



**Hon Le Pichon JA:**

2. This is an appeal by the Commissioner of Inland Revenue (“the Commissioner”) from part of the judgment dated 28 June 2006 of Deputy High Court Judge Poon on a Case Stated from the Board of Review dated 21 October 2005. Both the judge and the Board held that the taxpayer was liable to income tax on a portion of the sum of US\$11 million paid to the taxpayer by his employer, Consolidated Electric Power Asia Ltd (“the company”) upon the termination of the taxpayer’s employment contract, although they differed as to how that portion was to be quantified. The taxpayer on the other hand, cross-appealed on liability. At the conclusion of the appeal judgment was reserved which we now give.

**Background**

3. The taxpayer was one of the co-founders of the company which was engaged in the business of developing, constructing, owning, operating and maintaining electric power generation facilities. The taxpayer had been involved in that business for over 20 years. When Southern Energy-Asia Inc (“Southern”) a Delaware corporation acquired a controlling interest in the company on 29 January 1997, the taxpayer became its managing director and chief executive officer under an employment agreement dated the 30 October 1996 (“the Agreement”).

4. Under clauses 1 & 2 of the Agreement, the taxpayer was to serve for a term of five years from the effective date which was 29 January 1997. Nevertheless it was envisaged that the Agreement might be extended, renewed or replaced by mutual agreement. There was thus a provision for notice to be given by a party as to his or its willingness to negotiate such extension or renewal before the expiration of the fourth year of the term.

5. Clause 5 which dealt with the taxpayer’s compensation had six components: (a) a basic salary of US\$600,000 payable by equal monthly instalments; (b) a performance bonus of up to US\$400,000 based on the achievement of performance goals payable at six monthly intervals; (c) annual profit sharing equal to 0.5% of the Net Income (as defined in that sub-paragraph) of the company; (d) additional profit sharing in the event of the taxpayer’s employment coming to an end, other than for cause, after five years of service entitling the taxpayer (or his estate in the event of his death) to annual profit-sharing payments for each year of service up to 15 years with a proviso that if the taxpayer should die or cease to be employed as a result of permanent disability at any time prior to five years of service, he or his estate should be entitled to additional profit-sharing payments for a period equal to his length of service; (e) an annual allowance of US\$500,000 to cover personal expenses including housing and pensions for the term of the agreement; and (f) an Incentive Compensation Plan (“ICP”) described in greater detail below. On any view the taxpayer’s rights under the Agreement could be said to be considerable.

6. As regards the ICP, in pertinent part, clause 5 (f) provided as follows:

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- “(i) As soon as practical following the Effective Date, [the taxpayer] shall be awarded 5,000,000 nontransferable, nonassignable, Incentive Compensation Plan Units (the “Units”). During the term of this Agreement and for a period of two years thereafter, [the taxpayer] shall be entitled to additional Units in the amount of 500,000 units each upon the declared commercial operation date of the Company’s next six 660MW electrical generating units. Each 500,000 Unit block shall entitle [the taxpayer] to an annual payment in an amount equal to the Net Income of the Company multiplied by 0.0385 percent (the “Compensation Percentage”) less the Retention Percentage (as hereinafter defined ...
- (iii) ...The Units granted hereby are neither transferable nor assignable by [the taxpayer] except by will or by the laws of descent and distribution, in which event, [the taxpayer’s] heirs or beneficiaries shall succeed to [the taxpayer’s] rights under this [clause 5 (f)] and [clause] 8 hereof, provided however, that in the event of [the taxpayer’s] death the Company shall have the right on the tenth anniversary of [the taxpayer’s] death to terminate such Units in the hands of [the taxpayer’s] heirs or beneficiaries in exchange for the lump-sum payment provisions set forth in [clause] 9 hereof ...”

For convenience, hereafter in this judgment, I will refer to the 5 million units awarded on the effective date as “the existing units” and the additional units that might have been earned as “the future units”.

7. Clause 8 dealt with termination. Sub-clauses (a) to (d) (inclusive) gave the company the right to terminate the Agreement for cause and sub-clause (e) then provided for the immediate termination of the Agreement on the taxpayer’s death.

8. Clause 9 of the Agreement conferred on the taxpayer “... the right from time to time to elect to terminate all or part of the Incentive Compensation Plan” following the fifth anniversary of the effective date and to receive a lump sum payment in lieu calculated in accordance with the formula stated in that clause, which had a proviso reducing the multiplier of 13 to 10 proportionately over a 10-year period if the election is made after the termination of the taxpayer’s employment. Clause 9 went on to provide that notwithstanding the five-year period referred to, the taxpayer’s right to elect to receive a lump sum payment should vest fully upon the sale of substantially all of the common stock or assets of the Company to a purchaser unrelated to the Company, the initial public offering of the stock of the Company “*or as the Company may otherwise agree*”.

