Case No. D39/06

Salaries tax – the test whether a payment constitutes an inducement – whether or not the sum of money is a compensation for loss of employment – section 8(1)(a) and 9(1)(a) of the Inland Revenue Ordinance ('IRO').

Panel: Anthony So Chun Kung (chairman), Andrea Fong and Charles Wong Tuk Ching.

Dates of hearing: 21 April and 22 June 2006.
Date of decision: 1 September 2006.

The taxpayer was employed by Bank C. A retention award was provided in the Employment Letter. The taxpayer accepted the transfer of employment to Company D. By letter dated 17 January 2003, Company D terminated the taxpayer's employment.

The taxpayer filed tax return and disputed that a sum of money labeled as retention awards was not constituted as taxable income. It was the stance of the Revenue that the retention award was paid as 'inducement' to the taxpayer and therefore opined that the sum of money was income from the taxpayer's employment and was taxable.

The taxpayer contended that the retention award was not an inducement payment. Secondly, the sum of moneyed was a discounted payment received from Company D as a compensation for abandonment of his right to sue under the Employment Letter. Further if the retention award was in fact an employment income, it should be paid in full and there was no reason why the taxpayer would accept discounted payment. Thirdly, the retention award was a percentage share in a Variable Retention Pool set aside for the benefit of the taxpayer from the beginning of his employment. This Variable Retention Pool was in nature an investment fund. Therefore the Retention Award was the taxpayer's capital return and not his employment income.

The issue is the nature of the sum of money whether it was connected with the taxpayer's employment and therefore assessable to salaries tax.

Held:

1. The test whether a payment constitutes an inducement must be objective and not subjective. The Board have to look into the objective facts surrounding the introduction and payment of the Retention Award. The Board finds that the

retention award constitutes an inducement payment connected with the taxpayer's employment with Company D and is taxable to salaries tax (D80/00, IRBRD, vol 15, 715 and CIR v Yung Tse Kwong [6 HKTC 249] followed).

2. The sum of money was a discounted retention award after negotiation for advance payment. It was still a retention award and still paid by reason of the employment letter. The discounting was voluntarily done by the taxpayer in exchange for and advance payment of what would be due in future. It was a result of commercial negotiation. The taxpayer in substance had suffered no loss in his contractual entitlement to the retention award. In the premises, the Board finds the sum of money a contractual payment of the retention award which was discounted by the parties after negotiation for advance payment. The Board therefore decides that the sum of money was not a compensation for loss of employment (D24/97, IRBRD, vol 12, 195, Mairs v Haughey [1993] STC 569, D76/98, IRBRD, vol 13, 420 and D60/97, IRBRD, vol 12, 367 considered).

3. The Board finds that the Variety Retention Pool was not an investment of the taxpayer and that the retention award was not a capital return. The retention award was plainly part and parcel of the remuneration package of the taxpayer's employment.

4. The Board finds that the sum of money was an inducement payment paid according to the terms of employment of the taxpayer. It constituted the emoluments of the taxpayer's employment with Company D. The sum was therefore chargeable to tax under sections 8(1)(a) and 9(1)(a) of the IRO.

Appeal dismissed.

Cases referred to:

D80/00, IRBRD, vol 15, 715
CIR v Yung Tse Kwong [6 HKTC 249]
D24/97, IRBRD, vol 12, 195
Mairs v Haughey [1993] STC 569
D76/98, IRBRD, vol 13, 420
D60/97, IRBRD, vol 12, 367

Taxpayer represented by his representative.
Leung Wing Chi and Chan Tak Hong for the Commissioner of Inland Revenue.

Decision:

The appeal

1. This is an appeal by Mr A ('the Taxpayer') against the determination of the Deputy Commissioner of Inland Revenue dated 30 December 2005 ('the Determination').

2. In his Determination, the Deputy Commissioner of Inland Revenue maintained the assessment of the assessor to assess the Taxpayer for the year of assessment 2002/03 on a terminal payment of $3,499,068.30 known as retention awards.

Relevant facts

3. We have examined all the documents placed before us and we find the following facts relevant to this appeal:

(1) The Taxpayer signed an employment agreement dated 23 September 1998, commencing his employment with Company B from 1 September 1998.

(2) The remuneration package under the employment with Company B mainly includes:

(a) base salary;

(b) overtime payment;

(c) annual bonus;

(d) deferred compensation upon completion;

(e) reimburse housing expenditure.

