


Salaries Tax – Termination of employment and restricted shares

Summary



On 16 March 2022, the Court of Appeal (“CA”) handed down its decision on the case of *Heath Brian Zarin v Commissioner of Inland Revenue [2022] HKCA 412* confirming two previous judgements¹ of the Court of First Instance (“CFI”) that remuneration paid for assistance in litigation and restricted shares released pursuant to a Termination Agreement should not be subject to Salaries Tax.

The decision is useful precedence as it illustrates how the principle of whether a payment is “in return for acting as or being an employee” or “for something else” should be applied. The former is taxable, whereas the latter is not. Even though restricted shares may have been awarded during employment as a reward for past services their vesting or release may be attributable to something else – in this case, fresh consideration under the Termination Agreement.

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 in the form of restricted share awards. In 2013, the Bank terminated Mr Zarin’s employment on the grounds of redundancy. Following a series of negotiations, six months after the termination, the parties came to agreed terms (“Termination Agreement”) including five sums, described as “Sum A”, “Sum B1”, “Sum B2”, “Sum C” and “Sum D”, which were made to Mr Zarin. Sum A and Sum B1 represent the 2011 restricted shares awards (“2011 Shares”) that would continue to vest per the original award terms. Sum B2 and Sum C represent the 2012 restricted shares awards (“2012 Shares”) that would be conditional on Mr Zarin having not committed a breach of the Termination Agreement and providing post-termination support in respect of the Bank’s on-going litigation. Sum D represents the compensation that would be paid to Mr Zarin on daily basis for time spent in assisting certain litigation matters of the bank for the next five years (“Litigation Compensation”).

The present case heard by the CA deals with the Commissioner’s appeal in respect of Sums B2 and C - the 2012 Shares and Sum D – the Litigation Compensation. Prior to this, all five sums noted above were held to be taxable by the Board of Review. The Court of First Instance (“CFI”) initially granted leave to appeal in respect of the Litigation Compensation with the CA subsequently granting leave to appeal in respect of the 2012 Shares. The CFI upon re-examination allowed Mr Zarin’s appeals in respect of the 2012 Shares.

¹ See Hong Kong Tax Alert July 2021 Issue 7 for our coverage of the CFI judgement on the 2012 Share:

<https://home.kpmg/cn/en/home/insights/2021/07/tax-alert-7-hk-salaries-tax-termination-employment-restricted-shares.html>

The Decision

The CA dismissed the CIR's appeal ruling in favour of the taxpayer. The Litigation Compensation and 2012 Shares were found to stem from the Termination Agreement, for which the parties had agreed to new obligations.

In respect of the 2012 Shares, the CIR's representative argued that the CFI ought not to have disturbed the Board's conclusion highlighting that CFI judge had commented that the 2012 Shares were very much a borderline case. The CIR argued that (i) the 2012 Shares were awarded in return for Mr Zarin acting as or being an employee, or as a reward for his past services; and (ii) that the CFI failed to determine what constitutes the dominant purpose or substantial cause of the payment of the 2012 Shares. Emphasis was placed on the fact that the 2012 Shares constituted a significant part of the taxpayer's remuneration package and that they were awarded during employment as a reward for services. The CA refuted the argument of the CIR finding that (i) Mr Zarin had taken up new obligations under the Termination Agreement, over and above his obligations under the employment letter and (ii) the employment cannot be regarded as a substantial cause for the payment of the 2012 Shares. The CA confirmed that the CFI applied correct tests on both Litigation Compensation and the 2012 Shares.

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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