

Case No. D4/05

Salaries tax – income arising from employment – whether a payment induced taxpayer to continue in employment – whether payment compensation for loss of employment.

Panel: Colin Cohen (chairman), Edward Chow Kam Wah and Michael Wilkinson.

Date of hearing: 3 March 2005.

Date of decision: 13 April 2005.

The taxpayer appealed against a salaries tax assessment for the year of assessment 2001/02. He was employed with a company which was subsequently identified as a target for divestiture to potential purchasers. While the negotiations took place, the taxpayer remained in employment, although it was uncertain whether his employment would be continued by his potential new employers.

In these circumstances, the taxpayer received a sum of HK\$600,000 from the ex-holding company of his employer. This sum was described as an “Appreciation Bonus” which was an indication of the gratitude which the employer expressed towards the taxpayer for his work during the transitional period.

The issue before the Board was whether the sum was income arising from employment and hence chargeable to salaries tax.

Held:

1. The Board held that the payment to the taxpayer constituted additional remuneration paid to encourage him to stay on and as an inducement for his continued services during the transitional period. Accordingly, the payment was chargeable to salaries tax.
2. In determining whether a sum is income from employment, it is necessary to ascertain the true nature of the payment and the circumstances under which the payment was made. Any label given to it by the relevant parties is by no means conclusive.

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3. For a sum to be compensation for loss of employment, it must be shown that there is the loss or surrender of rights on the part of the taxpayer and a legal liability on the part of the employer to pay compensation for the loss of such rights.
4. As the taxpayer did not surrender any legal rights under his employment, the payment did not constitute compensation for loss of employment.

Appeal dismissed.

Cases referred to:

D90/96, IRBRD, vol 11, 727
D24/97, IRBRD, vol 12, 195
D60/97, IRBRD, vol 12, 367
D167/98, IRBRD, vol 14, 25
D80/00, IRBRD, vol 15, 715

Taxpayer in person.

Poon So Chi and Tsui Siu Fong for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal by Mr A ('the Taxpayer') whereby he has objected to the 2001/02 salaries tax assessment raised on him. The Taxpayer asserts that a sum of HK\$600,000 ('the Sum') received by him from the ex-holding company of his employer should not be subject to salaries tax.

2. The Taxpayer signed a letter dated the 1 August 2000 ('the Appointment Letter') whereby he was appointed as Director of Finance & Operations of Company B. His employment was due to commence on the 11 September 2000. The Taxpayer's Appointment Letter provided *inter alia* the following terms:

'2. **Job**

[The Taxpayer's] title will be Director of Finance & Operations and [the Taxpayer] will report to the Managing Director. [The Taxpayer] may be assigned to other duties as required by business needs from time to time.

...

7. **Assignment**

[Company B] reserves the right to assign [the Taxpayer] to work for other [Company C] companies and [the Taxpayer] may be required to relocate to where such work is to be carried out.

...

10. **Termination Notice**

During the probation period, [Company B] or [the Taxpayer] may terminate this agreement by giving one month's written notice. Thereafter, this agreement may be terminated by either party giving to the other party three months' written notice or payment in lieu.'

3. On the 11 September 2000, the Taxpayer commenced employment with Company B.

4. Shortly after the Taxpayer commenced employment, he was advised by his Managing Director that it was likely, in anticipation of the intended Company D Company C merger, that a decision may be made to divest some international operation companies and that his division had been identified as a potential divestiture candidate.

5. The Taxpayer received a memorandum dated 3 October 2000 ('the Memorandum') which notified him of this intended divestiture as well as drawing his attention to the fact that he would be entitled to an appreciation bonus of HK\$600,000. The Memorandum stated *inter alia* as follows:

'... in anticipation of the [Company D][Company C] merger, [Company E], made a decision to divest some international operating companies. While your division has been identified as a potential divestiture candidate, ...

The process of identifying and negotiating with potential buyers and liaising with customers is likely to take up to a year. During this period, your business knowledge and leadership skills will continue to be very valuable to us.

We have no way of projecting the outcome of this process, in regards to guaranteed employment under new owners. So in addition to other severance options from [Company F], [Company E] has instituted a supplemental compensation plan to express our appreciation for your commitment during this uncertain period.

... under this plan, you and each member of the senior executive team at [Company F] will be considered for an appreciation bonus up to \$600,000.

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To qualify for this appreciation bonus, you must be an active employee on the day the transaction closes. You should know, this bonus is not obligatory, and [Company E] plans pay it a few weeks after our receipt of sale proceeds, only as a good faith expression of gratitude for your leadership during the sale process and the immediate transition period.