(3) By a letter dated 1 April 1999, Company B proposed and the Taxpayer agreed to certain amendments, inter alia, that any deferred compensation balance of the Taxpayer with Company B of 1 January 1999 should earn a return equal to a LIBOR interest rate selected by Company B in its sole discretion.

(4) Company B and Bank C and some other parties entered into a Purchase Agreement dated 4 June 1999. With the consent of Company B, Bank C by a letter dated 8 October 1999 ('the Employment Letter') offered employment

to the Taxpayer 'with his current title (or more senior title) in his current position', an offer of which the Taxpayer accepted on 22 October 1999.

(5) The remuneration package under the employment offered by Bank C mainly included:

(a) base salary;

(b) annual bonus;

(c) transaction bonus

(d) retention award

(e) reimburse housing expenditure.

(6) The retention award was provided in the Employment Letter in the following terms:

'3(e) Retention Award

(i) In addition to the payments provided for in Section 3(a) (basic salary), 3(b) (annual bonus) and 3(c) (transaction bonus), you will be entitled to receive, subject to the terms and conditions specified herein, a Retention Award in an amount equal to .97% of the Variable Retention Pool (the "Retention Percentage") payable in four (4) installments on March 31, 2001, 2002, 2003 and 2004 (each such date a "Payment Date"); provided, however, that with respect to the first three annual payments, 40% of such payment shall be retained by the Company and credited to an account in your name (the "Account") but only to the extent that your accumulated Variable Retention Pool payments exceed (a) USD$11,700,000 multiplied by the Retention Percentage multiplied by (B) the number of previous Payment Dates (including the current Payment Date) divided by four. The cumulative amount of the Variable Retention Pool will vary based on the achievement of cumulative Pre-Tax Income (as defined below) benchmarks for each calendar year over the four year period as set forth on the chart attached hereto as Exhibit A. If the Total Variable Retention Pool Payout (as set forth on Exhibit A), for any year after calendar year 2000, exceeds the Total Variable Retention Pool Payout for the prior

year, the Company will provide you an additional payment equal to (A) the excess of the Total Variable Retention Pool Payout for the current year over the Total Variable Retention Pool Payout for the previous year multiplied by (B) the number of previous Variable Retention Pool payouts that have been made, not including the current payout, divided by four and multiplied by (C) the Retention Percentage. If the Total Variable Retention Pool Payout for the current year is lower than the Total Variable Retention Pool Payout for the prior year, the Company shall reduce the Account by an amount equal to (A) the difference between the Total Variable Retention Pool Payout for the previous year and the Total Variable Retention Pool Payout for the current year multiplied by (B) the number of previous Variable Retention Pool Payouts that have been made, not including the current Payout, divided by four and multiplied by (C) the Retention Percentage (the 'Clawback Payment'). If the Clawback Payment exceeds the balance in the Account, the difference will reduce the current installment of the Variable Retention Pool Payout but not below zero.'

(ii) 'In the event that you are terminated for Cause (as defined below) or voluntarily resign your employment prior to the last Payment Date you shall forfeit any unpaid Retention Award and any balance in your Account. If you are terminated for any other reason you shall continue to be eligible to receive the Retention Award on each Payment Date based on the Benchmark Pre-Tax Income Growth as of such Payment Date.'

(7) Termination of employment was provided in the Employment Letter in the following terms:

' 7 <u>Termination of Employment</u>

Your employment hereunder may be terminated by either party at any time and for any reason upon 30 days advance written notice. Notwithstanding any other provision of this Agreement, the provisions of this Section 7 shall exclusively govern your rights upon termination of employment; provided that your rights with respect to the Retention Award shall continue to be governed by Section 3 above.

…

c. Without cause

The Company, in its discretion, shall have the right to terminate your employment without Cause. Upon the effective date of a termination under this Section 7(c), you shall be entitled (upon your execution of a General Release in the standard form used by the Company) (i) Base Salary earned to the date of termination, (ii) a pro-rata share of any Annual Bonus, or in the case of calendar 1999, the 1999 Bonus (in each case based on service through the Severance Period (as defined below)) otherwise due for the year in which your employment terminates, (iii) continued Base Salary for the Severance Period and (iv) employee benefits continuation for the Severance Period or until you become re-employed, whichever first occurs. All other benefits shall cease or be paid based on your date of termination in accordance with applicable Company policies or plans. No benefit accruals based on service, including, but not limited to, vacation benefits, shall accrue beyond the effective date of termination. For purposes of this Agreement, Severance Period shall mean four weeks per year of service with the Company (including service with the Employer), with a minimum of 2 months for all employees, 3 months for Vice Presidents/Associate Directors and 4 months for Senior Vice Presidents/Directors or higher.'

