



HONG KONG TAX ALERT

July 2021 | Issue 7

Salaries Tax – Termination of employment and restricted shares

Summary

On 29 June 2021, the Court of First Instance (“CFI”) handed down its decision on the case of *Heath Brian Zarin v Commissioner of Inland Revenue [2021] HKCFI 1846* that restricted shares released pursuant to a Termination Agreement should not be subject to Salaries Tax.

Whilst the taxpayer was victorious, the fact that the CFI had previously ruled¹ in favour of the Inland Revenue Department (“IRD”) illustrates that whilst the applicable legal principles are clear, their application can still be challenging.

We expect the taxation of termination payments to continue to be an area of dispute between taxpayers and the IRD. That said, the case will be useful precedence as terminated employees retaining their restricted shares is not unusual.



Background

The taxpayer, Mr Zarin, was employed by a bank (“Bank”) under an employment letter, which afforded him participation in the Bank’s discretionary bonus scheme. As part of his annual discretionary bonus, Mr Zarin was granted restricted share awards which vested evenly over a three-year period. The restricted share plan included ‘good leaver’ provisions which permitted vesting following the cessation of employment, subject to the terms of a termination agreement.

In 2013, the Bank terminated Mr Zarin’s employment on the grounds of redundancy. Following a series of negotiations, in June 2013, the parties came to agreed terms (“Termination Agreement”) including the following:

- Mr Zarin was treated as a good leaver which permitted all remaining restricted shares previously awarded to him to vest on same terms.
- Any release of restricted shares granted in 2012 (the “2012 Shares”) would be conditional on Mr Zarin having not committed a breach of Termination Agreement. If Mr Zarin committed a breach, any unvested 2012 Shares would be forfeited and Mr Zarin would repay the cash value of any shares vested;
- Mr Zarin would provide post-termination obligations in respect of the Bank’s on-going litigation. Subject to Mr Zarin providing reasonable assistance in respect of the Bank’s litigation, the Bank would compensate Mr Zarin for the time spent, pay reasonable and pre-approved expenses incurred and provide reasonable security support.
- Mr Zarin would provide reasonable assistance in proceedings (including litigation) as required in relation to any matter with which Mr Zarin was dealing with during the course of his employment until their conclusion or five years from the date of the Termination Agreement, whichever earlier.

¹ *Heath Brian Zarin v Commissioner of Inland Revenue [2019] HKCFI 3101*

As a result of complying with the terms of the Termination Agreement, amongst other things, two sums arose from the 2012 Shares vesting in 2014 and 2015. The Inland Revenue Department (“IRD”) assessed these sums to Salaries Tax. The taxpayer appealed.

Prior to the present decision, the Board of Review had found in favour of the IRD on the matter of the 2012 Shares and that whilst their release was pursuant to the Termination Agreement, the purpose of such release was “in return for acting as or being an employee”. Similarly, the Court of First Instance (“CFI”), when it first heard the case, dismissed the taxpayer’s appeal with respect to the 2012 Shares on the grounds that it was not reasonably arguable as the release was derived from the good leaver provisions of the restricted share plan. However, the Court of Appeal subsequently granted leave to appeal as the Court of Appeal viewed it to be reasonably arguable that the continuing release was derived from the Termination Agreement and that the taxpayer had provided fresh consideration for the release. This led to the present case and the CFI taking a “fresh” approach to re-examine the facts, in particular, the substance of the Termination Agreement.

The Decision

After re-examining the facts, the CFI found that the 2012 Shares would not vest unless the participant had complied with the Termination Agreement. The ‘good leaver’ term in the restricted share plan envisaged that a participant might have to provide fresh consideration to become entitled to vesting, and such fresh consideration might have nothing to do with employment. The terms of the Termination Agreement identified the purpose for the release of the 2012 Shares, which was to procure Mr Zarin to provide long-term assistance in the Bank’s litigation. Whilst noting that the case was borderline, the CFI came to view that the release of the 2012 Shares was not taxable as it was not income from employment – it was “from something else”.

How we can help

The taxation of termination payments will continue to be a contentious matter in Hong Kong. KPMG has extensive experience working with organizations planning for and implementing employee redundancies/terminations and has represented numerous taxpayers in tax-related disputes.

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