions to this paragraph as they are inapplicable.)

We should mention here that the Revenue do not dispute the bonus was *attributable* to the year 1980/81.

Mr. Robertson's submissions before us preceded along the following lines:—

(1) The test of when a person becomes entitled to claim payment depends upon the terms of the service contract of each employee.

(2) In the case of the Taxpayer, though there is no written contract there was a contract between the Employer and the Employee whereby the former would pay a bonus and that obligation was evidenced by the resolution of the 31 December 1980. As to quantification that could be established by looking at bonuses paid to the Taxpayer over the preceding four or five years of employment, the Employer having confirmed that bonuses had been paid to B in the past.

(3) (*a*) The Board of Review Decision B/R 13/74, to which by correspondence prior to the hearing Mr. Gaskin had indicated he proposed to refer, concerned the payment of a gratuity to a government servant three days prior to the end of his service. In that case the Revenue had argued that the *date of payment* of the gratuity was the criterion for the purpose of section 11D(*b*). That Board were of the view that that sub-section was "clearly intended to mean that income accrues to a person when he has a *legal right to receive payment* of that income. In other words, when *his right to payment has crystallized* and he is entitled to "claim"—in the context meaning enforce-payment."

(*b*) Mr. Robertson did not take issue with but rather adopted that proposition and the test appearing later in the report, viz—"looking at the contract are we able to say when the appellant became entitled, as a matter of right, to receive payment". The Board went on to conclude that since the gratuity was conditioned upon completion of the appellant's period of service, his legal right to claim could not arise until completion, hence the anticipatory payment of the gratuity was concessary not obligatory.

(*c*) Having regard to the principle and test aforesaid, Mr. Robertson argued that even though the amount of the bonus could not be established immediately after the 31 December 1980, nonetheless it could be sued upon, leaving the actual amount to be ascertained when the actual profits were known.

(4) (*a*) Whilst Mr. Robertson conceded that the following two English cases, he referred us to depend upon the wording of Schedule E, and Rules 1 and 5 thereto, under the English Income Tax Act, Mr. Robertson considered that the case of Heasman v Jordon (1954 3LLR 432) and Dracup v Radcliffe (1946 27 TC 188) were nevertheless useful precedents because read together sections 11B and 11D(*a*) and its proviso and 11D(*b*) have the same effect as Rules 1 and 5 of Schedule E since both sections turn upon the use of the word "entitled".

(*b*) The argument in Heasman's case was that bonuses demonstrably given as a reward for services rendered during war time but paid on mid-1945 were, so the English Revenue said, "an emolument for the purposes of tax in the year in which it was received". The Commissioner found in favour of the Revenue but the Taxpayer appealed and the relevant portions of the Judgement of Roxburgh, J. read as follows (with emphasis added by us):—

> Rule 1 applicable to Schedule E provides that:
>
> "Tax under this Schedule shall be annually charged on every person having or exercising an office or employment of profit mentioned in this Schedule, or to whom any annuity, pension, or stipend, as described in this Schedule, is payable."
>
> — and there is no doubt that the Appellant comes within that description—
>
> "in respect of all salaries, fees, wages perquisites or profits whatsoever therefrom *for the year of assessment.*"
>
> Rule 5 provides:
>
> "If at any time, either *during the year* of assessment *or in respect of that year,* a person becomes entitled to any additional salary, fees, or emoluments beyond the amount for which an assessment has been made upon him, or for which at the commencement of that year he was liable to be charged, an additional assessment shall, as often as the case may require, be made upon him in respect of any such additional salary, fees or emoluments, so that he may be charged in respect of the full amount of his salary, fees or emoluments for that year."

In my judgment, "for the year of assessment" in Rule 1 means "in respect of the year of assessment"; and, where *reward for services* is in question, means "in respect of services rendered *during the year of assessment*". Sir Lynn first submitted that the words "for the year of assessment" meant "paid during the year of assessment"; but that is, in my judgment, in conflict with two cases to which I will refer.