(8) The Employment Letter was stated as the only and complete agreement of employment in the following terms:

' 15 Other Agreements

You represent and warrant that you are not a party to any agreement or bound by any obligation which would prohibit you from accepting and agreeing hereto or fully performing the obligation hereunder. You further represent and warrant that the terms and conditions of this Agreement constitute Equivalent Terms, as such is defined in your employment agreement with [Company B].

16 Complete Agreements

The provisions herein contain the entire agreement and understanding of the parties and fully supersede any and all prior agreements or understandings between them pertaining to the subject matter hereof. There have been no representations, inducements, promises or agreements of any kind which have been made by either party, or by

any person acting on behalf of either party, which are not embodied herein. The provisions hereof may not be changed or altered except in writing duly executed by you and a duly authorized agent of [Bank C].'

(9) By a letter dated 2 December 1999, Bank C proposed transferring the Taxpayer's employment to Company D with effect from 13 December 1999 on identical terms and conditions (including continuity of service in relation to the Taxpayer's employment that commenced on 1 September 1998) as per the employment letter with Bank C. The Taxpayer accepted the transfer of employment.

(10) By a letter dated 20 March 2000, Company D proposed amending the terms, inter alia, that the Taxpayer's period of continuous employment with Company D shall commence on 1 September 1998 and that the parties could terminate the employment upon three months' written notice or payment in lieu of notice. The Taxpayer accepted the amendment.

(11) By a letter dated 17 January 2003, Company D terminated the Taxpayer's employment with effect from 18 January 2003.

(12) Company D and the Taxpayer reached a compromise agreement and general release ['the Compromise Agreement'] dated 17 January 2003 which included, inter alia, the following terms and conditions:

' 1 Following the termination of the employment of (the Taxpayer) by [Company D] on 17 January 2003 [Company D] will, on the date of the next payroll, … pay to (the Taxpayer) the following amounts; (i) USD60,480.77 which represents payment in lieu of three months' advance written notice; (ii) USD55,592.31 which represents severance; (iii) USD196,182.50 which represents (the Taxpayer's) 2002 Variable Retention Award; and (iv) USD252,416.00 which represents a buy-out of (the Taxpayer's) 2003 Variable Retention Award and 2000 Variable Retention Award holdback both of which are originally payable on March 31, 2004 ((this payment is instead of an not in addition to (the Taxpayer's) rights to receive any Variable Retention payments as described in (the Taxpayer's Employment Letter))…) by way of compensation for loss of employment.

...

5. The arrangements set out in (the Compromise Agreement) are in full and final settlement of all or any claims, costs, expense or rights of action of

any kind whatsoever or howsoever arising …, which (the Taxpayer) has or may have against [Company D] or against any other company in the group of companies … or against any employee, agent or officer of [Company D] … and whether arising directly or indirectly out of or in connection with (the Taxpayer's) contract of employment with [Company D], its termination or otherwise but excluding any claim in respect of personal injury.'

(13) Company D filed a notification by an employer of an employee who is about to depart from Hong Kong ['Form I.R.56G'] in respect of the Taxpayer reporting that the Taxpayer was employed by the company in the capacity of a director during the period from 1 April 2002 to 17 January 2003. The total income accrued to the Taxpayer during the said period was $6,003,368.

(14) Company D provided a breakdown of the above total income as follows:

Item	**Payment Date**	**Amount (HK$ equiv.)**	
Base salary			
- April 2002 to December 2002	Monthly payment	965,250.00	
- 1 January 2003 to 17 January 2003	21-January-2003	58,814.52	
			1,024,064.52
Housing allowance			
- April 2002 to December 2002	Monthly payment	450,000.00	
- 1 January 2003 to 17 January 2003	21-January-2003	27,419.35	
			477,419.35
Cash alternative to pension			
- April 2002 to December 2002	Monthly payment	63,393.75	
- 1 January 2003 to 17 January 2003	21-January-2003	3,411.09	
			66,804.84
Cash in lieu of untaken annual leave	27-February-2003		30,642.85
Payment in lieu of notice (Sum A)	27-February-2003		471,750.00
Severance (Sum B)	27-February-2003		433,620.02
Back pay/ terminal awards and gratuities (Sum C)	27-February-2003		3,499,068.30
Total:			6,003,369.88

