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Court of Final Appeal affirms termination payment not subject to salaries tax

On 14 November 2019, the Hong Kong Court of Final Appeal (CFA) ruled that employee termination payments made not for services but for the abrogation of an employee's rights under an employment contract are not subject to salaries tax *[Commissioner of Inland Revenue v. Poon Cho Ming, John (FACV 1/2019)]*.

Background

The taxpayer entered into an employment contract with his employer on 20 October 1999. On 18 July 2008, the employer informed the taxpayer that his employment, as the Group Chief Financial Officer and executive director of a listed company, was to be immediately terminated. The taxpayer was unwilling to accept the termination and indicated that he would pursue legal action against the employer and also inform shareholders. Following negotiations between the parties, the terms of termination were agreed on 20 July 2008 in accordance with a separation agreement. The case involved the treatment for salaries tax purposes of the following two items in the separation agreement:

- A sum of money described as a "payment in lieu of a discretionary bonus" for the financial year ended 30 June 2008 (sum D); and
- Share option gains realized owing to the acceleration of the vesting dates in respect of three tranches of share options to the date of termination of the taxpayer's employment.

The Inland Revenue Department (IRD) assessed both amounts to salaries tax and the taxpayer challenged the IRD's approach. The Board of Review *(D7/15)* and the Court of First

Instance *(HCIA 2/2015)* upheld the IRD's decision but their decisions were overturned by the Court of Appeal *(CACV 94/2016)* on 1 June 2018. The Commissioner of Inland Revenue appealed the Court of Appeal's decision to the CFA.

Decision of the CFA

The CFA observed that payments representing rewards and/or inducements for past, present or future services are considered as income from employment under section 8(1) of the Inland Revenue Ordinance (Cap 112) and are subject to salaries tax. In contrast, payments made for "something else" (e.g. to relieve an employee's distress) would not be subject to salaries tax. In the case at hand, the CFA found no evidence that the payments represented rewards and/or inducements for past, present or future services.

The CFA adopted a "substance-over-form" approach and considered the purpose and nature of the payments, regardless of the names given to the payments. The CFA held that sum D could not, in substance, be a discretionary bonus since it was an arbitrary amount with no evidence that the employer's results or the taxpayer's performance for the financial year were considered when determining the payment. In addition, the bonus review process had not yet commenced when the taxpayer's employment was terminated. With regard to the share options, the employer had accelerated the vesting dates of the options to the termination date specified in the separation agreement, despite being under no obligation to do so. Otherwise, the taxpayer would not have had any right to receive the shares on termination of his employment.

The CFA concluded that both the payment of sum D and the accelerated vesting of the share options were undertaken to ensure that the taxpayer did not pursue legal action against the employer or seek shareholder intervention but instead would “go away quietly" and on generally good terms. The amounts received were not in recognition of past, present or future services and as such, were not income from employment and were not subject to salaries tax.

Comments

The treatment for salaries tax purposes of payments for the loss of employment is not specifically covered in the Inland Revenue Ordinance. Taxability is determined by the basic salaries tax principles established by case law, taking into account the specific circumstances of each case. The CFA’s decision affirms that payments that are not made for past, present or future services but for another purpose are not subject to salaries tax. It also clarifies what constitutes payment for services.

The dividing line between whether a payment is for services (to be) rendered or for some other purposes sometimes is narrowly construed. The CFA and the Court of Appeal's decisions are an important reaffirmation of the principle that analysis must follow the substance-over-form approach and look at the purpose and nature of the payments, not how they are described. The IRD often takes the view that a payment in lieu of a discretionary bonus is a substitute for the discretionary bonus and, therefore, taxable. The CFA’s decision

confirms that in connection with bonuses, both the employer's financial results and the employee's performance are matters of substance. The CFA in this case determined that the payment in lieu of a discretionary bonus was non-taxable as there was no evidence that the employer's results and/or the taxpayer's individual performance were considered when deciding whether or not to award a bonus.

The IRD is increasingly focusing on the tax treatment of termination payments, with increased scrutiny of how payments are structured and determined. This case illustrates that by adopting the substance-over-form principle, certain payments can be considered not to be remuneration for services, provided it can be demonstrated that the payment is made for "something else". The decision also may provide some guidance on the appropriate structuring of termination payments going forward.

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