First of all, there is the Irish case of McKeown v. Roe, (1928) I.R. 195. In that case:

> "The respondent was employed as solicitor to a Harbour Board … and he was to be paid such costs in respect of work done as were taxed and certified by the Taxing Master of the High Court. For work done during the period of his appointment (i.e. from 2 December 1924, to 29 May 1925), he furnished two bills of costs which were not taxed until after 5 April 1925. The total amount of his fees or profits for the period of his appointment was £617, of which £422 was, one the basis of work done, allocated to the year of assessment 1924–1925, the balance being allocated to the following year. From December 2, 1924 (the date of his appointment), until 5 April 1925, he did not receive any payment in respect of his bills of costs except a sum to cover certain disbursements made by him on behalf of the Harbour Board.
>
> Held that he was chargeable to income tax for the year of assessment 1924–25 under Schedule E of the Income Tax Act, 1918, in respect of the sum of £422, notwithstanding, that the bills of costs which included this sum were not taxed or paid within the year of assessment."

The President (Sullivan) towards the end of his judgment said this:

> "The argument on behalf of Mr. Roe is that, as the £422 was not received by him during the year 1924–25, it cannot be taken into account in the assessment for that year. I do not take that view. The effect of Rule 5 is that where a person subsequent to the year of assessment becomes entitled to additions to his salary for that year, these additions are to be taken into account as part of the salary for the year of assessment, 'so that he may be charged in respect of the full amount of his salary, fees, or emoluments for that year'. This seems to me to afford a clear indication that in taxing the profits of an office under Schedule E, such profits are not confined to the amount actually received in the year of assessment, but include fees or emoluments which were earned by the holder of the office during that year, and subsequently paid."

O'Bryne, J., said:

> "All the rules point to the conclusion that, where a person holds an office, the amount which he earns during any particular year of assessment is the amount on which he is liable to be assessed for the tax for that year."

(*c*) The Dracup case was also concerned with the question of a bonus which was voted en bloc for the year ending 30 June 1942 for the Taxpayer and other co-directors by her Employer Company at an AGM held on the 28 July 1942. In anticipation of such vote the directors themselves, immediately preceding the AGM, had resolved how the en bloc bonus should be distributed amongst directors. The Taxpayer contended that at the end of the Company's financial year i.e. 30 June, she had not become entitled to and had not received any part of the monies apportioned to her by the Board — the entitlement she argued only arose on the 28 July 1943. The Commissioner found in favour of the Revenue and Macnaghten J. dismissed the Taxpayer's appeal and we quote (with emphasis added by us the following relevant passages from his Judgment.

> "The point made on behalf of the Appellant is that *when the tax year 1942–43 terminated* at midnight on 5 April 1943, *she was not entitled* to any remuneration for her services during the preceding nine months. It is true there was a hope that the company in general meeting, in exercise of the powers conferred upon it by article 69 of the articles or association, would be pleased to vote some remuneration for the directors, but they had not done so, and they did not do so until 27 July. It is true that they then voted £1,500 free of tax, as they had done the previous year, and it is true that the directors decided that they would each of them take one-quarter of that sum; *but she was entitled, when 5 April 1943 ended, to anything,* and therefore, it is said that, although in fact she has been paid for her services as a director during those nine months, she cannot be assessed to Income Tax in respect thereof for the tax year 1942–43.
>
> That depends on the provisions of Schedule E and the Rules applicable thereto. Tax under that Schedule is chargeable on every person having an office or employment of profit under any company or society whether corporate of not corporate, in respect of all salaries, fees, wages, perquisites or profits whatsoever therefrom *for the year of assessment*.
>
> It seems to me that the case is a very plain one. It is made plainer by Rule 5, which reads thus: '*If at any time,* either *during the year of assessment* or *in respect of that year,* a person becomes entitled to any *additional salary, fees or emoluments* beyond the amount for which an assessment has been made upon him or for which at the commencement of that year he was liable to be charged, an additional assessment shall as often as the case may require, be made upon him in respect of any such additional salary'.
>
> It is obvious that where after the end of a tax year, the salary of the holder of an office is increased as from an antecedent date, say from the 1 January, the person to whom the additional salary is given would be liable to have an additional assessment.

> The case decided in the Irish Courts, McKeown v. Roe (1928) I.R. 195, is clear authority in favour of the view that has been put forward on behalf of the Crown, although that, of course, is not a decision binding upon me."