(15) The Taxpayer filed his 2002/03 tax return – Individuals declaring that the total income accrued to him during the year was $1,598,931 ($6,003,369.88 - $471,750.00 (Sum A) - $433,620.02 (Sum B) - $3,499,068.30 (Sum C), attaching thereto a schedule on payments of Sum A, Sum B and Sum C as follows:

Payments on Termination Employment

	$	$
Sum A (1)		471,750.00
Sum B (2)		433,620.02
2002/03 Retention Award (3)	1,530,223.50	
Buyout of 2000/01 Retention Award Holdback (4)	760,350.53	
Buyout of 2003/04 Retention Award (5)	1,208,494.27	
Sum C (6)		3,499,068.30
Total:		4,404,438.32

(1) ($107,250 + $50,000) x 3

(2) ($107,250 x 4.043077 (4 weeks per year of service from 1 September 1998 to 17 January 2003)

(3) Originally payable on 31 March 2003

(4) The original holdback amount which was payable on 31 March 2004 was $962,773.50, subject to clawback provision which might reduce the holdback amount depending on performance benchmarks

(5) The maximum possible amount of 2003/04 was $1,530,223.50 depending on performance benchmarks

(6) Retention Awards were not payments for service rendered but compensation for loss of employment paid under the terms of employment contract. They were not earned income.

(16) The assessor was of the view that Sum B and Sum C (but not Sum A) were the Taxpayer's employment income and chargeable to salaries tax. On 26 February 2003, the assessor raised on the Taxpayer the following salaries tax assessment for the year of assessment 2002/03:

	$
Income ($6,003,368 - $471,750 (Sum A))	5,531,618
Less:	
Contributions to recognized retirement schemes	(10,000)
Net chargeable income	5,521,618
Tax payable	828,242

(17) The Taxpayer objected to the above assessment on the ground that only the reported income of $1,598,931 should be taxable.

(18) On behalf of the Taxpayer, Messrs E by a letter dated 18 November 2003 made submissions, inter alia, in respect of Sum C as follows:

'…

2. (Sum C)

…

[Bank C] introduced a retention award scheme. As long as (the Taxpayer) was still employed by the end of March 31, 2001 to 2004, a payment would be given to him by the end of March of four years (from 2001 to 2004). Pursuant to 3.e.(i) of (the Employment Letter), the payment was made to (the Taxpayer) in four annual instalments on March 31, 2001 to 2004. Most importantly, (the Taxpayer) cannot determine how much he can receive as retention award when he signed (the Employment Letter).

(Sum C) was labeled as retention awards but they were given to (the Taxpayer) not due to his services rendered.

The employment between (the Taxpayer) and [Company D] was terminated on January 17, 2003. In order to secure an immediate departure, (the Taxpayer) and [Company D] reached an agreement whereby the retention award of 2003/04 and the holdback amount for 2000/01 were paid at a discount. The discounting factor was determined between (the Taxpayer) and [Company D]. For the retention award of 2002/03, since the employment termination date is quite near the payment date of the third instalment, the retention award was paid to (the Taxpayer) without discounting.

Pursuant to (the Employment Letter), (the Taxpayer) continued to be eligible to receive the retention award on each payment date (i.e. March 31, 2003 and 2004). As [Company D] wanted to terminate its contractual obligation in early 2003, [Company D] had to compensate (the Taxpayer) for what would otherwise have been a breach of contract.

As such, (Sum C) was paid to (the Taxpayer) as a compensation for surrender of his rights to claim [Company D] the remaining balance of the retention awards in subsequent years. In other words, it was paid for the total abandonment of all the contractual rights which (the Taxpayer) had under (the Employment Letter). Hence, it should not be constituted as a taxable income.

Please also note that if the retention awards were payments for his services rendered, (the Taxpayer) would not have accepted to receive a discounted amount…'

(19) By a letter dated 11 January 2005, the Taxpayer put forth further arguments to substantiate his claim that Sum C was not taxable as follows:

'…

1. Capital payment nature of Retention Award

The calculation mechanism of the Retention Award (hereinafter known as "RA") is shown in (the Employment Letter) submitted to you before. According to the terms, 40% of the payments of a qualified employee will be injected into a separate retention pool (hereinafter known as "RP") as principal for future capital appreciation purpose. Employee has no right to operate that pool and he may not know what his actual RP is as it depends on various future factors.

