Hong Kong: Termination payments not made for services rendered held not subject to tax

December 2, 2019

In brief

The Court of Final Appeal (CFA) handed down its judgment in *Poon Cho-ming, John v Commissioner of Inland Revenue (CIR)* on November 14, 2019. The CFA unanimously upheld the judgment made by the Court of Appeal (COA) on March 24, 2016 that (1) payment in lieu of a discretionary bonus made to the taxpayer; and (2) share option gains derived by the taxpayer from the accelerated vesting of previously granted options upon termination of employment are not income from employment. As a result, neither is subject to salaries tax.

In detail

Key facts of the case

The taxpayer was employed as the Group Chief Financial Officer and an executive director of a Hong Kong listed company (the Company) under a Service Agreement prior to the termination of his employment in July 2008. He proposed a two-pronged course of action to challenge the dismissal and was prepared to take his claims to court, which could have attracted media interest.

After negotiations between the two parties, the taxpayer and the Company entered into a Separation Agreement. Under this agreement, the taxpayer received, among other payments: (1) payment in lieu of a discretionary bonus for the financial year ended June 30, 2008 (Sum D) and (2) share option gains derived by the taxpayer from the exercise of three tranches of share options (Tranches A, B, and C) previously granted to him. The vesting dates were accelerated to the termination date under the Separation Agreement (hereinafter Share Option Gain).

Both Sum D and the Share Option Gain were assessed by the Inland Revenue Department as taxable employment income. The taxpayer appealed to the Board of Review and then Court of First Instance, both of which dismissed the taxpayer's appeal and held that both Sum D and the Share Option Gain were income from employment and thus taxable.

The taxpayer took the case to the COA, which overturned the CFI's judgment in June 2018 and concluded that neither Sum D nor the Share Option Gain is taxable because the payments were not income from employment. The CIR appealed against the COA's decision to the CFA.

For more details regarding the previous CFI and COA's judgments, please refer to our prior Mobility Insights dated July 2016 and October 2018.

The CFA's judgment

Reference to the 'Fuchs' case

Both the COA and CFA made references to the 'Fuchs' case, a leading authority on the taxability of termination payments. In the *Fuchs* case, the CFA distinguished between a payment that was made in satisfaction of an employee's rights under his employment contract (i.e., rights provided in the employment contract) and a payment that was made for abrogation of those rights. The former is income from employment and therefore is taxable, whereas the latter is not.

The determination of taxability requires an analysis of the purpose of the payments given the circumstances. In the present case, Sum D and the Share Option Gain were not provided for in the Service Agreement.

Sum D – Substance over form

Under the terms of the Service Agreement, the taxpayer was eligible to participate in an annual bonus scheme in which the terms and amount were to be determined by the Company's board from time to time. However, in the current case, despite the name 'in lieu of a discretionary bonus' at the time of the termination, the process for bonus determination for the period ending June 30, 2008 had not begun. There was no evidence that the Company's results and the taxpayer's performance had been considered, nor evidence that the taxpayer would be awarded a bonus in the amount of Sum D if the employment was not terminated.

On the contrary, as a matter of substance, Sum D was an arbitrary amount arrived at during negotiations between the taxpayer and the Company. The purpose of the payment was for the taxpayer to exit without attention and generally was the antithesis of rewarding the taxpayer for services under the Service Agreement. As a result, the CFA upheld the COA's decision that Sum D is not taxable.

Share Option Gain – Acceleration of vesting date

The taxpayer did not have any accrued rights to tranches A to C of the options at the time of the termination as they had not been vested. In fact, those share option rights were lost upon termination of the employment. Although the grant of the options stemmed from his employment, it was the acceleration of the vesting dates pursuant to the Separation Agreement that enabled the taxpayer to exercise these options and derive the benefits.

The acceleration of the options was negotiated and allowed with a view to settle all outstanding matters upon termination –not for rewarding the taxpayer for past services rendered, nor an inducement to provide future services. It was consideration for him to drop the proposed two-pronged course of action and additional covenants set out in the Separation Agreement. As with Sum D, the CFA agreed with the COA's decision that the Share Option Gain is not taxable.

The takeaway

The favorable CFA's judgment for the taxpayer illustrates that the test for determining the taxability of a termination payment lies in the true nature and substance of the payment rather than its form or label, thus requiring an in-depth analysis of the facts and circumstances leading to the payment. Careful planning and drafting of both the employment contract and termination agreement, together with the support by facts and circumstances of the situation, are crucial to substantiate the true nature of the termination payments for tax purposes.

Let's talk

For a deeper discussion of how this impacts your business, please contact your Global Mobility Services engagement team or one of the following professionals:

Global Mobility Services – Hong Kong

James Clemence, *Asia Leader*
+852 2289 1818
james.clemence@hk.pwc.com

Global Mobility Services – United States

Peter Clarke, *Global Leader*
+1 (646) 471-4743
peter.clarke@pwc.com