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Tax alert

Issue 5 – March 2011

Salaries Tax – the final chapter on termination payments?

The Court of Final Appeal (CFA) dismissed the taxpayer's appeal in *Fuchs, Walter Alfred Heinz v CIR* [2011] FACV 22/2000 in February 2011. At issue was whether two sums paid to Mr Fuchs on the termination of his employment were assessable to Salaries Tax as income from an office or employment within the meaning of section 8(1) of the Inland Revenue Ordinance (IRO). Alternatively, if the income was taxable, did it fall to be apportioned by virtue of section 8(1A) of the IRO.

Background

The background to this case is set out in Tax alert Issue 28 - November 2009.

In brief, Mr Fuchs employment contract provided for the following compensation in the event of his termination:

a) two annual salaries (Sum B)
b) an average amount of the bonuses paid in his three previous years of employment (Sum C).

It was argued for Mr Fuchs that Sums B and C were not paid in accordance with his entitlements under his employment contract, but pursuant to the termination agreement in consideration for the abrogation of his contingent rights under the employment contract. However, the CFA disagreed that the Sums were paid for the abrogation of any rights as Mr Fuchs rights to the Sums were not contingent and were enforceable in law.

The CFA agreed that a variety of payments may fall outside the scope of the charge to Salaries Tax, for instance:

a) damages obtained in a suit for wrongful dismissal or a payment under a settlement agreement reached in such a suit
b) a payment to indemnify an employee who had purchased a house under a housing scheme set up by the employer, but who then had to sell it at a loss when directed by the employer to work elsewhere in the country
c) an amount paid by a company to obtain a release from its contingent liability
d) a payment made to an employee for the total abrogation imposed on him of his contract of employment.

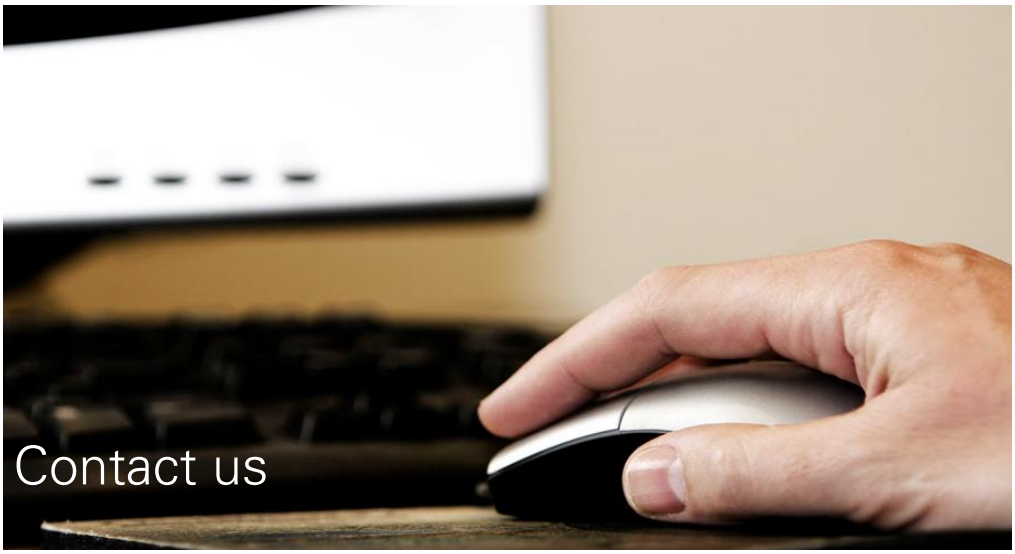
The CFA pointed out that the rights that accrued to Mr Fuchs upon termination were enforceable at law. Mr Fuchs could have sued to recover the sums if for any reason payment had not been made. Being given a right to substantial compensation in the event of early termination without cause was an important part of the contractual consideration and an inducement to Mr Fuchs to sign the employment contract.

The CFA also rejected the argument for apportionment. The contract was silent on the 27 years of service rendered by Mr Fuchs prior to its commencement and moreover was governed by the laws of Hong Kong.

Comment

The CFA decision was reached on reasoning, which proceeded much along the lines of the Court of Appeal's decision. Income chargeable under section 8(1) is not confined to income earned in the course of employment, but embraces payments made "in return for acting as or being an employee", or "as a reward for past services or as an inducement to enter into employment and provide future services". If a payment, viewed as a matter of substance and not merely of form and without being "blinded by some formulae which the parties may have used", is found to be derived from the taxpayer's employment in the abovementioned sense, it is assessable.

As previously advised, care should be taken when drafting a contract of employment which includes a termination clause as the Court's will critically review the contract to determine the true nature of a termination payment.



Contact us

For more information, please contact:

Corporate Tax, KPMG China

Khoon Ming Ho
Partner in Charge, Tax
China and Hong Kong SAR
Tel: +86 10 8508 7082
khoonming.ho@kpmg.com

Vaughn Barber
Partner
Tel: +852 2826 7130
vaughn.barber@kpmg.com

Charles Kinsley
Principal
Tel: +852 2826 8070
charles.kinsley@kpmg.com

Jennifer Wong
Partner
Tel: +852 2978 8288
jennifer.wong@kpmg.com

Ayesha Macpherson
Partner in Charge, Tax – Hong Kong SAR
Tel: +852 2826 7165
ayesha.macpherson@kpmg.com

Darren Bowdern
Partner
Tel: +852 2826 7166
darren.bowdern@kpmg.com

Curtis Ng
Partner
Tel: +852 2143 8709
curtis.ng@kpmg.com

Garry Laird
Senior Tax Advisor
Tel: +852 2143 8795
garry.laird@kpmg.com

Chris Abbiss
Partner
Tel: +852 2826 7226
chris.abbiss@kpmg.com

Nigel Hobler
Partner
Tel: +852 2143 8784
nigel.hobler@kpmg.com

John Timpany
Partner
Tel: +852 2143 8790
john.timpany@kpmg.com

International Executive Services, KPMG China

Barbara Forrest
Principal
Tel: +852 2978 8941
barbara.forrest@kpmg.com

kpmg.com/cn