Case No. D71/06

Salaries tax – consideration of termination of employment agreement – sections 8(1), 9(1)(a), 52(5), 68(2D) and 68(4) of the Inland Revenue Ordinance ('IRO')

Panel: Kenneth Kwok Hing Wai SC (chairman), Alan Ng Man Sang and David Yip Sai On.

Date of hearing: 3 November 2006.
Date of decision: 21 December 2006.

This is an appeal against the determination of the Acting Deputy Commissioner whereby salaries tax assessment for the year of assessment 1994/95 and 1995/96 were raised against the appellant. This appeal was heard under section 68(2D) of the IRO in the absence of the appellant and her authorised representative.

The appellant was employed by a Hong Kong Company which was a member of a group of overseas companies. By letter dated 27 October 1995, the second overseas company referred to 'previous discussions' and outlined the terms and conditions 'defining the termination' of the appellant's employment with the companies in the group. By an agreement dated 31 October 1995 made between the appellant and the Hong Kong Company, both parties confirmed that the Hong Kong Company 'has made a capital payment of HK$410,000 … which eliminates all contractual obligations on the side of [the Hong Kong Company] as well as on the side of the employee'. The appellant's case is that $401,250 of the sum $410,000 paid to her upon termination of her employment was not chargeable to salaries tax.

Held:

1. By the termination agreement and the supplemental termination agreement, all contractual obligations under the service agreement with the Hong Kong Company were 'eliminated'. The service agreement(s) went altogether and some sum became payable and was paid for the consideration of the total abandonment of all the contractual rights which the appellant had under the service agreement(s). On the facts of this case, the sum paid was in the nature of a sum paid in consideration of the surrender by the appellant of her rights in respect of the office. For these reasons, $401,250 was not income from employment and the appeal succeeds.

Appeal allowed.

Cases referred to:

CIR v Humphray [1970] HKLR 447
Hochstrasser (Inspector of Taxes) v Mayes [1960] AC 376
Shilton v Wilmshurst (Inspector of Taxes) [1991] 1 AC 684
D60/97, IRBRD, vol 12, 367
D24/05, (2005-06) IRBRD, vol 20, 382
CIR v Yung Tse Kwong [2004] HKLRD 192
Henley v Murray (Inspector of Taxes) 31 TC 351

Taxpayer in absentia.
Wong Siu Suk Han for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal against the Determination of the Acting Deputy Commissioner of Inland Revenue dated 31 August 2006 whereby:

(a) Salaries tax assessment for the year of assessment 1994/95 under charge number 9-2078365-95-9, dated 27 August 1996, showing assessable income of $576,457 with tax payable thereon of $86,468 was increased to assessable income of $634,102 with tax payable thereon of $95,115.

(b) Salaries tax assessment for the year of assessment 1995/96 under charge number 9-0496360-96-9, dated 27 August 1996, showing assessable income of $1,079,137 with tax payable thereon of $161,870 was reduced to assessable income of $982,575 with tax payable thereon of $147,386.

Appeal heard under section 68(2D)

2. This appeal was heard under section 68(2D) of the Inland Revenue Ordinance, Chapter 112, in the absence of the appellant and her authorised representative.

The salient facts

3. By letter dated 15 March 1994 ('the Employment Letter') written on letter papers of an overseas company and signed by a director of a Hong Kong company of the same group, the

appellant was offered the position of 'Head of Controlling' of the Hong Kong company with effect from 1 April 1994 on terms which included the following:

(a) 'Your monthly basic salary will be HK$47,700, payable in 12 monthly instalments.'

(b) 'The Company will pay business class air fares from Hong Kong to [a named overseas country] for you upon termination of your employment in Hongkong.'

(c) 'You will be supplied with accommodation at the Company's expense.'

(d) 'Your employment shall continue for a period of two years provided, however, either party may upon thirty days' notice terminate this Agreement in which case all rights and liabilities hereunder shall cease except in regard to repatriation.'

4. By a document called 'Supplementary Provisions to the Terms of Employment Agreed' dated 8 April 1994 ('Supplementary Provisions') and signed on behalf of another overseas company of the same group ('the second overseas company') and by the appellant, the parties agreed terms which included the following:

(a) 'The Supplementary Provisions to the contract shall take effect, respectively remain valid as long as the Employee ... is in the employment of the subsidiary company concerned.'

(b) 'Date on which contract shall take effect 1 April 1994'.

(c) 'This agreement has no fixed terms; the contract may be terminated at any time by either party at the end of a calendar month, subject to six months' notice ...