In the event there is no buyer or the buyer's consideration is not cash, there will be no bonus. This is a completely discretionary [sic] supplement from [Company E], and not a substitute for other severance payments you might be entitled under [Company F] policy or your employment agreement with [Company F], in the event your employment is later terminated by new owners. This bonus may also be subject to other terms and conditions.

... right now it's now important that you keep your staff focused on core operational duties while you split your time between operations and assisting [Mr G], [Ms H], [Mr I], me and others from [Company E] with our work on the divestiture.'

6. On the 27 April 2001, [Company E] paid the Sum to the Taxpayer.
7. On the 31 July 2001, [Company B] advised the Taxpayer that his position within their organization had become redundant but he would be able to stay until the 31 August 2001 and advised the Taxpayer that he would be entitled to receive three months' salary as an ex-gratia payment by the end of 31 August 2001.
8. By a letter dated 30 August 2001, [Company B] confirmed the termination of the Taxpayer's employment with effect from the 1 September 2001.
9. The issue in this appeal is whether the payment of the Sum, described as 'an Appreciation Bonus' and paid to the Taxpayer by the ex-holding company, Company E of his employer, Company B, is chargeable to salaries tax.
10. The Taxpayer decided to give evidence and there was no dispute as to the facts regarding the history and background of his employment. He provided us with further details as to the circumstances in which he received the Memorandum. His Managing Director advised him as to the intended discussion in respect of the Company D merger with Company E and that it was likely that his division may be subject to divestiture. However, he accepted that he was never involved nor participated in any of the negotiations nor was involved in any discussions with respect to the merger. He was advised that he should keep the contents of the Memorandum confidential. It was clear that Company B was keen to ensure that the current management remained in place. When cross-examined, the Taxpayer again confirmed that he was never involved in the intended acquisition. He did provide some financial information by way of a PowerPoint presentation when asked to do so. He also confirmed that there was no change to his employment terms and

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conditions as a result of him becoming redundant or as a result of the organization restructure after the acquisition.

11. Section 8(1) of the Inland Revenue Ordinance ('IRO') provides as follows:

'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 profits; and'

12. Section 9(1)(a) gives a non-exhaustive definition of the term 'income from employment' as follows:

'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'

13. The burden of proof in respect of an appeal to the board is set out in section 68(4) of the IRO is as follows:

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

14. The Revenue's representative drew our attention to the relevant applicable legal principles and drew our attention to D90/96, IRBRD, vol 11, 727, D24/97, IRBRD, vol 12, 195, D60/97, IRBRD, vol 12, 367, D167/98, IRBRD, vol 14, 25 and D80/00, IRBRD, vol 15, 715. These authorities illustrate that in determining whether a sum is income from employment, one has to ascertain the true nature of the payment and the circumstances under which the payment was made. Any label given to it by the relevant parties is by no means inclusive.

15. From the Memorandum, it is clear that the Sum was paid as an appreciation of the Taxpayer's commitment during the uncertain period of the divestiture. We accept that this was paid in order to induce the Taxpayer to continue to contribute his business knowledge during the sale process. Indeed, it was under the Taxpayer's own admission that Company E wanted him to continue to work on the divestiture and as such, the Memorandum was issued to offer him that sum. In order to qualify for the appreciation bonus, he had to be an active employee when the date of the transaction closed and that the payment was to be expressed as an appreciation for his commitment during an uncertain period.

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16. We are of the view that the Sum was an additional remuneration paid to encourage the Taxpayer to stay on and as an inducement for his continued services during the transitional period. We accept that the Sum was the Taxpayer's income from employment and subject to salaries tax even under the narrower approach as described in D24/97.

17. The Taxpayer also tried to argue that the Sum was compensation for loss of employment. This cannot be correct. For a sum to be compensation, it must be shown that there is the loss or surrender of rights on the part of the Taxpayer and a legal liability on the part of Company B to pay compensation for loss of such rights. However, the Taxpayer's employment with Company B was determinable by any party upon giving the appropriate three months' written notice. When the notice period was proposed and accepted and paid to the Taxpayer, there was no breach of contract on the part of Company B and his employment continued. Furthermore, the Taxpayer admitted that the Sum was a unilateral offer from Company E without asking him to surrender any rights. We accept the Revenue's submissions that the Taxpayer had lost no rights and was not entitled to claim any damages from any party for the potential loss of office in Company B when the Sum was proposed or paid to him.

18. For the above reasons, the Taxpayer has not discharged the burden of proof and the assessment by the Deputy Commissioner was correctly chargeable to salaries tax. We therefore dismiss the Taxpayer's appeal.