RA will generate from such RP, which is similar to an investment pool for employees (like that of retirement fund). To the employee' s point of view, he cannot ascertain at the beginning of his employment whether he can have RA, whether in the course of employment or during his termination, since:

i. This is not a guarantee payment;

ii. The company may have failed to achieve certain goals that are essential for granting RA and such are beyond employees' control;

iii. RP may fluctuate and there is a possibility that the RP of an employee may be less than the principal originally injected by an employee into the pool. That leads the employee to get nothing from RP, even the circumstances conditions allow the employer

to provide such.

Therefore, the RA is a capital payment to me rather than a service payment, as I can hardly ascertain and anticipate whether I can have such during my employment.

2. Inducement nature of Retention Award

Before the launching of the mechanism of discounting RA, my ex-employer had experienced cases of legal disputes with some terminated employees for payment matters. To avoid such problem again, that discounted RA mechanism has been implemented to compensate those terminated employees by early payments of RA and induce them to give up any legal claim. However, the determination of discounting factor is arbitrary in nature. Since the employee cannot anticipate whether he can get anything in future, he is more willing to accept such discounted RA and surrender future legal sue against the employer.

As the calculation of discount is based on an arbitrary formula factor, it can be justified that the nature of such payment has already deviated from the above said capital payment nature. Also, the original intention of such payment is a compensation inducement to avoid legal disputes being raised from terminated employees.

Therefore, the discounted RA is actually an inducement for me to guarantee no legal action against the employer. Such discounted RA has already been mutated from capital payment to compensation payment.'

(20) The assessor agrees that Sum B was in the nature of compensation for loss of employment and not taxable, but the assessor maintains that Sum C was income from employment and should be chargeable to salaries tax. He proposes to revise the assessment as follows:

	$
Income ($5,531,618 - $433,620 (Sum B))	5,097,998
Less:	
Contributions to recognized retirement schemes	(10,000)
Net chargeable income	5,087,998
Tax payable	763,199

(21) The Deputy Commissioner of Inland Revenue by his Determination dated 30 December 2005 confirmed the revised assessment as proposed by the assessor.

The hearing

4. At the hearing on 21 April 2006, Mr F, the Taxpayer's representative submitted a written submission to the Board, and informed the Board that the Taxpayer had returned to Country G and would not attend the hearing to give evidence. However, Mr F said that the person-in-charge of Company D had agreed to give evidence on the Employment Letter and the Retention Award and its discounting and he was trying to arrange him to give evidence before the Board. With no objection from the Revenue, we adjourned the hearing to allow time to the Taxpayer to arrange a witness.

5. At the adjourned hearing on 22 June 2006, Mr F and his assistant Miss H notified the Board that the Taxpayer would not call any witness, and the hearing would proceed on the documents and submissions submitted by the parties.

6. It has all along been the Revenue's argument that the Retention Award was paid as an 'inducement' to the Taxpayer. The Revenue maintained its stance at the hearing on 22 June 2006. The Revenue in its letter dated 5 June 2003 put to the Taxpayer's former representatives Messrs E, Certified Public Accountants:

> '[Messrs E]
>
> …
>
> Your client was paid what he was entitled to under his employment agreement with his employer…Furthermore, for the purposes of inducing him to stay in the employment, [Company D] offered him a Retention Award. The terms and conditions of such Award are also exhibited in the employment agreement. As such, (the Taxpayer) was paid …the "retention award" pursuant to the employment agreement and (the Taxpayer) had surrendered no rights in consideration for accepting (the Retention Award). (The Retention Award is) therefore not compensation payments.
>
> In view of the above, I opine that the sum of …$3,499,068.30 (is) income from your client's employment and (is) taxable.'

The Taxpayer's arguments

7. Mr F for the Taxpayer summarizes arguments for the Taxpayer's as follows:

(a) Among his remuneration package, the Taxpayer focused mainly on the bonus payment because bonus payment is his major source of income. The Retention Award was too complicated and uncertain a payment that the Taxpayer would not be induced by it into accepting Company D's employment. The Retention Award was therefore not an inducement payment and therefore could not be an income connected with the Taxpayer's employment with Company D.

(b) Sum C was a discounted payment received from Company D as a compensation for abandonment of his right to sue under the Employment Letter. Being compensation payment, Sum C was not connected with Taxpayer's service and therefore should not be assessable to salaries tax. Further, if the Retention Award was in fact an employment income, it should be paid in full and there was no reason why the Taxpayer would accept discounted payment.