9. Less than five months into his employment under the Agreement, on 12 June 1997, Southern requested the taxpayer to resign from the company. On the same day, the parties signed a termination agreement which, *inter alia*, provided as follows:

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- Clause 1 provided for the taxpayer's immediate resignation from his directorship and employment with the company and all its subsidiaries and associated companies.
- Clause 2 provided for the payment by the company to the taxpayer of US\$2 million on 13 June 1997.
- Clause 3 contained the taxpayer's agreement to the cancellation of his ICP units for a payment of US\$11 million to be paid no later than 12 July 1997 with a provision for failure to pay (which did not happen).
- Clause 4 contained the company's agreement to forgive the repayment of the principal on the US\$8 million loan from the company to the taxpayer as and when such principal repayments fell due, with a proviso that is immaterial for present purposes.
- Clause 5 was a 2 year non-compete provision, the taxpayer also agreeing not to disclose confidential information etc.

10. The Board concluded that:

- (1) the sum of US\$11 million was a payment made in exchange for the taxpayer's ICP units, comprising the existing units and the future units;
- (2) the portion of the sum attributable to the future units was not taxable applying the principle laid down in *Henley v Murray* (1950) 31 TC 351 that compensation for wrongful termination of an employment contract was not, as a matter of law, income from employment and that it was a payment for the abrogation of the taxpayer's rights in respect of the future units;
- (3) the existing units constituted an inducement to the taxpayer to enter into the Agreement and therefore the portion of the sum attributable to those units was taxable; and
- (4) 50% of the sum should be apportioned to the existing units by adopting a "rough and ready" method of apportionment.

11. The Commissioner accepted the Board's decision summarised in paragraph 10(1) and (2) above. The judge upheld the Board's decision in 10(3) but concluded that the sum attributable to the cancellation of the existing units covered not only the sum representing the value of the inducement (which sum was held to be taxable), but also a sum representing the compensation for abrogating the taxpayer's right to annual payments under

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clause 5 (f) and the lump-sum payment under clause 9 (which sum was held not to be taxable). He therefore remitted the case back to the Board to reconsider apportionment. The appeal to this court is limited to liability to income tax in respect of the existing units and the question of apportionment.

12. The questions of law in the Case Stated are the following:

“The Commissioner’s question

- (i) “Whether on the facts found by the Board, the Board’s conclusion that 50% of the Sum should be apportioned to the 5M Units was one which a reasonable tribunal could arrive at.”

The Taxpayer’s questions

- (ii) “Did the Board err in law in failing to conclude that, upon the true construction of the Termination Agreement and the Employment Agreement, all of the Sum, including the part representing the Taxpayer’s entitlement in respect of the 5M Units, was damages for the abrogation of the Taxpayer’s Employment Agreement and therefore not chargeable to tax?”
- (iii) “Was the Board correct in law in concluding that Part III of Cap. 112 (as it stood in June 1997) permitted apportionment of sums received by the Taxpayer under the Termination Agreement for the purpose of determining what part of the Sum was taxable thereunder?”
- (iv) “If apportionment is permitted by Part III, was the Board correct in law in adopting the ‘rough and ready’ method of apportionment?” ”

**This appeal**

13. The central issue in this appeal is whether the taxpayer is liable to income tax on *any part* of the sum of US\$11 million. It was common ground that the portion of US\$11 million as is attributable to the value of the future units was not taxable. The question therefore was whether any part of the balance attracted income tax.

14. Mr Fung who appeared for the Commissioner contended that the existing units constituted an inducement to the taxpayer to enter into the Agreement, that such an inducement must necessarily be income from employment which would be liable to salaries tax and that the value of the existing units represented what the taxpayer would have received by reason of owning those units applying the “substitution” approach laid down in *Mairs v Haughey* [1994] 1 AC 303. It was submitted that the judge was wrong to conclude that the value attributable to the existing units

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comprised two components, namely, a portion representing the value of the inducement and a portion representing compensation for abrogating the taxpayer's rights to annual payments and in holding that only the former was taxable. For the taxpayer, it was argued that the lump sum paid (being part of the US\$11 million) to cancel the existing units was nothing more than compensation for abrogating the taxpayer's rights in respect of those units, and thus no taxable liability whatever arose in respect of that sum.