The company reserves the right to terminate the contract without notice if the Employee's contract with its subsidiary company is terminated, and to modify the conditions of the contract in case of a transfer'.

(d) 'If circumstances require it, [the overseas company referred to in paragraph 3 above] shall have the right to recall the Employee to [the named overseas country] any time or, with her consent, transfer her temporarily or permanently to another country. In such case of recall or transfer, the terms of employment, in particular those concerning salary and other benefits, shall be modified and adapted to the new working conditions.'

(e) 'The Employee shall receive for her services <u>in HONGKONG</u>

- a gross salary of HKD700,000, payable in accordance with the practice of [the Hong Kong company]. An exchange rate guarantee of 100 HKD/19[Currency A] is granted on 20% of the salary.

- Benefits in kind:

- rental for unfurnished accommodation in Hongkong, provided that the cost is in a reasonable frame for local conditions. This benefit is valued as income with [Currency A] 15,600 p.a. (basis: unfurnished 3-room apartment).

  The company will contribute 70% to the total cost of utilities.'

(f) The second overseas company shall meet the cost of direct Economy Class Air Passages for the Employee and her family (children [up to] 20 years of age) if she returns to [the named overseas country] immediately after termination of the contract or if [the second overseas company] should recall her prematurely. [The second overseas company] shall also meet reasonable expenses for the transport and insurance of the Employee's personal effects'.

(g) 'PREMATURE DISCHARGE OF AN EMPLOYEE UNDER NOTICE

Without prejudice to the Employee's remuneration as set out in this contract, [the second overseas company] may wholly or partly forgo her services between the date when notice is given and the date of expiry of the contract.

In this case, the Company has the right to pay in cash for perquisites of any kind to which the Employee may be entitled until expiration of the contract period. Such cash payments will be based on the amounts considered for these perquisites in the calculation of her income.'

(h) 'These supplementary Provisions supercede all earlier agreements as from [1 April 1994]'.

5. By an Employer's Return dated 28 April 1995, the Hong Kong company reported that the appellant's accrued income for the year ended 31 March 1995 totalled $576,457, comprising $573,607 as salary from 6 June 1994 to 31 March 1995 and $2,850 as other rewards, allowances or perquisites for the same period and that it had paid $495,000 to the landlord for the quarters provided from 12 May 1994 to 31 March 1995.

6. By letter dated 27 October 1995 ('the Termination Agreement'), the second overseas company referred to 'previous discussions' and outlined the terms and conditions 'defining the termination' of the appellant's employment with the companies in the group. The

appellant signed signifying her agreement. The terms agreed by the second overseas company and the appellant included the following:

(a) 'The contract of employment between yourself and [the Hong Kong company] resp. [the second overseas company] will be terminated on 30 April 1996.'

(b) 'You will cease all further activities for [the group] immediately and surrender to [the Hong Kong company] all business documents and property ...'

(c) 'Your salary will be paid to you up to 30 April 1996. [The Hong Kong company] is prepared to make a lump sum payment of HKD371,000 covering the six month period from November 1995 until April 1996.'

(d) The Hong Kong company 'will grant a housing allowance of HKD 25,000 (net after tax) for the month of December 1995'.

(e) The second overseas company 'will pay you an amount of [Currency A] 8,000 in lieu of covering the cost of your return transfer including relocation of household goods'.

(f) 'With respect to the exchange rate guarantee given to you in your contract with [the Hong Kong company] we will compensate the loss of HKD 14,000 for a total period of 16 months (January 1995 – April 1996).'

(g) 'You can take advantage of your club membership in Hongkong until the end of November 1995.'

(h) 'This settlement is being offered to you on the understanding that you will adhere to the terms of this agreement and refrain from taking any action prejudicial to the [group]'.

7. By an agreement dated 31 October 1995 ('the Supplemental Termination Agreement') made between the appellant and the Hong Kong company, both parties confirmed that the Hong Kong company 'has made a capital payment of HK$410,000.00 ... which eliminates all contractual obligations on the side of [the Hong Kong company] as well as on the side of the employee'.

8. In an 'Emoluments Analysis' which accompanied the appellant's tax return dated 1 November 2004 for the year of assessment 1995/96, the appellant apportioned $8,750 of the exchange rate guarantee of $14,000 for the period from 1 April 1995 to 31 October 1995 and $5,250 for the 'Ex Worked Period' from 1 November 1995 to 30 April 1996.