(c) The Retention Award was in fact a percentage share in a Variable Retention Pool (the 'VRP') set aside for the benefit of the Taxpayer from the beginning of his employment. The VRP was in nature an investment fund operated by Company D. Value of the Retention Award depended on the performance of the VRP. If the VRP performed well, Taxpayer's Retention Award would increase, if it performed badly, Taxpayer's Retention Award could decrease. Such a variable nature of the Retention Award could not be connected with the services rendered or to be rendered by the Taxpayer as an employee, rather it was a capital appreciation in the value of the Taxpayer's share in the VRP. Basically Mr F argued that because the VRP was in nature an investment fund, the Retention Award being Taxpayer's share in the VRP must necessarily be his profit in his investment fund and therefore his capital return and not his employment income, and therefore should not be assessable to salaries tax.

8. Mr F at the hearing, however, conceded that:

(i) the Retention Award was in fact a device of Company D in 'attracting talents' and in inducing staffs to stay;

(ii) the Retention Award could not cause any loss unto the Taxpayer, the worst was a zero return for the Taxpayer, the Taxpayer could only benefit but never suffer from such an employment term of Retention Award;

(iii) the discounting of Retention Award was related only to the Taxpayer's Retention Award entitlement under the Employment Letter, the Taxpayer had

surrendered no other type or form of rights or claims in return of such discounting.

The issue

9. The issue for this Board to decide is the true nature of the payment of Sum C, whether it was connected with the Taxpayer's employment and therefore assessable to salaries tax.

Analysis and findings

10. We begin with the arguments of the Taxpayer.

An inducement payment?

11. Mr F argued that the Retention Award was not an inducement payment because the Taxpayer was not induced by it. The presumption underlying such an argument is that a payment can be an inducement only if the employee is induced by it, a presumption which depends on the subjective view of a particular employee.

12. The test whether a payment constitutes an inducement however must be objective and not subjective.

13. The Board in D80/00, IRBRD, vol 15, 715, 725 said:

> *'…Of course, Organization B decided to make the payment because it was going to terminate the employment, but that does not begin to explain why the payment could be regarded as compensation for loss of office. Consequently, we do not feel able to attach much weight to Ms C's understanding of the nature of the payment. We have already referred to the Board's decision in D3/97 which made the point that it is not the label, but the real nature of the payment, that is important. Similarly, it would not be right for this Board to take the say-so of an employee or that of the representative of the employer in determining what is the real nature of the payment. This is not to say or suggest in any way that Ms C was not truthful to the Board. It is simply that the Board cannot abdicate its responsibility of finding* ***objectively*** *(emphasis added) what is the nature of the payment on the basis of the evidence before it.'*

14. We have to look into the objective facts surrounding the introduction and payment of the Retention Award.

15. The Retention Award was introduced in the Employment Letter as follows:

> ' In addition to the payments provided for in Section 3(a) (basic salary), 3(b) (annual bonus) and 3(c) (transaction bonus), you will be entitled to receive, subject to the terms and conditions specified herein, a Retention Award in an amount equal to .97% of the Variable Retention Pool (the "Retention Percentage") payable in four (4) installments on March 31, 2001, 2002, 2003 and 2004 (each such date a "Payment Date")'

16. The Employment Letter terms the Retention Award as part and parcel of the remuneration package similar in nature to basic salary, annual bonus and transaction bonus. It is quite obvious that it is a promise to pay in future and accordingly an incentive to induce an intending employee to enter or continue employment, the very fact that a particular employee, the Taxpayer in this case, was not particularly influenced or induced by it could not change the fundamental fact that the underlying nature of such an award was to induce an employee to enter or stay in employment.

17. Indeed, at the hearing, Mr F conceded that insofar as the terms of employment as set out in the Employment Letter are concerned, the Retention Award was a device deployed by Company D, the employer, in ' attracting talents'.

18. In CIR v Yung Tse Kwong [6 HKTC 249, 266], Tang J (as he then was) said:

> *'… I should mention that Mairs v. Haughey is clear authority that payment made as an inducement to enter into employment is taxable, and that it does not matter whether it was paid before, during or on termination of the employment.'*

19. We therefore find that the Retention Award constitutes an inducement payment connected with the Taxpayer's employment with Company D and is taxable to salaries tax.

Compensation for abandonment of contractual rights?

