

GMS Flash Alert

2021-202 | July 21, 2021



Hong Kong – Salaries Tax: Termination of Employment and Restricted Shares

On 29 June 2021, Hong Kong's Court of First Instance ("CFI") handed down its decision in a recent case that restricted shares released pursuant to a Termination Agreement should not be subject to Salaries Tax.¹

WHY THIS MATTERS

Although the taxpayer – who was the appellant – was victorious, the fact that the CFI had previously ruledⁱ in favour of the Inland Revenue Department ("IRD") illustrates that whilst the applicable legal principles are clear, their application can still be challenging.

It is expected that the taxation of termination payments to continue to be an area of dispute between taxpayers and the IRD. That said, the case will be a useful precedent because it is not unusual for terminated employees to retain their restricted shares.

Background

The taxpayer (the appellant in the case) 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, the taxpayer 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 the taxpayer'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:

- The taxpayer 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 the taxpayer having not committed a breach of Termination Agreement. If the taxpayer committed a breach, any unvested 2012 shares would be forfeited and the taxpayer would repay the cash value of any shares vested.
- the taxpayer would provide post-termination obligations in respect of the Bank’s on-going litigation. Subject to the taxpayer providing reasonable assistance in respect of the Bank’s litigation, the Bank would compensate the taxpayer for the time spent, pay reasonable and pre-approved expenses incurred, and provide reasonable security support.
- the taxpayer would provide reasonable assistance in proceedings (including litigation) as required in relation to any matter with which the taxpayer was dealing during the course of his employment until their conclusion or five years from the date of the Termination Agreement, whichever earlier.

As a result of complying with the terms of the Termination Agreement, amongst other things, two sums arose from the 2012 shares having vested in 2014 and 2015. The IRD assessed these sums to Salaries Tax. The taxpayer appealed.

Courts’ Review and Outcomes

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 while 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 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 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.

KPMG NOTE

After re-examining the facts, the CFI found that the 2012 shares would not have vested 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 the taxpayer to provide long-term assistance in the Bank’s litigation. Although 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.”

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

FOOTNOTE:

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

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