Post-employment compensation – is it taxable?

DENTONS

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When an employment relationship comes to an end, it is not unusual for the employer and the employee to negotiate and enter into a separation agreement to put in writing the employee's benefits, entitlements and post-employment obligations. It may be within the leaving employee's expectation that most of the payments under the termination agreement (such as accrued salary, payment in lieu of notice and annual leave pay) would be subject to salaries tax, but is this really the case for all compensation/benefits received from the employer after termination of employment?

Two recent cases, *Heath Brian Zarin v. The Commissioner of Inland Revenue*[1] and *Commissioner of Inland Revenue v. Poon Cho Ming John*[2], offer some insights on this issue.

Heath Brian Zarin v. The Commissioner of Inland Revenue

The *Heath* case involves an appeal by a taxpayer against a decision of the Inland Revenue Board of Review, which found the compensation received by the taxpayer for the assistance he rendered to his former employer in certain litigation to be "income from employment" chargeable to salaries tax. The taxpayer was a senior member of staff at a Hong Kong company. After he was laid off on grounds of redundancy, he entered into a termination agreement with his former employer, whereby it was agreed that, in return for the taxpayer providing reasonable assistance in respect of the litigation (in relation to which the taxpayer had relevant knowledge), the employer would compensate him for his time spent on the matter, calculated at the rate of HK$12,692 per day, including four days of his time already spent during the period from the termination of his employment up to the making of the termination agreement. The employer later paid the taxpayer a total of HK$50,768 as agreed compensation.

The issue before the court was whether the sum of HK$50,768 was subject to salaries tax pursuant to sections 8(1)(a) and (9)(1)(a) of the Inland Revenue Ordinance (Cap. 112).

In considering the issue, the court referred to the following key applicable principles laid down by the Court of Final Appeal in *Fuchs v. Commissioner of Inland Revenue*[3]:

- income chargeable under section 8(1) is not confined to income earned in the course of employment, but embraces payments made "in return for acting as or being an employee", or "as a reward for past services or as an inducement to enter into employment and provide future services";
- if a payment, viewed as a matter of substance and not merely of form and without being "blinded by some formulae which the parties may have used", is found to be derived from the taxpayer's employment in the sense mentioned above, it is assessable;
- a payment that is concluded as being "for something else" is not assessable, and does not come within the above

test.

The vital questions were therefore: what is the "substance of the bargain" made between the employer and the taxpayer for the payments in question, and what was the purpose of the payment? Applying these principles, the court ruled in favour of the taxpayer, holding that the sum of HK$50,768 was not money received by the taxpayer "from" his "employment" and was therefore not subject to salaries tax.

In so concluding, the court took into account the following particular circumstances of the case which pointed away from the services as being provided and paid for "from" the former employment:

- while the taxpayer was useful to the employer due to his knowledge obtained during employment, the taxpayer had no compulsion to assist in the way he agreed, and he agreed to do so only as part of the termination agreement;
- the termination agreement specified that the taxpayer would provide reasonable assistance even on matters arising after the termination of his employment, and that he might be required to do so for as long as five years after the date of the termination agreement; and
- the termination agreement specifically envisaged the possibility of a conflict arising between the taxpayer's interests and those of the company.

Commissioner of Inland Revenue v. Poon Cho Ming John

The case of *Poon Cho Ming John* also applied the same principles identified in the *Fuchs* case. Here, the taxpayer was a senior executive of a Hong Kong listed company who was dismissed by the company pursuant to a separation agreement, under which the taxpayer was to receive a sum of €500,000 "in lieu of a discretionary bonus", and which provided that the taxpayer would be entitled to exercise his stock options, despite the cessation of his employment. The case was brought before the court as the Inland Revenue Board of Review held the view that the sum of €500,000 and the gain derived from the share options were both taxable.

The Court of Final Appeal found in favour of the taxpayer and held that those benefits were not derived from the taxpayer's employment. Rather, they were paid to make him "go away quietly", so as to eliminate any possible claim/challenge that he might advance against the company. The court specifically considered the following circumstances:

- regarding the sum of €500,000, although the separation agreement described it as being paid "in lieu of a discretionary bonus", it was found to be an arbitrary amount arrived at during the negotiations for the separation agreement. The sum could not be said to have been paid in substitution for a discretionary bonus which the taxpayer might have received under his employment contract, as there was no evidence suggesting that the employer's results or the taxpayer's performance (which were matters typically of particular relevance when it comes to determining bonuses) were considered;
- as for the share options, the court placed emphasis on the fact that they would have lapsed and the taxpayer would never have received them at all, had the parties not entered into the separation agreement accelerating the vesting dates of the options to the date of the agreement. Viewed in this light, and coupled with the fact that these were part of the consideration to "make him go quietly", the court found that they were not given "as a reward for past services or as an inducement to enter into employment and provide future services".

Key takeaways

These two cases have set out the proper approach in determining whether certain termination payments are taxable. In a nutshell, one should ask:

- What was the substance of the bargain for the payments in question?
- What was the purpose of the payment?
- Was it a reward for services past, present or future (in which case it was from his employment or office), or was it "for some other reason" (in which case it was not)?

If the departing employee was entitled to the payment under the contract of employment, it follows that the payment was income "from the employment", as the purpose of the payment was for the employer to perform its obligations under the contract. However, if the employee was not so entitled, and upon examination of the facts under the above analysis, the payment was made for some purpose other than rewarding the employee for past services during the employment (such as benefits to make someone go away quietly, or compensation for post-employment assistance), it is likely that the payment will not be taxable under salaries tax.

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1. [2020] HKLRD 229. ↩
2. [2019] HKCFA 38. ↩
3. (2011) 14 HKCFAR 74. ↩

Your Key Contacts

Jenny Zhuang
Of Counsel, Hong Kong
D +852 2533 3660
jenny.zhuang@dentons.com

Henry Li
Associate, Hong Kong
D +852 2533 3678
henry.li@dentons.com