20. It is a fact that Sum C was a discounted payment agreed between the Taxpayer and Company D. But is it in nature compensation paid to the Taxpayer for his abandoning his right to sue under the Employment Letter?

21. In reference to the terms of the Employment Letter, the Taxpayer would suffer no loss in his entitlement to Retention Award upon termination of his employment. Clause 3(e)(ii) clearly states, '….you shall continue to be eligible to receive the Retention Award on each Payment Date …', and each Payment Date has been clearly stipulated in clause 3(e)(i) as '…on March 31, 2001, 2002, 2003 and 2004 (each such date a "Payment Date")…'.

22. The Taxpayer's employment was terminated with effect from 18 January 2003. Pursuant to clause 3(e) of the Employment Letter, the Taxpayer could still continue to receive the Retention Award on 2 more Payment Dates, namely, 31 March 2003 and 31 March 2004. The Taxpayer would suffer no loss upon termination of his employment. Indeed, Mr F conceded at the hearing that the discounting related only to the Taxpayer's entitlement of Retention Award under the Employment Letter, and the Taxpayer had suffered no other type or form of rights or claims in return for such discounting.

23. As rightly put by the Revenue, the discounting of payment was in fact a commercial negotiation for an advance payment of what could be due in future, the extent of the discounting was purely a commercial bargain between the parties; it would be wrong to label such an advance payment as bargained by the parties as a compensation for loss of employment.

24. The Board in D24/97, IRBRD, vol 12, 195, 202 & 203 said:

> '*32. It is true that the determination did not mention the waiver and the compromise. However, it is clear that the Relevant Sum was paid under the relevant clause in the letter of employment. That set out a formula for payment. Mr Vanderwolk for the Taxpayer accepted that if the clause had specified an amount and his client was paid the specified amount, it would have been a contractual payment. But he argued that if the clause set out a formula for payment and there was disagreement over the amount payable under the formula would have made a difference. That cannot be right. This is not a waiver or a compromise on a breach of agreement or a claim for wrongful dismissal. Bank B was entitled to terminate the Taxpayer's employment on the basis of the relevant clause. It is clear that the termination was under that clause and payment was due under that clause. The dispute as to the amount cannot change the nature of the payment. If the original entitlement under the contract is taxable, it does not become non taxable because the parties reached a settlement on the amount payable….'*

25. The above view was endorsed and applied by the Board in D76/98, IRBRD, vol 13, 420, 430-431.

26. And in Mairs v Haughey [1993] STC 569, 577j & 580j, Lord Woolf said:

> '*… It is inevitable that if a payment is made in substitution for a payment, which might, subject to a contingency, have been payable that the nature of the payment which is made in lieu will be affected by the nature of the payment which might otherwise have been made. There will usually be no legitimate reason for treating the two payments in a different way. …*

… As already indicated, the payment made to satisfy a contingent right to a payment derives its character from the nature of the payment which it replaces…'

27. The Board in D60/97, IRBRD, vol 12, 367, 375 & 376 also said:

'One of the major difficulties facing the Taxpayer in this case was that he could not show explicitly what "loss" he had suffered which the Sum was alleged to have recompensed. …

The only specific matter that the Taxpayer referred to in arguing that the Sum was compensation for loss of employment was the contention that his transfer from Company B to Company C resulted in reduced job security in the long term. Whatever the respective financial strengths of Company B and Company C may be (and we have no direct evidence of this matter), the fact is that, after the transfer of the business, Company B still held a sizable 40% interest in Company C. In the circumstances, looking as we must to the substance of the matter in determining the nature of the Sum in dispute, we attach very little weight to the Taxpayer's allegation in this regard.

In the result, the Taxpayer has totally failed to convince us that the nature of the Sum was compensation for loss of employment. As a substantive matter the Taxpayer lost nothing.'

28. Sum C was a discounted Retention Award after negotiation for advance payment. It was still a Retention Award and still paid by reason of the Employment Letter. The discounting was voluntarily done by the Taxpayer in exchange for an advance payment of what would be due in future. It was a result of a commercial negotiation. The Taxpayer in substance has suffered no loss in his contractual entitlement to the Retention Award. In the premise, we find Sum C a contractual payment of the Retention Award which was discounted by the parties after negotiation for advance payment. We therefore decide that Sum C is not a compensation for loss of employment.

Capital return in an investment?

