INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D3/94

Salaries tax – lump sum payment to induce employee to sign employment contract – whether lump sum payment capital or subject to salaries tax.

Panel: Robert Wei Wen Nam QC (chairman), John C Broadley and Jao Yu Ching.

Date of hearing: 7 February 1994.
Date of decision: 20 April 1994

The taxpayer was paid a lump sum payment as an inducement to join the employment of an employer. The taxpayer argued that the lump sum payment was a capital payment in nature and not subject to salaries tax.

Held:

Whether or not the lump sum payment was an inducement to enter into the employment contract is not material. On the facts before the Board the payment was an inducement and was accordingly subject to salaries tax. Alternatively the payment was salary and also taxable.

Appeal dismissed.

Cases referred to:

Pritchard v Arundale 47 TC 680
Glantre Engineering Ltd v Goodhand 56 TC 165
Shilton v Wilmshurst [1991] STC 88
D19/92, IRBRD, vol 7, 156

Tse Yuk Yip for the Commissioner of Inland Revenue.
Taxpayer in absentia.

Decision:

1. In this appeal an individual (the Taxpayer) is appealing against the salaries tax assessment raised on him for the year of assessment 1991/92 (as confirmed by the Deputy Commissioner of Inland Revenue in his determination dated 23 August 1993) on the ground

that a sum of $162,000 received by him under a contract of employment was not assessable to salaries tax.

2. The Taxpayer was outside Hong Kong at the date of the hearing of this appeal, having applied under section 68(2D) of the Inland Revenue Ordinance for this appeal to be heard in the absence of himself or his authorised representative. Miss Tse the representative of the Commissioner of Inland Revenue not objecting, we granted the application.

3. The relevant provisions of the contract of employment in question were as follows:

> 'Commencement Date: 1 May 1991
>
> Salary: You will receive a lump sum of $162,000 payable in 12 equal instalments over the 6-month probation period as an inducement to joining the company.
>
> You will receive a monthly salary of $27,000 after the 6-month probation period with an annual salary of not less than $350,000.
>
> …'

4. By a letter dated 13 July 1993 and addressed to the Commissioner, the Taxpayer stated the following with regard to the assessment in question:

> 'Please note that the payments from [the employer] were $13,500 on around 15 and 30 each month from 1 May 1991 to 31 October 1991 as the incentive for joining the company and thereafter from 1 November 1991 to 31 March 1992 as salary together with an additional salary payment to $18,123 in December 1991; which are all in accordance with the contract of employment provided to you earlier.
>
> I remain (sic) that the incentive for joining [the employer] is capital in nature which should not be assessable as taxable income.'

5. By a notice of appeal dated 20 April 1993 the Taxpayer advanced the following grounds of appeal:

> '(a) The lump sum inducement payment of $162,000 for joining [the employer] … is a payment capital in nature, and is therefore not subject to salaries tax.
>
> (b) The inducement of $162,000 is a compensation to the employee for the permanent deprivation of:
>
> (i) a prestigious commercial office in District A and

(ii) a right to purchase imported luxurious brands of goods at a greatly reduced staff price;

upon leaving his existing employment … to joining [the employer], an office located at an industrial site in District B. The inducement is not a salary for past, present or future services rendered to the employer; which has already been adequately rewarded by an annual salary of not less than $350,000 contract …

(c) The relevant sum of $162,000, though grouped under the heading of 'salary', is explicitly stated as an inducement to joining [the employer], not a salary or an income from employment, and does not, therefore, fall under sections 8 and 9 of the Inland Revenue Ordinance …

(d) The manner of payment alone should never bear enough weight to alter the explicitly expressed nature of the relevant sum as an inducement …

(e) … even if the contract of employment was terminated during the 6-month probation period, the inducement of $162,000, which would not be payable if it was a salary payment as construed by the IRD, will still be paid in the manner as prescribed in the contract once the employee joined the company, without the employee performing any services for the company…'

6. The employment commenced on 1 May 1991. From that day until 31 March 1992, the Taxpayer was paid $13,500 on about 15 and 30 each month together with an additional payment to $18,123 in December 1991. He argued that the twelve payments received during the 6-month probationary period, totalling $162,000, were an incentive or inducement to join the company and not salary. We have to point out at once that even if the argument had been correct, it would not have helped him, because an inducement to enter the employment is just as taxable as salary, as will be shown in paragraph 7 below. However, we must first deal with the question of whether the $162,000 payment was inducement or salary. The Taxpayer's argument required us to ignore the fact that the sum was subsumed within the head 'Salary' in the contract; that we cannot do unless there is the clearest evidence to show that that was the intention of the parties. It is important to note that the Taxpayer received nothing other than the sum of $162,000 during the probationary period. If it had not been salary but only inducement, the Taxpayer would have worked throughout the probationary period without salary – a scenario so extraordinary that we find it unacceptable. In fact, the Taxpayer was paid an effective $27,000 per month for the probationary period – the same monthly sum as that he received after the probation. We find that the Taxpayer received a salary of $27,000 per month both during and after the probationary period; we find that that is why the sum of $162,000 was included under the head 'salary'. Megarry J stated in Pritchard v Arundale 47 TC 680 at 690:

'… Nor, I may add, do I think that this decision will provide any passport for tax-free emoluments disguised as initial lump sum inducements to enter an

> employment; for it is the realities of the payments that matter, and not any disguises or labels with which they may be provided…'

The realities of the payments in this case lead us to the conclusion that the $162,000 payment was salary and we must disregard the lump sum inducement to enter the employment as suggested by the contract. As for the argument that the $162,000 inducement would still have been payable even if the employment had been terminated during the probationary period (see paragraph 5(e) above), one has only to state the argument to see how divorced from the realities it was.