15. What were the taxpayer's rights in relation to the existing units? On that issue, the Commissioner and the taxpayer differed fundamentally as to the taxpayer's rights upon his ceasing to be employed by the company less than five months after the effective date. As I understand it, the Commissioner's stance was that once conferred (i.e. through the execution of the Agreement), the existing units gave the taxpayer and his estate the right to be paid 0.385% of the Net Income of the company under clause 5 (f)(i) ("the relevant income") on an annual basis, indefinitely. On the taxpayer's death, subject to any election to be paid a lump sum under clause 9 in lieu, the relevant income would continue to be payable to his estate subject to the company's right to terminate such units in exchange for the lump sum payment provisions of clause 9 on the 10<sup>th</sup> anniversary of the taxpayer's death. It mattered not that the taxpayer ceased to be employed by the company during the period of service contemplated by the Agreement. Taking an extreme example, Mr Fung submitted that even if the taxpayer's employment were to terminate after only one day, that would not affect his and his estate's entitlement, forevermore, to be paid the relevant income until the lump sum provisions were triggered. Mr Barlow, for the taxpayer, submitted that the taxpayer's entitlement to the relevant income was dependant on his having completed the relevant year of service.

16. The issue comes to this: whether, on the true construction of the Agreement, the right to the relevant income was tied to the taxpayer's employment with the company.

17. In my view, given the factual matrix, the answer to that question must be yes. The taxpayer was clearly not a run-of-the-mill employee. I say this because it is apparent from the recitals to the Agreement that the taxpayer's experience in the business engaged in by the company of which he had been a co-founder and managing director and chief executive for many years no doubt accounted for the unusual and generous compensation package he was able to command. His appointment as managing director and chief executive officer was clearly then perceived to be pivotal to the future success or otherwise of the business. A long association was plainly envisaged: see, for example, the additional profit sharing arrangements.

18. More specifically, the ICP formed but one of six components of compensation payable by the company to the taxpayer in respect of his employment under the Agreement. Second, entitlement to future units plainly was premised on the taxpayer continuing to be employed in that capacity upon the declared commercial operation of each of the next six 660 MW electrical generating units within the seven-year period from the effective date. This necessarily follows from the opening words in the second sentence of paragraph (i) of clause 5 (f), viz "during the term of

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this Agreement and for a period of two years thereafter”. In my view, as paragraph (i) has to be read as a whole, those words would similarly qualify entitlement to be paid the relevant income which is part of paragraph (i). Third, it should be noted that the definition of “Net Income” in the Agreement had a proviso enabling it to be pro-rated *inter alia* “when an obligation of the Company to make payments pursuant to [clause 5(c) or (d)] or, in respect of some or all Incentive Compensation Plan Units, pursuant to [clause 5 (f)], ceases...”. On Mr Fung’s reading of the Agreement, the company’s obligation would never ‘cease’ if the lump sum provisions are not triggered. If he is right, it may be asked, what is meant by the company’s obligation under clause 5 (f) ‘ceasing’ in the course of a fiscal year?

19. If the proviso is to have any meaning at all, it can only mean that the company has no obligation to make payments of relevant income in respect of any period *after* the taxpayer ceases to be an employee. In substance, I consider that the ICP could be viewed as a “top up” of the profit-sharing arrangement of 0.5% of Net Income already provided by clause 5 (c), increasing it by a range of between 0.385% and 0.616% per annum of the Net Income depending on the number of additional blocks of 500,000 units to which the taxpayer might become entitled. As profit sharing was linked to the office, one would expect any “top up” to be subject to the same condition.

20. In my view, on the true construction of the Agreement, as at the date of the termination agreement, whilst the existing units *per se* conferred on the taxpayer entitlement to a share of the Net Income (if any) calculated *pro rata* to the number of completed months in the company’s fiscal year comprised in the relevant period, it was contingent on there being “Net Income” as defined in the Agreement during the relevant fiscal year. Moreover, as will become apparent, at the date of the termination agreement, the taxpayer had no right to ‘cash out’ under the lump sum provisions of clause 9 and therefore could not be treated as being entitled to a capital sum.

