Case No. D40/11

Salaries tax – employer offering retention incentives to appellant in anticipation of sale of business to new buyer – whether ex-gratia payment of completion bonus taxable – whether the said payment 'received from employment' – sections 8(1) and 9(1)(a) of the Inland Revenue Ordinance ('IRO').

Panel: Cissy K S Lam (chairman), Simon Wing Yin Leung and Ng Man Sang Alan.

Date of hearing: 3 October 2011.
Date of decision: 13 December 2011.

The Appellant was an employee of Bank A ('the Bank'). Her employment was terminable by one month's notice by either party or payment in lieu thereof. The Bank later negotiated to sell part of its business. By a letter to the Appellant ('Letter'), the Bank offered (and the Appellant accepted) retention incentives in anticipation of the sale. The Letter further contained a caveat stating that the payments could be used by the Bank and the future buyer of the business to offset any statutory obligations they might owe to the Appellant on termination of her employment.

The Bank subsequently sold its business to a buyer ('the Buyer'). By consent the Appellant left the Bank earlier and took up employment with the Buyer. Pursuant to the Letter, the Appellant received from the Bank: (1) Performance Bonus; (2) Completion Bonus; and (3) Success Award. The Completion Bonus was paid to the Appellant before her employment with the Bank terminated, but within 30 days of the sale and purchase agreement between the Bank and the Buyer.

In the relevant year of assessment, the Appellant, who had been assessed for the payments received above, accepted that the Performance Bonus and Success Award were taxable earnings, but objected the assessment on Completion Bonus, stating that it was compensation of the loss of office together with the compensation on the long years services by breaking down the Completion Bonus into: (i) Severance Payment; (ii) Payment in Lieu of Notice; and (iii) Ex-Gratia Payment.

The Assessor was of the view that since the Severance Payment was in excess of the statutory amount, the Ex-Gratia Payment could not be regarded as compensation for loss of employment. The Assessor proposed to revise the assessment by excluding the Severance Payment and Payment in Lieu of Notice, but maintained that the Ex-Gratia Payment was taxable. The Appellant objected. Her objection being rejected, the Appellant appealed to the Board.

In her evidence, the Appellant said that her understanding was that the Completion Bonus was compensation for the loss of her job. She further claimed that some of her former colleagues being in a similar situation as hers had got their tax refunded.

Held:

1. Income chargeable under section 8(1) of the IRO was not confined to income earned in the course of employment but embraced payments made 'in return for acting as or being an employee', or 'as a reward for past services or as an inducement to enter into employment and provide future services'. A payment would be assessable if, viewed as a matter of substance and not merely of form and without being 'blinded by some formulae which the parties may have used', was derived from the taxpayer's employment. It was only where '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', that the emolument was not received 'from the employment'. Thus, where a payment fell within the test, it was assessable and the fact that it might also be described in some other terms, eg, as 'compensation for loss of office', did not displace liability to tax. (Fuchs v CIR [2011] 2 HKC 422 considered)

2. In the present case, it was clear that the payments were received 'from the employment': (a) the Appellant remained in employment with the Bank on the terms of the Letter after it was signed. The Appellant had an accrued right to the payments once the stipulated obligations were fulfilled. They were contractual payments; (b) the Letter made it clear that the Bank wanted to give the Appellant incentives to continue to stay with the Bank despite the impending sale. The incentive package was proposed in return for the Appellant agreeing to a number of obligations, including an obligation to continue working for the Bank and not to terminate her employment before a specific date, and also to agree to work for the new buyer provided that the terms of the new employment would not be less favourable; (c) the incentive package was paid not only to reward the Appellant for past services and to induce the Appellant to remain in employment with the Bank, but further to induce the Appellant to enter into employment and provide future service to the Buyer. (Shilton v Wilmshurst [1991] 1 AC 684 considered)

3. In deciding whether an income was taxable, the Inland Revenue Department ('IRD') and the Board were not bound by any label, title or intention that the parties might use or have, but must look at the real nature of the payment. The sale by the Bank of part of its business affected a number of employees. The Appellant's evidence would not affect the Board's decision because (1) the Board did not know if the situations of her former colleagues were indeed identical to hers; (2) even if they were, the Board was not bound by

any decision made by assessors in other assessments. (Henry v Foster 16 TC 605 considered)

4. The Ex-Gratia Payment was part of the contractual payments paid to the Appellant as a reward for past services and as an inducement to remain in employment with the Bank and an inducement to enter into employment and provide future services to the Buyer. It was assessable under section 8(1) of the IRO. (Fuchs v CIR [2011] 2 HKC 422 considered)

Appeal dismissed.

