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GMS Flash Alert

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Hong Kong - Taxation of Share Awards, Vesting vs. Forfeiture

On 24 August 2021, Hong Kong's Court of First Instance (CFI) issued an important decision on equity-based compensation that reversed the prior decision of the Board of Review.[1]

The decision confirms the distinction between a vesting period for share grants, which defers the accrual of the income, and an outright grant with the possibility of forfeiture on the occurrence of a future event. The CFI 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 same group of companies of 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 CFI concluded that the grant of the shares was a perquisite and that perquisite accrued on grant, notwithstanding the possibility of subsequent forfeiture.

WHY THIS MATTERS

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 ongoing employment.

Background

The taxpayer in the case was employed by a bank in the United Kingdom from 2002 to 30 June 2014. On 1 July 2014, the taxpayer transferred to another company in the bank's group and was employed under a Hong Kong employment contract with the capital markets arm of the Group. Both employers were within the same group, hereinafter referred to as "the Group."

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- During the U.K. employment period, the taxpayer was awarded forfeitable shares, described in the case as the EVA Shares, on 29 May 2012, 4 June 2013, and 27 May 2014 ("the U.K. Awards") under the Group's Share Incentive Plan ("the Plan"). These U.K. Awards were granted to the taxpayer during and for his U.K. employment.

- When awarded, the shares were transferred and held by the taxpayer's nominee as his agent, and 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 U.K. 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.

- For each tranche of these shares, the expiry date upon the grantor's reservation of a contingent entitlement of forfeiture rights was 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 CFI decision, the Board of Review had 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 made the shares subject 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.

CFI Decision

In its decision, the CFI emphasised the date when the recipient was able to "turn the EVA Shares into a pecuniary account." According to the CFI's ruling, 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 CFI 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 CFI stated that this did not affect the accrual of income and that the Board of Review had erred in its decision. The CFI decision draws a clear distinction between vesting and forfeiture, articulating that "forfeiture" is the loss of a right/interest and there can be no forfeiture without prior vesting of the interest.

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The CFI also reversed the Board of Review's decision on the taxability of the dividends as income from employment, holding that the dividends were due to the taxpayer because the nominee was registered as the holder of the shares, on behalf of the taxpayer, as agent and for the sole benefit of the taxpayer.

KPMG NOTE

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, when rapid growth is anticipated, it may be preferrable to pay tax at the grant of shares on a lower value and to have the subsequent gain accrue as capital growth. Valuations will be an important consideration in this respect. It is however unfortunate that the judgement did not explain how shares subject to forfeiture might be valued for tax purposes.

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

FOOTNOTE:

1 *Richard Paul Mark Aidan Forlee v Commissoner of Inland Revenue* [2021] HKCFI 2476.

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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
National Head of People Services
Tel. +852 3927 5671
murray.sarelius@kpmg.com

David Siew
Partner, People Services Hong Kong
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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