21. But this is not to say that from the taxpayer’s point of view the existing units were not valuable. On any view, the income stream that would have flowed from them, had the Agreement not been terminated prematurely, could have been significant. Assuming that his employment had not been terminated, the taxpayer would have enjoyed the right (albeit contingent on there being Net Income for the relevant fiscal year) to receive the relevant income. Whilst the units were neither transferable nor assignable, the right to the relevant income would survive his own demise and enure to the benefit of his estate provided he was so employed at the date of his death, subject to the company’s right on the 10<sup>th</sup> anniversary of the taxpayer’s death to terminate the units in exchange for a lump sum. He also had a right from time to time to elect under clause 9 of the Agreement to receive cash in lieu of the ICP units at any time following the 5<sup>th</sup> anniversary of the effective date. In addition, under clause 5 (f)(i), if and to the extent that the taxpayer is or becomes liable for Hong Kong salaries tax on any of the payments made thereunder, the company was obliged to reimburse the taxpayer on a ‘grossed up’ basis. Accordingly, the termination of his employment brought those not inconsiderable rights to a premature end.

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22. I now turn to consider the basis upon which the Board concluded that the award of the existing units to the taxpayer constituted an inducement to him to enter into the Agreement thus attracting salaries tax. Fundamental to its conclusion was the Board's understanding that the taxpayer was *entitled* to "cash out" the existing units with the company, whether under clause 9 "or otherwise". That is apparent from paragraphs 37 and 38 of its Decision:

"37. The Board concluded that on the 12<sup>th</sup> June 1997, the Taxpayer undoubtedly had the [existing units] and he was entitled to annual payments in accordance with the terms of Clause 5.f.; equally, he was entitled to "cash out" his [existing units] with [the company] (whether under Clause 9 or otherwise); that whether the Employment Agreement was terminated on that day could not have changed that position; and that the principle of Henley had no application here; that the payment for the [existing units] was not different in nature from the sum of £577 in Henley, being remuneration earned by an employee during the currency of his employment contract.

38. It appeared to the Board to be abundantly clear that under the Hong Kong salaries tax regime an inducement to the Taxpayer to enter into the Employment Agreement was chargeable to tax [see CIR v Yung Tse Kwong, CFI, [2004] 3 HKLRD 192]. The Board considered that the fact that the [existing units] had been "cashed out" merely meant that, instead of the annual payments being liable to salaries tax, the money received for cancellation of the [existing units] became so liable; that for the purposes of revenue law, the substitute for the annual payments was treated in the same way as the annual payments themselves, the authority for this proposition being Mairs v Haughey [1994] 1 AC 303 where it was held, at p.319D-E, that:

"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." "

(Pausing there, it is to be noted that what the Board meant by reference to "or otherwise" is not readily apparent.) Further, the Board never addressed the question whether the taxpayer's right to be paid the relevant income was tied to his employment by the company. Rather, in paragraph 37 the Board appeared to have assumed that had the taxpayer not been bought out by having the ICP units "cancelled", because he already owned the existing units, thus he would have been entitled to receive annual payments indefinitely although no longer employed by the company.

23. At paragraph 46, the Board opined that:

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“there was no real distinction between salary owed to an employee and paid on the date of termination (the £577 in *Henley*) and paid in exchange for an existing right to a share of profits which (the share of profits) was to be paid in the future ( the payment for the [existing units]). Applying the *ratio* of *Henley*, the payment for the [existing units] was attributable to the Employment Agreement rather than the termination of it (or loss of employment); and that this was so notwithstanding the fact that one could say that, without the termination, the [existing units] would not have been bought out.”

24. In my view, the Board has misconstrued the Agreement. The taxpayer had no *right* to “cash out” the existing units until after the 5<sup>th</sup> anniversary of the effective date. Before the expiration of the five-year period, he could do so only with the company’s agreement. The taxpayer could not compel or require the company to give its consent. Further, he had no contingent right to share in any Net Income attributable to a period after his employment came to an end.

25. It will be seen that the Board’s reasoning throughout was premised on a misreading of the Agreement which necessarily undermines its conclusion. The taxpayer had no contractual basis for requiring a buy-out. Moreover, as noted above, the taxpayer’s entitlement was limited to a contingent right to a *pro rata* share of the relevant income and nothing further. So despite the Board’s findings, there were errors of law which would warrant interference by this court.

26. The judge agreed with the Board that the award of the existing units constituted an inducement. He did so on the basis that part of the US\$11 million was taxable as “an accrued quantified entitlement”. He considered that the Board’s finding of an inducement could not be flawed because the existing units “would entitle the taxpayer to annual payments as provided under Clause 5 (f)(i); or subject to [the company’s] agreement a lump sum payment in lieu under Clause 9.” He fell into the same error as the Board in overlooking the taxpayer’s limited contingent right to a *pro rata* share of the relevant income and the fact that he had no right to cash out during the first five years of the Agreement.