Cases referred to:

Fuchs v CIR [2011] 2 HKC 422
Shilton v Wilmshurst [1991] 1 AC 684
Henry v Foster 16 TC 605

Taxpayer in person.
Chan Wai Lin, Chan Man On and Ng Lai Ying for the Commissioner of Inland Revenue.

Decision:

1. The Appellant objected to the Second Additional Salaries Tax Assessment for the year of assessment 2006/07 dated 5 May 2010 ('the Second Additional Assessment') on the ground that an ex-gratia payment paid to her by her former employer was compensation for her loss of office and not subject to tax. By a Determination dated 26 May 2011 ('the Determination'), the Acting Deputy Commissioner of Inland Revenue rejected her objection. She now appeals to us.

The facts

2. The Appellant was employed by Bank A ('the Bank') from 2 July 2002 to 25 March 2007. At the relevant time she was its Senior Vice President.

3. Under the terms of the letter of employment dated 26 June 2002, her employment was terminable by one month's notice by either party or payment in lieu thereof.

4. In November 2006, the Bank was in negotiation to sell part of its banking business. By a letter of 3 November 2006 ('the 3 November 2006 letter') the Bank offered and the Appellant accepted 'retention incentives' in anticipation of the sale. It is important to set out the relevant part of this letter in full.

‘ **Sale of […] Banking business – Retention incentives**

[The Bank] after consideration of its strategic objectives is proposing to sell [part of] its […] banking business.

Your contribution to the success of the […] banking business is integral to the ongoing value of that business. Therefore prior to commencement of the search for a buyer, we would like to propose your contribution and value to the sale be recognised through this agreement. In return for the payments set out within the paragraph headed “Incentive package” we look to you to facilitate the maximisation of the sales proceeds and agree to be employed within the buying organisation.

1. Incentive package

In consideration of your agreement to the obligations contained under paragraph 2 below, [the Bank] agrees to provide the following incentive payments:

(a) Performance bonus re 2006

Under the terms of your employment contract you are eligible for a discretionary performance bonus relating to your contribution during the year ended 31 December 2006. The Bank hereby confirm that this discretionary performance bonus will be USD75,000 which will become payable in March 2007.

(b) Completion Bonus

In recognition of your contribution to a successful completion of the sale prior to the 30 June 2007 you will receive a payment of USD125,000 which will become payable within 30 days of the unconditional sale and purchase agreement being signed. This payment includes a gratuity for the purposes of Parts VA and VB of the Employment Ordinance and is calculated by reference to your years of service with the Bank.

(c) Success Award

In order that you share in the success of the sale you will be entitled to 1.5% of the net consideration received by the Bank under the Sale Contract in excess of USD7,500,000. The Success Award will be paid to you within 30 days of the completion date.

It is a condition of payment of the Incentive package that you agree to comply fully with all of the conditions set out in paragraph 2 below.

The payments under this letter may be used by the Bank and the buyer to offset any contractual and statutory obligations the Bank and the buyer may have to you on termination of your employment.

2. Your obligations

In return for the payments set out above you agree to the following:

(a) You will continue to perform your contract of employment with the Bank in good faith and must not divert clients of the Bank and their transactions or assets under administration ("AUM") to any third party not nominated by the Bank.

(b) You must not terminate or give notice to terminate your contract of employment prior to 31 July 2007 unless with the prior written consent of the Bank.

(c) You must keep this letter, the contents of this letter and all details surrounding the proposed sale of the […] banking business confidential.

(d) You will provide such reasonable assistance as is required by the Bank to transfer clients and their AUM to any third party that the Bank may nominate.

(e) You agree to sign a contract of employment with the purchaser of the […] banking business provided that the terms and conditions of such contract of employment will not be less favourable than those you are currently on with the Bank. Your years of employment will commence from the date of signing of the new contract with the buyer. You agree to waive your rights to claim severance pay or long service pay from the buyer in respect of your period of service with the Bank.

(f) You must notify us immediately if any third party seeking to offer you employment approaches you.'

5. The three incentive payments stipulated in the letter will be referred to as 'Performance Bonus', 'Completion Bonus' and 'Success Award' respectively below.

6. Early in 2007, the Bank sold part of its banking business to a buyer ('the Buyer').

7. By consent the Appellant left the Bank earlier than 31 July 2007 to take up employment with the Buyer. Her last day of employment with the Bank was 25 March 2007.