(*d*) In our view the English law plainly contemplates that bonuses are to be treated as exigible to tax in the basis year in which they were earned—which may or may not be the year in which they are paid: the date of payment is irrelevant. Neither Schedule E nor the rules thereto contain the equivalent of S. 11D(*b*). Granted that, as Mr. Robertson contended, S. 11D(*b*) and Rule 5 use the word "entitled". The English legislation however contemplates the possibility of the entitlement occurring either in the year of assessment or some subsequent year: obviously where the bonus is not expressed as a lump sum but as a percentage of year end profits it is axiomatic that the latter must first be determined before a figure can be put on the bonus and such determination would normally occur after the year's end. (Of course if the employer were an individual with one transation only in the year it is conceivable that the profits could be said to be known after business hours on the last day—that would however be an unusual case.) In England therefore there is relation back to the year in which it was earned—but because of P.A.Y.E. certain concessions apply which need not concern us because they do not change the law. However in Hong Kong the critical date is that upon which a taxpayer is legally entitled to claim payment—that is the "accrual date" for the purposes of section 11D(*a*). We therefore consider that neither of the two cases cited by Mr. Robertson affords precedent on this particular point.

5. Mr. Gaskin for the Revenue contended as follows:—

(*a*) That the Employer in its Returns for the year 1981/82 had included the bonus—albeit with a reference to the fact that it referred to the earlier year. We do not think this Employer's evidence is adverse to the Taxpayer's case; indeed it is understandable that the Employer would file Returns showing payments made during the year to which the Return related even though these payments were in respect of earlier years.

(*b*) The Appellant himself had filed salaries tax returns for the years 1981/82 to 1984/85 in which he treated the bonus as being liable to tax in the year in which he received it rather than the year to which it related. Again we do not think this constitutes evidence against the Taxpayer since we believe that the latter approach would have made no difference to him, since evidently in those years he was liable to tax on other income at the maximum rate; only for the tax year 1980/81 was it material to him to argue that the accrual date occurred within that year.

(*c*) The bonus is only payable "as long as the Company makes a profit" and the profit for the year 1 April 1980 to 31 March 1981 was not ascertained until early May 1981 and that as a matter of chronology, since the Net Profit upon which the bonus was to be calculated must mean the entire fiscal year, there could be no certainty that a profit would be made until after the 31 March 1981 (the end of the Employer's accounting year). Moreover whatever view the directors might have held on the 31 December 1980 they could not be sure that events in the subsequent three months could result in the company incurring a net loss for the entire year.

(*d*) The existence of a profit was a "contingent" condition and referred us to Vol. I para 601 of Chitty on Contracts, 23rd Edition, to the effect that such a condition was a provision that, on the happening of some uncertain event an obligation shall come into force, or that an obligation shall not come into force until such an event happens. In this latter case, the non-fulfilment of the condition gives no right of action for breach; it simply suspends certain obligations of one or other party.

(*e*) In support of this Mr. Gaskin referred to Professor Willoughby's book "Hong Kong Revenue Law" (Vol. 2 at page 2–142) where the author stated that "bonuses and commissions that are related to sales or profits will not accrue earlier than the date when the sales or profits, in respect of which payments are to be calculated, had been ascertained."

(*f*) The Hong Kong tax law on the point differs so materially from the English law that neither the Heasman nor the Dracup cases are reliable authority. For the reasons given above we accept Mr. Gaskin's submission on this point.

We therefore reach the crux of this case, namely was the Taxpayer legally entitled to claim payment of the bonus in question before the 31 March 1981?

Mr. Robertson submitted that a legal claim arose on the 31 December 1980; but we agree with Mr. Gaskin that since the bonus was by reference to a percentage of net profits, rather than a lump sum irrespective of profits, the obligation to pay it could not possibly arise until the net profits were established which, in the absence of evidence to suggest that no further trading or liabilities occurred after the 31 December 1980, would of necessity be after the conclusion of the fiscal year.

Moreover it will be seen from 3 above that there was no commitment to a precise percentage: the words used are "not more than 25% …" In the letter referred to at 5 above the Employer said "The general formula". In short the Employer, probably out of prudence in case problems should arise with any given employee, retained a strong element of discretion.

We have therefore regretably drawn to the conclusion that notwithstanding the 31 December 1980 Resolution and in the absence of (*a*) evidence of the exercise by the Directors of their powers under article 17(*k*) (which might have achieved a point of crystalization prior to the 31 March 1981) and (*b*) convincing legal argument that a legal claim could have been sustained by the Taxpayer prior to the 31 March 1981, the Taxpayer had no legal claim to a bonus before May 1981 because the claim itself was both dependent upon the May 1981 audited results and a decision by the Directors as to the precise percentage of bonus.

We say "regretably" because it is quite clear that his bonus did relate back to a period when the Taxpayer was not liable to tax—it related to work he had done for the Employer company outside Hong Kong—and we have some sympathy for his predicament, but we are bound by our own view of the law.

Accordingly this appeal is dismissed.