27. Had the taxpayer’s employment not come to an end prematurely, income received by him by virtue of owning the existing units would have been chargeable to income tax. But that fact is of little assistance to Mr Fung. The same can be said of the perquisites (other than the ICP units) receivable by the taxpayer and set out in paragraph 4 above. Those perquisites can also be said to constitute an inducement to enter into the Agreement. Yet, under the principle in *Henley v Murray* which on behalf of the Commissioner Mr Fung accepts, payments received as compensation for loss of office are not chargeable to income tax.

28. In *Henley*, Sir Raymond Evershed, MR (at page 363) contrasted the case in which “the contract persists”, where the employers remain liable under the contract for the remuneration they had contracted to pay though they gave up their right to call upon the employee to perform the

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duties under the contract with another class of case where the bargain was of an essentially different character, where “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”. The critical distinction was the continued existence or otherwise of the contract of employment. As Jenkins LJ remarked (at page 367), “the question in each case is whether, on the facts of the case, the lump sum paid is in the nature of remuneration of profits in respect of the office or is in the nature of the sum paid in consideration of the surrender by the recipient of his rights in respect of the office.” In the present case, the Agreement unquestionably came to an end.

**Conclusion**

29. What clause 3 of the termination agreement shows is that *all* the taxpayer’s rights under the Agreement in respect of the ICP units, existing and future, were to be cancelled in return for the payment of US\$11 million. Those rights necessarily encompassed his contingent right to a *pro rata* share of the relevant income for the tax year 1997/1998. The bargain evidenced by clause 3 of the termination agreement was the extinguishment of all ICP units, existing and future, and the rights thereunder in return for a lump sum. As a practical matter, any attempt to isolate and value that contingent right as at the date of the termination agreement would have been fraught with difficulty. To value it with the benefit of hindsight is not a solution because that luxury was not available to the parties at the date of the termination agreement. As the contingent right had not yet crystallised as at the date of the termination agreement, it could not be said with certainty what, if anything, it would yield at the end of the day.

30. Looking at the matter in the round, in my view, the entire sum of the US\$11 million constituted compensation for the abrogation of *all* of the taxpayer’s rights in relation to the ICP units, existing as well as future, including the contingent right to a *pro rata* share of the relevant income. In substance, the contingent right was part and parcel of the ‘whole bundle of rights’ which was extinguished through the cancellation of the ICP units. In my view, no part of that sum attracts income tax because no part of it was paid to the taxpayer “in return for acting as or being an employee”: the whole sum was to compensate the taxpayer for his loss of the ICP units.

31. I would therefore dismiss the appeal and allow the cross-appeal. As to the questions posed in the Case Stated, I would answer (ii) in the affirmative. In view of that answer, the other questions posed do not arise for consideration. I would also make an order *nisi* that the costs here and below be to the taxpayer.

**Hon Stone J:**

32. I respectfully agree with the judgment of Le Pichon JA.

33. The obvious conceptual problem in arriving at a suitable formula for apportionment, a difficulty encountered both by the Board and also by the learned judge below, who had decided to

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remit this issue to the Board for further consideration, in my view highlights the flaw in purporting to characterize as chargeable to income tax a notional sum representing the existing 5 million units (be it the “rough and ready” 50% as adopted by the Board, or, for example, the 62.5% advocated by Mr Fung in this appeal) when, as Le Pichon JA has pointed out, the value to the taxpayer of these units was contingent upon his continued employment and the existence of a Net Income stream for the relevant financial year.

34. In these circumstances, it strikes me as somewhat arbitrary, and certainly unrealistic, to purport to categorize such notional sum representing these existing units within the ‘inducement’ pigeon hole (thus rendering taxable a quantified/apportioned sum said to represent these existing units) rather than to recognize, as in my view was the situation in the present case, that these existing units, taken together with the potential future units, simply represented an element within the entire employment package – aptly described by Le Pichon JA as the employee’s ‘whole bundle of rights’ – which, upon agreed payment, was being expropriated by this employer from this employee upon early termination, and as such represented compensation which, under the *Henley* principle, is accepted as non-taxable.

**Hon Rogers VP:**

35. There will accordingly be an order in terms of paragraph 31 above.

(Anthony Rogers)  
Vice-President

(Doreen Le Pichon)  
Justice of Appeal

(William Stone)  
Judge of the  
Court of First Instance

Mr Eugene Fung, instructed by the Department of Justice, for the Appellant

Mr Barrie Barlow, instructed by Messrs Lovells, for the Respondent

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