She remains in the employment of the Buyer to date.

8. Pursuant to the 3 November 2006 letter, the Appellant received the stipulated payments as follows:

(1) Performance Bonus in the sum of HK$586,125 (equivalent to US$75,000) was paid on 9 March 2007.

(2) Completion Bonus in the sum of HK$976,875 (equivalent to US$125,000) was paid on 9 March 2007.

(3) Success Award totaling HK$1,617,291 was paid by three instalments on 9 March, 31 August and 7 December 2007 respectively.

9. We note that the Completion Bonus was paid to the Appellant before her employment with the Bank was terminated, but within 30 days of the sale and purchase agreement as stipulated in the 3 November 2006 letter.

10. Three notifications by an employer of an employee who is about to cease to be employed were filed by the Bank pursuant to section 52(5) of the Inland Revenue Ordinance, Chapter 112 ('IRO'). For convenience they are referred to as Notifications 1, 2 and 3 in accordance with their chronological order, particulars of which are as follows:

Notification No.	1	2	3
Date of notification	22-03-2007	31-01-2008	04-01.2010
Capacity in which employed	Senior Vice President		
Period of employment	01-04-2006 – 25-3-2007		
Reason for cessation	Termination		
Income	$	$	$
Salary	885,483	885,483	885,483
Leave pay	18,658	18,658	18,658
Other rewards, allowances or perquisites	993,554	2,215,738	3,192,613
Total	1,897,695	3,119,879	4,096,754

The breakdown of the sum 'Other rewards, allowances or perquisites' in Notifications 2 and 3 is as follows:

		$	
Performance Bonus	:	586,125	
Success Award	:	1,617,291	
		$	
Mortgage interest subsidy	:	12,322	
		2,215,738	[see Notification 2]
Add: Completion Bonus	:	976,875	
		3,192,613	[see Notification 3]

11. By her tax return of the relevant year, the Appellant declared an income of HK$1,897,695 (as per Notification 1) and the original Salaries Tax Assessment for the year of assessment 2006/07 ('the Original Assessment') was made based on this sum. Following Notifications 2 and 3, Additional Salaries Tax Assessment for the year of assessment 2006/07 ('the Additional Assessment') and the Second Additional Assessment were raised.

12. The Appellant had no objection to the Original Assessment or the Additional Assessment. She accepted that the Performance Bonus and the Success Award paid to her pursuant to the 3 November 2006 letter were taxable earnings. She, however, objected to the Second Additional Assessment which included the Completion Bonus (less a statutory severance payment of $70,950). By a letter of 31 May 2010, she stated her objection as follows:

> ' The amount should be the compensation of the loss of office together with the compensation on the long years services. My understanding that this is not subject to tax and also the reason why [the Bank] nor myself has reported this amount in our tax return for 2006/07.'

13. Following her objection, the Appellant obtained a breakdown of the Completion Bonus from the Bank as follows:

(1) Severance payment : $356,250 (1 month / year of service)

(2) Notice period : $75,000 (1 month)

(3) Ex-gratia payment: $545,625 (that is additional extra payment)

14. The above are referred to below as 'Severance Payment', 'Payment in lieu of Notice' and 'the Ex-Gratia Payment' respectively.

15. The Assessor was of the view that since the Severance Payment was in excess of the statutory amount, the Ex-Gratia Payment could not be regarded as compensation for loss of employment. She proposed to revise the Second Additional Assessment by excluding the Severance Payment and Payment in lieu of Notice from the Appellant's assessable income, but she maintained that the Ex-Gratia Payment in the sum of $545,625 was taxable. It is the Ex-Gratia Payment which is in dispute in this appeal.

16. The Appellant maintained and continues to maintain that it is compensation for loss of office and not taxable. The Bank took the same view as stated in their letter of 10 September 2010 and 7 February 2011 to the Inland Revenue Department ('IRD').

17. In the letter of 7 February 2011 following an enquiry from the Assessor as to how the Bank determined the Completion Bonus and the Ex-Gratia Payment thereof, the Bank replied that the Completion Bonus 'of $976,875 is the redundancy payment we paid to [the Appellant] for the compensation of loss of office, there is no formula in calculating

such payment; however, it was calculated by reference of [the Appellant's] years of service with us and 1 month's salary for each year of service.'

18. This formula of 1 month's salary x years of service = $75,000 x 4.75 years = $356,250 explained the Severance Payment, but left the Ex-Gratia Payment unexplained.

