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Corporate Commercial Client Alert

Tax

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Salaries tax alert: Payment of bonus shares to former employee and per diem for post-employment assistance to former employer held not taxable

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When an employment relationship comes to an end, it is not uncommon for the parties to enter into a termination agreement setting out the departing employee's rights and obligations. A question naturally arises as to whether, and to what extent, benefits arising to a departing employee under a termination agreement are chargeable to salaries tax. Generally, a payment is chargeable to salaries tax only if and to the extent that it is "from [the taxpayer's] employment". In the recent decision in **Heath Brian Zarin v CIR** [2022] HKCA 412, the Court of Appeal again affirmed the orthodox, common law interpretation of the words "from employment" in the context of the charge to salaries tax.

Deacons acted for Mr. Zarin both as solicitors and as advocates throughout these proceedings.

Background

The taxpayer, Mr. Zarin, was employed by a bank (the "**Company**") and was accorded the right to participate in a discretionary bonus scheme. In 2012, Mr. Zarin was granted a restricted share award under that scheme, on which terms the shares (the "**Bonus Shares**") would vest in three tranches in 2013, 2014, and 2015 respectively. The share plan ("**Plan**") relevantly provided that:

- The rules of the Plan did not form part of Mr. Zarin's employment contract.
- The Bonus Shares would vest on the dates specified in the Plan, provided that Mr. Zarin remained continuously employed within the group or left the group as a good leaver (including being terminated on redundancy).
- If Mr. Zarin left the group as a good leaver and had entered into a termination agreement, any unvested Bonus Shares would not vest until he had complied with, or was released from his obligations under, that termination agreement.

The Company terminated Mr. Zarin's employment in January 2013 on the ground of redundancy. After series of negotiation on the termination package, the parties entered into an agreement in June 2013 setting out the terms and conditions regarding Mr. Zarin's termination of employment ("**Termination Agreement**"). The terms of the Termination Agreement included that:

- Mr. Zarin would be treated as a good leaver for the purpose of the Plan and the remaining Bonus Shares would vest on the dates specified in the Plan subject to the terms of the Termination Agreement.
- Mr. Zarin agreed to comply with various post-termination obligations (including, among others, to provide reasonable assistance in a litigation in which the Company was involved ("**Litigation**"), to withdraw an outstanding data access request and to provide the usual release and discharge of claims).
- Any release of the Bonus Shares would be conditional on Mr. Zarin not committing any breach of any terms of the Termination Agreement.

- In case Mr. Zarin did commit any breach under the Termination Agreement, any unvested Bonus Shares would be forfeited.

- Mr. Zarin would be paid a *per diem* by the Company for each day he spent assisting in the Litigation.

Having complied with the terms of the Termination Agreement, and provided assistance in the Litigation while in Singapore, Mr. Zarin received two sums in 2014 and 2015 representing the final two tranches of the Bonus Shares and a cash *per diem* payment (the "**Per Diem**"). The Inland Revenue Department assessed each of those sums to salaries tax, and Mr. Zarin appealed. The Board of Review dismissed his appeal, and he appealed to the Court of First Instance (the "**CFI**").

The CFI heard Mr. Zarin's appeals on the Bonus Shares and the Per Diem separately. In two separate decisions, the Honourable Mr. Justice Coleman allowed Mr. Zarin's appeals, holding that the Bonus Shares and the Per Diem were not "from employment" because they represented consideration for covenants and undertakings that Mr. Zarin had accepted in the Termination Agreement, which post-dated the cessation of his employment and were therefore unrelated to any past, present, or future services he may have provided to the Company as an employee.

The Commissioner of Inland Revenue (the "**Commissioner**") appealed both decisions, and the Court of Appeal directed that the two appeals be heard together.

The Court of Appeal Decision

The Court of Appeal had to determine whether the Per Diem and the vesting of the Bonus Shares were "from" employment and so chargeable to salaries tax under ss.8(1) and 9(1) of the Inland Revenue Ordinance (Cap. 112) (the "**IRO**"). The Court answered those two questions in negative, and dismissed the Commissioner's appeals.

First, and as regards the Bonus Shares, the Court held that there was a fundamental distinction between the grant of a share subject to vesting, at which time the participating employee gets nothing of value unless and until he complies with all of the applicable vesting conditions, and the actual vesting of the same, when a transfer of value does, indeed, take place. Referring to authorities including **Fuchs v CIR** (2011) 14 HKCFAR 74 and **CIR v Poon Cho Ming** [2019] HKCFA 38, the Court confirmed that in ascertaining whether a sum is from employment for salaries tax purposes, one needs to ascertain the substance of the bargain for the payment and the purpose of payment. If the payment in question were in substance a reward or inducement for past, present or future services rendered as employee, it would be income "from" employment chargeable to salaries tax. If the payment were made for some other reason, it would not qualify as a taxable income. In the context of termination, it is not conclusive simply to show that the taxpayer agrees to surrender or forego some pre-existing contractual rights by receiving the payment in question. The ultimate question remains one of the purpose of payment and there must be some causal link between the taxpayer's employment and the payment.

Second, and as regards the Per Diem, the Commissioner's argument was in essence that because it was customary for highly paid employees to render reasonable post-termination assistance, Mr. Zarin's assistance in the Litigation was nothing more than what he should have provided as an employee and was on that footing "from employment" within the meaning of the IRO. Conversely, the CFI below had found that the Termination Agreement was a new fee-earning contract, and not a contract of employment, such that the Per Diem could not be said to be from an employment.

The Court concurred in all respects with the analysis of the CFI below, and found that the main purpose for releasing the Bonus Shares and paying the Per Diem to Mr. Zarin was to procure that he provide potentially long-term assistance in the Litigation (instead of rewarding him for services provided in the course of his employment with the Company) and agree to the prospective undertakings and covenants in the Termination Agreement. The Court placed much weight on the provision in the Plan stating that in case a good leaver entered into a termination agreement pursuant to the cessation of his employment, the Bonus Shares would not have vested unless and until the awardee's obligations under such agreement have been complied with or waived.

The Court further took the opportunity to reiterate certain cardinal principles of salaries tax, including an important reminder that for a sum to be "from employment" within the meaning of the IRO, it must have some causal connection with the employment in question. It rejected the Commissioner's suggestion that it adopt an impressionistic or broad-brush approach: not all payments from an employer to an employee or an ex-employee are taxable, and it is not sufficient to show that the payment is in some loose sense connected with an employment, or would not have been paid if the recipient had not been an employee.

How we can help

As observed by the Court, matters concerning the taxability of income received in connection with employment are highly fact sensitive and may involve difficult issues decided on narrow distinctions. We have extensive experience advising

clients in both non-contentious and contentious employment tax matters, and representing them before the Board of Review and higher courts in salaries tax disputes and stand ready to assist.

Want to know more?

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