9. By letter dated 2 November 1995, the second overseas company wrote to the Hong Kong company referring to the termination of the appellant's employment with the Hong Kong company 'as per April 30, 1996' and asking the latter to consider the following 'issues':

> 'Compensation
>
> [The appellant] shall receive her salary up to April 30, 1996 on the basis of HKD 742,000 p.a (gross). It is mutually agreed … that [the appellant] shall receive a lump sum payment of HKD 371,000 for the six month period ending April 30, 1996.
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> In addition she shall receive a housing allowance of HKD 25,000 (net after tax) for the month of December 1995 as the lease for her apartment is already terminated by December 2, 1995.
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> Exchange Rate Guarantee
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> According to her contract [the appellant] is entitled to a payment by [the Hong Kong company] for losses on exchange rates for the period between 1st January 1995 and 30 April 1996. This payment amounts to HKD 14,000 (net after local tax)
>
> Relocation
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> [The appellant] has decided not to return to [an overseas place] or [the named overseas country] for the time being and there is no relocation to be organised/paid by [the Hong Kong company]. [The appellant] will receive a payment by [the second overseas company] in lieu of the relocation expenses.
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> Vacation
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> All vacation entitlement is fully compensated by the agreement to cease all activities for the company immediately.
>
> Club Membership
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> [The appellant] is entitled to use her club membership with … until the end of November 1995.'

10. By a Notification under section 52(5) of the Ordinance dated 21 November 1995, the Hong Kong company reported that the appellant's period of employment was from 1 April 1995 to 1 November 1995; that the appellant's emoluments totalled $981,034, comprising $571,034 as salary from 1 April 1995 to 31 October 1995; $385,000 as back pay, terminal awards for the same period; $25,000 as rewards, allowances or perquisites for the same period;

and that it had paid $387,661 to the landlord for the quarters provided from 1 April 1995 to 5 December 1995.

The appellant's contention

11. The appellant contended that $401,250, that is, the 'capital sum' of $410,000 less the sum of $8,750 referred to in paragraph 8 above, paid upon termination of her employment was not chargeable to salaries tax.

The relevant authorities

12. Section 8(1) provides that:

> *'(1) 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 –*
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> *(a) any office or employment of profit; and*
>
> *(b) any pension.'*

13. Section 9(1)(a) provides that:

> *'(1) 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 other ...'*

14. Section 68(4) provides that the onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.

15. In CIR v Humphrey [1970] HKLR 447 at page 452, CA, Blair-Kerr J said that the following are the corresponding English provisions:

> *'The corresponding English statutory provisions are s. 156 of the Income Tax Act 1952 and rule 1 of the Rules applicable to Schedule E (9th Schedule to the Act). These provisions read as follows:-*
>
> *"s. 156..... Schedule E*
>
> *1. Tax under this Schedule shall be charged in respect of every public office or employment of profit.....".*

> *"r. 1. Tax under Schedule E. shall be annually charged on every person having or exercising an office or employment of profit mentioned in Schedule E..... in respect of all salaries, fees, wages, perquisites or profits whatsoever therefrom ....."."*

16. In Hochstrasser (Inspector of Taxes) v Mayes [1960] AC 376 at pages 387-388, Viscount Simonds cited section 156 of the 1952 Act and commented on Upjohn J's summary of the law:

> *'It is by section 156 of the Income Tax Act, 1952, provided as follows:*
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> *"The Schedule referred to in this Act as Schedule E is as follows –*
>
> *"Schedule E*
>
> *"1. Tax under this Schedule shall be charged in respect of every public office or employment of profit. ...*
>
> *"2. Tax under this Schedule shall also be charged in respect of any office employment or pension, the profits or gains arising or accruing from which would be chargeable to tax under Schedule D but for the proviso to paragraph 1 of that Schedule. ...*
>
> *"5. The provisions set out in Schedule IX to this Act shall apply in relation to the tax to be charged under this Schedule."*
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> *Schedule IX, so far as relevant, was as follows:*
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> *"Rules Applicable To Schedule E*
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> *"1. Tax under Schedule E shall be annually charged on every person having or exercising an office or employment of profit mentioned in Schedule E, or to whom any annuity, pension or stipend chargeable under that Schedule is payable, in respect of all salaries, fees, wages, perquisites or profits whatsoever therefrom for the year of assessment, after deducting the amount of duties or other sums payable or chargeable on the same by virtue of any Act of Parliament, where the same have been really and bona fide paid and borne by the party to be charged."*
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> *...*