19. The Determination rejected the Appellant's objection and adopted the revision proposed by the Assessor (see paragraph 15 above) and set out the revised assessment in paragraph 1(9) of the Determination.

Relevant sections of the IRO

20. By section 8(1)(a), salaries tax shall be charged on every person in respect of his income arising in or derived from Hong Kong from any office or employment of profit.

21. By section 9(1)(a), income from any office or employment includes any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite or allowance, whether derived from the employer or others.

Fuchs v CIR

22. The one issue in this appeal is whether the Ex-Gratia Payment is income from an office or employment within the meaning of section 8(1)(a) above. This same issue is examined recently with an extensive review of the authorities by the Court of Final Appeal in Fuchs v CIR [2011] 2 HKC 422. Ribeiro PJ stated the test in clear term [pages 430 to 431, paragraphs17 to 18]:

> '*Income chargeable under [section 8(1) of the IRO] is likewise not confined to income earned in the course of employment but embraces payments made (in Lord Radcliffe's terms) "in return for acting as or being an employee", or (in Lord Templeman's terms) "as a reward for past services or as an inducement to enter into employment and provide future services". If a payment, viewed as a matter of substance and not merely of form and without being "blinded by some formulae which the parties may have used", is found to be derived from the taxpayer's employment in the abovementioned sense, it is assessable. This approach properly gives effect to the language of section 8(1).*
>
> *It is worth emphasising that a payment which one concludes is "for something else" and thus not assessable, must be a payment which does not come within the test. As Lord Templeman pointed out, it is only where "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, [that] the emolument is not received 'from the employment'." Thus, where a payment falls within the test, it is assessable and the fact that, as a matter of language, it may also be possible to describe the purpose of that payment in some other terms, eg, as "compensation for loss of office", does not displace liability to*

> *tax. The applicable test gives effect to the statutory language and other possible characterisations of the payment are beside the point if, applying the test, the payment is "from employment"'.*

23. In Fuchs, the taxpayer was employed, likewise by a bank, on a three-year contract. In the event of early termination, clause 9(c) of his employment contract provided for the payment of two sums, namely (1) two annual salaries and (2) an average amount of the bonuses paid in the three previous years of employment, as 'agreed compensation or liquidated damages'. Before the end of the three year term, the employer bank was taken over by another bank and as part of the resultant re-organisation, the taxpayer's employment was terminated. A termination agreement was made between him and his employer under which the taxpayer was paid three sums called A, B and C therein, (1) Sum A being a sum equivalent to the taxpayer's salary for the remaining term of the employment contract (12 months); (2) Sum B being two annual salaries and (3) Sum C being the average amount of the bonuses paid in the three previous years. So Sums B and C were the same as the two sums stipulated in the contract of employment.

24. Sum A was accepted as being compensation for the early termination and not taxable. Sums B and C, however, were found by the Court of Appeal and the Court of Final Appeal as payment made pursuant to clause 9(c) of the employment contract and assessable. Ribeiro PJ concluded at page 437, paragraph 26:

> '*It follows, in my view, that Sums B and C were paid in satisfaction of the rights which had accrued to the taxpayer under clause 9(c) and were plainly amounts derived "from his employment". They were not sums paid in consideration of the abrogation of the taxpayer's rights under the employment contract. Like Colonel de Soissons [in Dale v de Sissons (1950) 32 TC 118], Mr Fuchs surrendered no rights. Instead, by negotiation, he augmented his clause 9(c) rights by securing an additional year's salary represented by Sum A. Sums B and C accordingly come within the charge to salaries tax contained in section 8(1). This conclusion is reached on reasoning which proceeds much along the lines of the Court of Appeal's approach.*'

25. In the present appeal, the Incentive Package was not stipulated in the original contract of employment. But clearly after the 3 November 2006 letter was signed, the Appellant remained in employment with the Bank on the terms of that letter. The Appellant had an accrued right to the payments, that is Performance Bonus, Completion Bonus and Success Award, once the stipulated obligations were fulfilled. They were contractual payments same as Sums B and C in Fuchs.

26. The 3 November 2006 letter spoke of 'Retention Incentives'. The opening paragraphs of that letter made it clear that the Bank wanted to give the Appellant incentives to continue to stay with the Bank despite the impending sale. The incentive package was proposed in return for the Appellant agreeing to a number of obligations. These obligations included an obligation to continue working for the Bank and not to terminate her employment before 31 July 2007, and also to agree to work for the new buyer provided that

the terms of the new employment would not be less favorable (see paragraph 4 above). It is clear to us that payments made under such obligations fall squarely within the test in Fuchs.