7(1). Even assuming that the $162,000 payment was an inducement to enter the employment, it still would not have helped him. Under the corresponding United Kingdom legislation, it has been held that such an inducement was taxable as an emolument from the employment (Glantre Engineering Ltd v Goodhand 56 TC 165 at 182). For present purposes 'emolument' corresponds with 'income' in sections 8 and 9 of the Inland Revenue Ordinance; we consider that as an inducement the sum of $162,000 would have been taxable as income from the employment. In the later House of Lords case of Shilton v Wilmshurst [1991] STC 88, Lord Templeman had this to say at 91:

> 'Section 181 is not confined to "emoluments from the employer" but embraces all "emoluments from employment"; the section must therefore comprehend an emolument provided by a third party, a person who is not the employer. Section 181 is not limited to emoluments provided in the course of employment; the section must therefore apply first to an emolument which is paid as a reward for past services and as an inducement to continue to perform services and, second, to an emolument which is paid as an inducement to enter into a contract of employment and to perform services in the future. The result is that an emolument "from employment" means an emolument "from being or becoming an employee". The authorities are consistent with this analysis and are concerned to distinguish in each case between an emolument which is derived "from being or becoming an employee" on the one hand, and an emolument which is attributable to something else on the other hand, for example, to a desire on the part of the provider of the emolument to relieve distress or to provide assistance to a home buyer. If an emolument is not paid as a reward for past services or as an inducement to enter into employment and provide future services but is paid for some other reason, then the emolument is not received "from the employment".'

Lord Templeman's construction of the words 'from employment' provided the ratio decidendi for the unanimous decision that the payment of a sum of money by a third party, a person who was not the employer, to the taxpayer as an inducement to enter into a contract of employment with the employer was taxable as an emolument 'from employment' because it was an emolument 'from becoming an employee'. A sum of money paid by the employer to the taxpayer was conceded to be taxable within section 181 because it was paid as an inducement to enter into the contract of employment. It may be said that the Shilton case is not an authority on inducement payments from an employer. However, clearly the

principle stated therein applies to payments from an employer as well as from a third party; we think that it is open to us to adopt that principle and apply it to this case, which we hereby do. In our view, therefore, 'income from employment' in our Ordinance means 'income from being or becoming an employee'. Therefore, even if, as the Taxpayer contended, the $162,000 payment was an inducement to enter the employment, it would still be taxable as income from the employment under section 8 because it was income 'from becoming an employee'.

7(2). In Hong Kong, the decision D19/92, IRBRD, vol 7, 156 went against the taxpayer who was employed by an employer in Hong Kong having previously been employed with an associated company in the United Kingdom. The Hong Kong employer paid to the taxpayer a lump sum payment on his joining the employment of the Hong Kong employer. It was found that the lump sum payment was both a relocation allowance and an inducement to enter into a contract of employment. The decision states at D19/92, IRBRD, vol 7, 164:

> 'There is nothing in sections 8 and 9 of the Inland Revenue Ordinance which limit taxable payments to remuneration for services rendered or to be rendered. Section 8 relates to income from a source namely the employment. This lump sum payment was part and parcel of the employment of the taxpayer with the HK employer. It arose directly from the employment which the HK employer offered to the taxpayer and which the taxpayer accepted. Accordingly it is assessable to salaries tax.'

Those words are in our view equally applicable to the facts of this case.

8. Moving on to the ground that the 'inducement' sum of $162,000 was a 'compensation' for the loss of certain rights and benefits to which the Taxpayer was entitled under the previous employment (see paragraph 5(b) above), we take the view that it must fail. First, in so far as the sum of $162,000 was said to be both 'inducement' and 'compensation', then it must be taxable as an inducement, because, for reasons already stated above, an inducement is taxable as income from the employment. Second, in so far as the sum was said to be 'compensation' as distinct from 'inducement' and therefore not taxable because it was not income from the employment but compensation for giving up something from the previous employment, the point was raised for the first time at the hearing of this appeal; no explanation was given as to why it had not been raised before the Commissioner at the objection stage. Furthermore, this was a question of fact which had to be proved by evidence; the burden of proof was on the Taxpayer, but he did not produce any evidence. Moreover, like the 'inducement' argument, the 'compensation' argument also leads to the unacceptable scenario where the Taxpayer would have worked throughout the probationary period without being remunerated for his service.

9. We shall not deal specifically with grounds (c) and (d) set out in paragraph 5 above; they were covered when we dealt with the other grounds.

10. We conclude that the payment of $162,000 was income from the employment within the meaning of section 8 of the Inland Revenue Ordinance and therefore assessable to salaries tax. The assessment in question is hereby confirmed.