> *Upjohn J., before whom the matter first came, after a review of the relevant case law, expressed himself thus in a passage which appears to me to sum up the law in a manner which cannot be improved upon. "In my judgment," he said, "the authorities show this, that it is a question to be answered in the light of the particular facts of every case whether or not a particular payment is or is not a profit arising from the employment. Disregarding entirely contracts for full consideration in money or money's worth and personal presents, in my judgment not every payment made to an employee is necessarily made to him as a profit arising from his employment. Indeed, in my judgment, the authorities show that to be a profit arising from the employment the payment must be made in reference to the services the employee renders by virtue of his office, and it must be something in the nature of a reward for services past, present or future." In this passage the single word "past" may be open to question, but apart from that it appears to me to be entirely accurate.'*

Lord Radcliffe (at pages 391-392) thought that the test was whether a payment was made in return for acting as or being an employee:

> *'For my part, I think that their meaning is adequately conveyed by saying that, while it is not sufficient to render a payment assessable that an employee would not have received it unless he had been an employee, it is assessable if it has been paid to him in return for acting as or being an employee.'*

Lord Cohen (at page 393-394) said that the court must be satisfied that the service agreement was the causa causans and not merely the causa sine qua non of the receipt of the profit:

> *'My Lords, I am prepared to accept that statement of the law but it is, I think, clear from the final conclusion of Morris L.J. in the case last cited, and from the decisions cited by Jenkins L.J. in his judgment in the present case (see especially Beak v. Robson, per Lord Simon, and Cowan v. Seymour, per Younger L.J.) that it is not enough for the Crown to establish that the employee would not have received the sum on which tax is claimed had he not been an employee. The court must be satisfied that the service agreement was the causa causans and not merely the causa sine qua non of the receipt of the profit.'*

17. In Shilton v Wilmshurst (Inspector of Taxes) [1991] 1 AC 684 at pages 688 & 689, Lord Templeman who delivered the leading judgment in the House of Lords cited sections 181 and 183 of the English Income and Corporation Taxes Act 1970, and stated what emolument 'from employment' or 'from the employment' meant:

> *'Section 183 of the Act of 1970, now replaced by section 131 of the Income and Corporation Taxes Act 1988, provided that:*

> *"(1) Tax under Case I, II or III of Schedule E shall . . . be chargeable on the full amount of the emoluments falling under that Case . . . and the expression "emoluments" shall include all salaries, fees, wages, perquisites and profits whatsoever."*
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> *It is common ground that the sum of £75,000 paid by Nottingham Forest to Mr. Shilton was an emolument as defined by section 183.*
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> *Section 181(1) of the Act of 1970, as amended and now replaced, so far as material, by section 19(1) of the Act of 1988, provided that tax under Schedule E:*
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> *"shall be charged in respect of any office or employment on emoluments therefrom which fall under . . . Case I: where the person holding the office or employment is resident and ordinarily resident in the United Kingdom . . ."*
>
> *...*
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> *... 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, secondly, 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".'*

18. Hochstrasser (Inspector of Taxes) v Mayes and Shilton v Wilmshurst have been cited and applied in some Board cases, e.g. D60/97, IRBRD, vol 12, 367 and D24/05 (2005-06), IRBRD, vol 20, 382

19. In CIR v Yung Tse Kwong [2004] HKLRD 192 at paragraphs 38 – 40 , Tang J (as he then was) cited Shilton v Wilmshurst and held that the crux of the matter was what was the reason for the payment sought to be taxed:

> *'38. In Shilton v. Wilmshurst (Inspector of Taxes) [1991] 1 AC 684, the taxpayer, a professional footballer, was employed by Nottingham Forest Football Club under a contract due to expire in July 1983. In July 1982, the club accepted an offer from Southampton Football Club, subject to agreement by the taxpayer, for the transfer of the taxpayer for a fee of £325,000. The taxpayer agreed to sign on to play for Southampton on payment being made to him by Nottingham Forest of a lump sum of £75,000. He then entered into a new contract of employment with Southampton Football Club.*
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> *39. The issue there was whether the £75,000 was taxable under Schedule E, and it was held by the House of Lords allowing the appeal that an emolument was chargeable to Schedule E as being 'from' employment if the payment in question had been made to the taxpayer as a reward for past services or as an inducement for him to agree to become, or to remain, an employee; and that in relation to such payment by third parties, it was not necessary to show that the person making the payment had any interest in the performance of the services to be undertaken by the employee under his contract of employment. And that since the payment of £75,000 had been made to, and accepted by, the taxpayer in return for his agreeing to become an employee of Southampton and for no other reason, there was accordingly an emolument from his employment with that club chargeable to tax. Lord Templeman said at p.689E :*
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> *"…. 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"."*
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> *Again, this decision went to the question, which was one of fact, what was the reason(s) for the payment sought to be taxed.*
>
> *40. These authorities confirm my view that the crux of the matter is whether Sum A was paid solely or partly as an inducement to enter into employment or was it solely or partly for the making of the Severance Agreement and in particular the giving of the restrictive covenants.'*

