



# HONG KONG TAX ALERT

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## Salaries Tax – Taxation of Share Awards (Vesting vs. Forfeiture)

### Summary

On 24 August 2021, the Court of First Instance's ("CFI") decision in *Richard Paul Mark Aidan Forlee v Commissioner of Inland Revenue [2021] HKCFI 2476* allowed the taxpayer's appeal reversing the previous decision of the Board of Review.

The decision is important as it confirms a distinction between a vesting period, which defers the accrual of the income, and an outright grant with the possibility of forfeiture on the occurrence of a future event.

The Court held that the benefit derived from the grant of shares should be taxed at the time of grant despite the shares being subject to forfeiture provisions. The scheme provided for a Release Period during which the shares would be forfeited if the employee ceased to work for the Group of companies in which the employer was a member.

Central to the decision was the fact that the taxpayer enjoyed the benefit of dividends and voting rights that came with ownership of the shares held via a nominee. The Court concluded that the grant of the shares was a perquisite and that perquisite accrued on grant, notwithstanding the possibility of subsequent forfeiture.

This case will be of interest to employers that have or are looking to establish equity-based remuneration schemes to reward and incentivise staff, while having a retention element by linking the grant of shares to on-going employment.



### Background

The Taxpayer, Mr Forlee was employed by Investec in the UK from 2002 to 30 June 2014. On 1 July 2014, the Taxpayer transferred within the Group and was employed under a Hong Kong employment.

- During the UK employment period, the Taxpayer was awarded EVA Shares on 29 May 2012, 4 June 2013, and 27 May 2014 ("the UK Awards") under the Group's Share Incentive Plan ("Plan"). These UK Awards were granted to the Taxpayer during and in respect of his UK employment.
- When awarded, the Shares were transferred and held by the Taxpayer's nominee as an agent of the Taxpayer, and on behalf of the Taxpayer for his sole and absolute benefit until the end of the relevant retention period (see below).
- Subject to the provisions of the Plan, the Taxpayer had all the rights of a shareholder in respect of the UK Awards from the date of the award. He had the right to dividends, the right to vote and the right to direct the nominee how to vote.

- In respect of each tranche of these shares, the expiry date upon the Grantor's reservation of a contingent entitlement of forfeiture rights were set from 29 May 2012 to 27 May 2017, i.e. the "Release Dates".
- If the Taxpayer ceased to be an employee of the Group before the Release Dates, he would forfeit the unreleased EVA Shares, and would have no entitlement under the plan, unless a committee decided otherwise.
- Upon release, the EVA Shares ceased to be subject to forfeiture, but the Taxpayer was not able to transfer or dispose them until the expiry of the Plan's relevant retention period.

### Board of Review

Prior to the present decision, the Board of Review determined that the benefit of the shares accrued to the taxpayer on the Release Date, i.e., that it was only after the EVA Shares were free of risk of forfeiture that they accrued and became taxable. This conclusion was important as, although it delayed the taxing point, it brought them within the charge to Hong Kong salaries tax on the basis that a part of the period over which the shares were earned coincided with the period of Hong Kong employment.

### The CFI Decision

In the decision, the CFI placed emphasis on the date when the recipient was able to 'turn the EVA Shares into a pecuniary account'. The Court held that the fact that the EVA Shares were not fully transferrable or disposable should not be considered to preclude the accrual of the benefit of the Shares.

The Court emphasised the fact that, from the date the EVA Shares were awarded to him, the Taxpayer became entitled to claim the income represented by the Shares.

- i. The Shares were issued, transferred to and held by the nominee as the agent of the taxpayer
- ii. The shares were held for his sole and absolute benefit
- iii. He was paid, and received, dividends on the Shares

Addressing the issue of the Shares being subject to forfeiture prior to the release date under the terms of the Plan, the Court stated that this did not affect the accrual of income and that the Board had erred in its decision. The decision draws a clear distinction between vesting and forfeiture, articulating that "forfeiture" is the loss of a right/interest and that there can be no forfeiture without prior vesting of the interest.

The Court also reversed the Board's decision that the dividends were taxable as income from employment, holding that the dividends were due to the Taxpayer by virtue of the fact that the Nominee was registered as the holder of the Shares, on behalf of as agent and for the sole benefit of the Taxpayer.

### KPMG Comment

This decision is important as it draws a clear distinction between a vesting period, which defers the accrual of the income, and an outright grant with the possibility of forfeiture on the occurrence of a future event.

Employers establishing share-based remuneration plans will need to consider the implications of this decision carefully, as it highlights the subtle but important distinction between vesting conditions and forfeiture provisions which will impact the timing of taxation and share valuation.

For early stage companies and other incentive arrangements, where rapid growth is anticipated, it may be preferable to pay tax at grant on an lower value and to have the subsequent gain accrue as capital growth. Valuations will be an important consideration in this respect. It is however a shame that the judgement did not extend to how shares subject to forfeiture might be valued for tax purposes.

Employers should review existing arrangements and those setting up share-based remuneration schemes should take steps to ensure scheme rules align with remuneration objectives and expected tax outcomes.

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