27. In laying down his test quoted above, Ribeiro PJ referred to the words of Lord Templeman when giving the judgment of the House of Lords in Shilton v Wilmshurst [1991] 1 AC 684. That decision concerned the world famous goalkeeper Mr Shilton back in the 1980s. In August 1982, he was transferred from Nottingham Forest to Southampton. There were three parts to the transfer. Nottingham Forest agreed with Southampton to transfer
Mr Shilton for a transfer fee of £325,000. Nottingham Forest agreed with Mr Shilton to pay him £75,000 if he agreed to be transferred. Mr Shilton agreed with Southampton to play for Southampton for four years on various agreed terms if Southampton paid him £80,000. The revenue assessed both the sums of £75,000 and £80,000 to income tax. Mr Shilton agreed to the assessment so far as it applied to the sum of £80,000 paid by Southampton but not to the sum of £75,000 paid by Nottingham Forest. It was on those facts that Lord Templeman held that assessable income embraced payments made 'as an inducement to enter into employment and provide future services', in that case, an inducement by Nottingham Forest to Mr Shilton to enter into employment with Southampton and provide future services to Southampton.

28. Likewise in the present appeal, the Incentive Package that is Performance Bonus, Completion Bonus and Success Award, were paid not only to reward the Appellant for past services and to induce the Appellant to remain in employment with the Bank, but further to induce the Appellant to enter into employment and provide future service to the Buyer. On the authority of Shilton such payments clearly constituted part of the Appellant's assessable income.

29. There is one caveat in the 3 November 2006 letter which may take a payment outside the test, namely that the payments could be used by the Bank and the Buyer to offset any statutory obligations the Bank and the Buyer may owe to the Appellant on termination of her employment. So if a sum was paid in lieu of the statutory severance payment, then it was rightly a compensation for loss of office and not assessable.

30. The Severance Payment of $356,250 is much more than the statutory amount. The IRD was prepared to accept that figure. We will not disturb it. The IRD was also prepared to accept the Payment in lieu of Notice as non-assessable. Again we will not disturb that concession. For the Ex-Gratia Payment, on the other hand, the IRD was not prepared to make any concession and the IRD was right to do so.

31. The Appellant in her evidence told us that her understanding was that of the three payments, the Performance Bonus was a reward for past services and the Success Award was an incentive for staying on and seeing to the success of the sale. But the Completion Bonus, she argued, was compensation for the loss of her job.

32. This may be her understanding and indeed the understanding of the Bank (see paragraphs 16 and 17 above), but in deciding whether an income is taxable, the IRD and this

Board are not bound by any label, title or intention that the parties may use or have, but must look at the real nature of the payment.

33. In Henry v Foster 16 TC 605, (referred to in Fuchs at pages 432 to 433) the taxpayers were entitled under article 109 of their contracts to a 'compensation for loss of office' if he were to resign in stated circumstances. The Court of Appeal found the 'compensation' taxable. Romer LJ stated as follows:

> '*... article 109 expresses that the sum to be paid in the last year of office is to be compensation for loss of office. Now, do those words make any difference? In my opinion they do not. In the first place, it cannot matter what the parties call the money which is to be paid in the last year of office if one finds, as here, that the only consideration for the payment by the company of that sum is the service by the director and that it is a sum for which the director must be deemed to have stipulated when offering his services to the company and that it is paid to him by reason of his having performed those services.*'

34. The sale by the Bank of part of its banking business affected a number of employees. The Appellant claimed that she knew that some of her former colleagues being in a similar situation as hers had got their tax refunded. She repeated this claim at the hearing. We fully understand how the Appellant may feel aggrieved in the circumstances. But as we have explained to the Appellant, such evidence will not affect our decision because first of all, we do not know if the situations of her former colleagues are indeed identical to hers, and secondly, even if they are, this Board is not bound by any decision made by assessors in other assessments.

35. In conclusion, we find that the Ex-Gratia Payment falls squarely within the test in Fuchs. It was part of the contractual payments paid to the Appellant as a reward for past services and as an inducement to remain in employment with the Bank and an inducement to enter into employment and provide future services to the Buyer. It is assessable under section 8(1) of the IRO. The Second Additional Assessment as revised as per paragraph 1(9) of the Determination is confirmed and the appeal is dismissed.