29. It is not disputed that the Retention Award was a percentage share in the VRP and the VRP was an investment fund operated by Company D. But is the VRP an investment of the Taxpayer such that the Retention Award is a capital return thereof belonging to the Taxpayer?

30. As reasoned and found in paragraphs 11 – 16 above, the Retention Award is in fact a remuneration connected with the Taxpayer's employment with Company D.

31. As pointed out by the Revenue, the Retention Award and the VRP was provided in and by the Employment Letter which was the only and complete agreement between the parties (fact 3(8) above). There is no investment contract and there is also no evidence showing what investment or financial contribution the Taxpayer has put into the VRP and if so, by what means.

32. In fact, the Retention Award and VRP is a remuneration given out by Company D as a term of employment and not as a gift of investment because pursuant to the terms of the Employment Letter, Company D could forfeit such Retention Award.

33. The Employment Letter at Clause 3(e)(ii) provided that, 'In the event that you are terminated for Cause (meaning "willful disobedience", "willful misconduct", fraud or dishonesty, or "habitual negligence of duties", see clause 7(d)) or voluntarily resign your employment prior to the last Payment Date (meaning 31 March 2004, see clause 3(e)(i)) you shall forfeit any unpaid Retention Award and any balance in your Account…'

34. Furthermore, clause 3(e)(i) of the Employment Letter protects the Taxpayer from any loss, '…If the Clawback Payment exceeds the balance in the Account, the difference will reduce the current installment of the VRP Payment, but not below zero.' There is definitely an element of remuneration instead of investment in the provision of Retention Award because if it is an investment, an investor would have to assume all loss aside from benefit.

35. As rightly challenged by the Revenue, an investment that protects an investor from loss is far from commercially real.

36. As Mr F conceded at the hearing that the Taxpayer could never suffer any loss under the term of the Retention Award, instead, he could only benefit. This clearly contradicts the Taxpayer's contention that the VRP is an investment of his and that the Retention Award is a capital return thereof.

37. It is beyond contest that Sum C was in fact a Retention Payment. It was a contractual payment expressly provided in the Employment Letter. It was a payment paid in addition to basic salary, annual bonus and transaction bonus. It was not gratuitous. It could be forfeited for cause or should the Taxpayer resign from his employment. In the circumstance, it could only be said to be paid for the Taxpayer's services.

38. In the premise, we find that the VRP is not an investment of the Taxpayer and that the Retention Award is not a capital return. The Retention Award is plainly part and parcel of the remuneration package of the Taxpayer's employment.

The Taxing Provisions

39. Having found that the Retention Award is part and parcel of the remuneration

package, we now turn to the relevant taxing provisions.

40. The relevant taxing provisions in this case are sections 8 and 9 of the Inland Revenue Ordinance ['IRO']:

(i) Section 8(1)(a) of the IRO provides:

'*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;…'

(ii) Section 9(1)(a) of the IRO provides:

'*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…'

40. The Board in D24/97, IRBRD, vol 12, 195, 201 said:

'*29. … The key to liability is the nature of payment and whether it is made in return for acting as or being an employee…'*

41. And the Board in D80/00, IRBRD, vol 15, 715, 725 said:

'*…we do not feel able to attach much weight to Ms C's understanding of the nature of the payment. We have already referred to the Board's decision in D3/97 which made the point that it is not the label, but the real nature of the payment, that is important. Similarly, it would not be right for this Board to take the say-so of an employee or that of the representative of the employer in determining what is the real nature of the payment. This is not to say or suggest in any way that Ms C was not truthful to the Board. It is simply that the Board cannot abdicate its responsibility of finding objectively what is the nature of the payment on the basis of the evidence before it.*'

42. After carefully examining the Employment Letter, the Termination Letter, the Compromise Agreement, relevant tax returns filed by the Taxpayer and Company D respectively, the payment breakdown provided by Company D, the replies sent to the Revenue by Company D

and the Taxpayer and his representatives respectively and the submissions by Mr F in the hearing, and as reasoned in paragraphs 10 – 38 above, we find that Sum C in the sum of $3,499,068.30 is an inducement payment paid according to the terms of employment of the Taxpayer. It constitutes the emoluments of the Taxpayer's employment with Company D. The Sum is therefore fully chargeable to tax under sections 8(1)(a) and 9(1)(a) of the IRO.

Conclusion

62. Section 68(4) of the IRO provides that:

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

For reasons stated above, we find that the Taxpayer has failed to discharge his onus.

66. In the result, we dismiss the Appellant's appeal and confirm the assessment.