GMS Flash Alert

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Hong Kong - Court Issues Decision on Separation / Termination Payment

In Hong Kong, the Court of Final Appeal ("CFA") has issued an important decision applying the principle that a payment made in return for acting or being an employee is taxable, whereas a payment that is "for something else" is not.

The CFA handed down its decision in the case of *Commissioner of Inland Revenue v Poon Cho-ming, John FACV No. 1 of 2019*, which upholds the (lower) Court of Appeal's decision that dismissed the Commissioner's appeal.

Ultimately, the CFA decided in favour of the taxpayer in concluding that a payment in lieu of bonus (referred to as "Sum D") and share option gain arising from a separation agreement should not be subject to Salaries Tax.

WHY THIS MATTERS

The decision of the CFA has significant impact on the taxation of termination packages as well as how they might be structured by employers. Employers and employees should carefully plan and review documentation pertaining to the termination of employment.

Background

The taxpayer was employed in Hong Kong as the Group Chief Financial Officer and executive director of a company. On 20 July 2008, the taxpayer's employment was terminated pursuant to a separation agreement under which the taxpayer received several sums, namely:

A. Payment in lieu of notice;

B. Statutory long-service pay;

C. Payment in lieu of unused leave;

D. Payment in lieu of bonus;

E. Payment in consideration of covenants made by the taxpayer.

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In addition to the above, the separation agreement also permitted the taxpayer to exercise share options granted to him during his employment. Vesting of the share options was accelerated to permit the taxpayer to exercise the options, which he duly did, giving rise to the share option gain in dispute. Of the sums above, Sum D and the share option gain were the two items in contention before the Board of Review and courts.

Both the Board of Review and Court of First Instance decided in favour of the Commissioner, which was subsequently overturned by the Court of Appeal ("CA"), which decided in favour of the taxpayer (i.e., that Sum D and the share option gain were not taxable). The Commissioner appealed the CA's decision claiming the question put forward of great general or public importance, but leave was ultimately granted on the basis that it would be helpful for the CFA to follow up the decision in the Fuchs case[1].

Court of Final Appeal Decision

The CFA found that the CA was correct in holding that Sum D and the share option gain were not taxable. In coming to its decision, the CFA applied the principles established in Fuchs, that a payment made in return for acting or being an employee is taxable, whereas a payment that is "for something else" is not. In the Fuchs case, the terminal payments made to the taxpayer were provided for in his contract of employment and were held to be taxable.

With respect to Sum D, the Commissioner contended that, being in lieu of bonus, the sum was made in recognition of the taxpayer's efforts and therefore taxable. The Commissioner also sought to apply a "substitution test" extracted from *Mairs v Haughey* [1994] 1 AC 303, which would operate such that a sum made in true substitution of another takes on the nature of the latter. In considering the substance of Sum D, the CFA referred to the facts and decision of the CA, which found no evidence that the employer's results and the employee's performance had been considered for the purpose of determining a bonus to him. Sum D had been determined arbitrarily and was of a different nature, paid to make him go away quietly.

With respect to the share option gain, the Commissioner put forward arguments placing emphasis on the fact that share options were originally granted during the taxpayer's employment and therefore arose substantially from his employment. The CFA found otherwise, agreeing with the CA that acceleration of vesting leading to the share option gain was not to reward the taxpayer for past services (and clearly could not be for future services), but rather, was for something else – to make him go away quietly.

KPMG NOTE

The decision of the CFA is welcomed as it brings further clarity to the taxation of termination payments. The decision affirms the principles established in Fuchs – i.e., that a payment made in return for acting or being an employee is taxable, whereas a payment that is "for something else" is not. Furthermore, the principles apply even if the consideration is a payment in lieu of a lost bonus or the right to retain share options that would have otherwise been forfeited. The long running nature of this case, differing views, and sizeable body of case law on the taxation of termination payments demonstrate that it can often be difficult to apply the principles and there is often a fine distinction between what is taxable as opposed to non-taxable.

In practice, the Inland Revenue Department, when assessing the taxability of termination payments, may indeed continue to consider each case on its own merits. Taxpayers, in determining whether a termination payment is subject

to Salaries Tax, will need to consider all relevant documents and their interpretation. With the law being clear, the question becomes one of fact and substance.

FOOTNOTE:

1 *Fuchs v Commissioner of Inland Revenue (2011)* 14 HKCFAR 74.

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Contact us

For additional information or assistance, please contact your local GMS or People Services professional or one of the following professionals with the KPMG International member firm in Hong Kong:

Murray Sarelius
Tel. +852 3927 5671
Murray.sarelius@kpmg.com

David Siew
Tel. +852 2143 8785
david.siew@kpmg.com

The information contained in this newsletter was submitted by the KPMG International member firm in Hong Kong.

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