

# Recent High Court decision on taxability of bonus shares vested after termination of employment

DENTONS

August 6, 2021

In our previous article *Dentons Hong Kong: Post-employment compensation – is it taxable?*, we reviewed the judgment in *Heath Brian Zarin v. The Commissioner of Inland Revenue*<sup>1</sup> and examined the Court's approach in determining whether payments received by a dismissed employee from his former employer for offering assistance in the employer's litigation in the post-termination period are taxable. In a more recent judgment delivered in the same case<sup>2</sup>, the Court further considered the taxability of the value of shares that were awarded to the employee under a discretionary bonus scheme while he was employed but only vested after the termination of his employment. Under sections 8(1)(a) and (9)(1)(a) of the Inland Revenue Ordinance (Cap. 112), salaries tax will be charged on income arising in or derived from any office or employment of profit, which includes any wages, salary, fee, commission and bonus.

The applicable principles for determining the issue, as identified in our previous article, are those set out by the Court of Final Appeal in *Fuchs v. Commissioner of Inland Revenue*<sup>3</sup>. The key question remains whether the income is "from" the taxpayer's "employment". In answering this question, the Court will have regard to a series of considerations: 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)? Further, the Court will look at the substance, not the form or formulae or labels which might have been adopted by the parties.

In contending that the value of the shares should not be chargeable to salaries tax, the employee advanced no less than 18 points to support his position. In essence, the employee argued that this was a case where he was not entitled to the shares, either contractually or beneficially, as at the date of termination of his employment and he only acquired the right to be paid the shares upon agreeing to enter into and performing a termination agreement. He relied on the following peculiar features of the share award plan and circumstances of the vesting of shares:

1. Although the subject shares were granted to the employee on 12 March 2012, while he was employed, the shares did not vest at the same time. Instead, those shares were to vest as to 33%, 33% and 34% in March 2013, 2014 and 2015 respectively. The grant of shares did not entitle the employee to a transfer of those shares, so that the grantee received nothing of value unless and until the shares vested in accordance with the relevant rules of the share award plan.

2. The relevant rules of the share award plan provided, among other things, that:

- The employer apparently had unfettered discretion to impose vesting conditions as it saw fit, which might or might not relate to performance in employment.
- Where the employee entered into a termination agreement in connection with the cessation of his employment, and subject to the discretion of the employer unilaterally to cancel a grant of shares or otherwise to impose such further conditions as it saw fit, the award in question would not vest until the outgoing employee had complied

with the terms of that termination agreement.

- The rules and operation of the plan did not form part of the contract of employment, and that rights and obligations arising from the employment relationship were separate.
- No employee had a right to compensation for any loss in relation to the plan, including loss or reduction of rights or expectations in circumstances of the termination of employment.

3. The employer terminated the employee's employment on grounds of redundancy in January 2013. About five months later, the parties entered into a termination agreement providing for terms and conditions regarding the employee's termination of employment.

4. Under the termination agreement, the continued vesting of the shares was expressly stated to be in consideration for the contractual obligations agreed under the termination agreement, which contained covenants and undertakings from the employee as to various matters, including providing active assistance in the employer's litigation for up to five years. Those covenants and undertakings were fresh consideration provided by the employee in order to procure the employer to agree to matters including the vesting of the shares.

Although it took the view that this case was "very much a borderline case", the Court ultimately accepted that the value of the shares was not "from" the employee's "employment" and ruled that the sums released for the value of the shares should not be subject to salaries tax. In so concluding, the Court placed emphasis on the terms of the plan that envisaged that a participant/employee might have to provide fresh consideration to become entitled to vesting of shares, and such fresh consideration might have nothing to do with the employment. The Court was persuaded on the basis that the termination agreement identified that the purpose for releasing the shares was, amongst other things, to procure the employee to provide potentially long-term assistance in the employer's litigation.

The case of *Heath Brian Zarin* helpfully illustrates that, in an appropriate case, it is possible to structure post-termination packages containing vesting of shares options so that any such shares vested may be excluded from assessment of salaries tax. This may be achieved through careful negotiation of an amicable exit and drafting of a termination agreement. That being said, one must bear in mind that each case will be considered by the Court on its particular facts.

---

1. [2020] 2 HKLRD 229.↩

2. [2021] HKCFI 1846.↩

3. [2011] 14 HKCFAR 74.↩

## Your Key Contacts



**Richard Keady**

Partner, Hong Kong

D +852 2533 3663

[richard.keady@dentons.com](mailto:richard.keady@dentons.com)



**Henry Li**

Associate, Hong Kong

D +852 2533 3678

[henry.li@dentons.com](mailto:henry.li@dentons.com)