20. In Henley v Murray (Inspector of Taxes) 31 TC 351, the issue was whether a sum was or was not within the phrase or formula: salaries, fees, wages, perquisites or profits whatsoever from an office or employment of profit, paraphrasing, so far as necessary, the words of Rule 1 of the Rules applicable to Schedule E (see page 361). At page 363, Sir Evershed said that bargains of the kind might take one of two forms.

> *'If that is a correct analysis, it seems to me that the case is clearly one of the first kind which I have stated -- a case in which the contract persists. Though the right of one party to call on the other for performance of its terms may be modified, or, indeed, wholly given up, still the corresponding right to require payment either of the whole remuneration or of some less figure is preserved and is still payable under the contract.*
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> *But, there is another class of case where the bargain is, as it seems to me, of an essentially different character, the contract itself goes altogether and some sum becomes payable for the consideration of the total abandonment of all the contractual rights which the other party had under the contract.'*

At page 367, Jenkins LJ posed the question thus:

> *'As the many cases on this topic show, it is often very difficult to determine the character of a payment made to the holder of an office when his tenure of the office is determined, or the terms on which he holds it are altered, and the question in each case is whether, on the facts of the case, the lump sum paid is in the nature of remuneration or profits in respect of the office, or is in the nature of a sum paid in consideration of the surrender by the recipient of his rights in respect of the office.'*

21. In passing, we note that none of the cases cited above is on the Revenue's list of authorities.

The appellant's contractual entitlements

22. Under the Employment Letter, the appellant was entitled to be 'supplied with accommodation at the Company's expense'. Under the Supplemental Provisions, the appellant was entitled to 'rental for unfurnished accommodation'. If the appellant's employment had continued until 30 April 1996, the appellant would have been entitled under her service contract(s) to quarters. The Employer's Return dated 28 April 1995 and the Notification dated 21 November 1995 showed that the monthly rental for the quarters provided to the appellant until 5 December 1995 exceeded HK$25,000. Needless to say, the appellant's contractual entitlement to quarters for the period from early December 1995 to 30 April 1996 substantially exceeded HK$25,000 (net after tax).

23. Under the Employment Letter, the appellant was entitled to 'business class air fares from Hong Kong [to a named overseas country] ... upon termination' of her employment in Hong Kong. Under the Supplemental Provisions, the appellant was entitled to direct Economy Class Air Passages for her and her family (children up to 20 years of age) if she returned to the named overseas country immediately after termination of the contract, plus reasonable expenses for the transport and insurance of her personal effects. If the appellant's employment had continued until 30 April 1996, her contractual entitlement to economy class air passages would depend on her itinerary immediately after 30 April 1996, not around early November 1995. The sum of [Currency A] 8,000 'in lieu of' covering the cost of her return transfer including relocation of household goods referred to in the Termination Agreement did not form part of the $410,000 paid to her.

The Board's Decision

24. The appellant's case is that $401,250 of the sum of $410,000 paid to her upon termination of her employment was not chargeable to salaries tax.

25. In the Board's view, $401,250 was not paid in reference to the services the appellant rendered by virtue of her office. Nor was it paid in return for acting as or being an employee. Nor was her service agreement(s) the causa causans and not merely the causa sine qua non of the receipt of the payment. Nor was it an emolument from being or becoming an employee. It was attributable to the Termination Agreement and the Supplemental Termination Agreement.

26. By the Termination Agreement and the Supplemental Termination Agreement, all contractual obligations under the service agreement with the Hong Kong company were 'eliminated'. The service agreement(s) went altogether and some sum became payable and was paid for the consideration of the total abandonment of all the contractual rights which the appellant had under the service agreement(s), including, in particular, her entitlement to quarters. On the facts of this case, the sum paid was in the nature of a sum paid in consideration of the surrender by the appellant of her rights in respect of the office.

27. For these reasons, $401,250 was not income from employment and the appeal succeeds. The case is remitted to the respondent to revise the assessments appealed against to give effect to the Board's Decision.