Deloitte.

Deloitte Tax LLP
Global Employer Services

GES NewsFlash

Hong Kong – Salaries Tax: Termination Payment

March 4, 2011

In this issue:

Summary

There have been numerous cases concerning the taxability of payments received upon termination of employment. The most recent case is the Court of Final Appeal (CFA) case, Fuchs, Walter Alfred Heinz v Commissioner of Inland Revenue (CIR). The judgment was delivered on February 1, 2011. The CFA concurred with the Court of Appeal (CA's) decisions and ruled in favor of the CIR. The disputed sums were held to be fully taxable.

The facts

Mr. Fuchs (the appellant) first became employed by a German bank in 1976. He worked in Germany until 2000, and thereafter at its Singapore branch. He was relocated to work in Hong Kong and signed a contract of employment ("the employment contract") with its Hong Kong branch in November 2003.

The employment contract was valid for three years from January 1, 2004. It contains a termination clause which provides that "in the event that the Bank terminates or purports to terminate this agreement…, the Bank shall pay to you as agreed compensation or liquidated damages":

- Two annual salaries (referred to as "Sum B")
- an average amount of the bonuses paid in the three previous years of your employment with the Bank (referred to as "Sum C")

As a result of the acquisition by an Italian banking group, Mr. Fuchs' employment would be terminated by December 31, 2005 (the end of the second year of the contract's three-year duration). The Bank was to pay him "a one-time compensation for the loss of his position due to the termination of the employment relationship for operational reasons" ("the termination payment"), consisting of Sum A which represents the salary for the remaining 12 months of the employment contract, and Sums B and C referred to above.

The dispute

The main questions are:

1. Whether Sums B and C are assessable to salaries tax
2. If Sums B and C are assessable, whether the disputed income should be apportioned over the entire career with the group (29 years)

Mr. Fuchs claimed a full exemption for the termination payment. The Revenue agreed that Sum A was compensatory in nature for Mr. Fuchs' loss of salary due to early termination, but Sums B and C should be chargeable.

Mr. Fuchs' appeal to the Court of First Instance (CFI) by-passing the board of review was allowed in part in that Sum B should be nontaxable while Sum C was rightly assessed to tax. The CFI rejected Mr. Fuchs' fall-back argument that Sum C should be taxed on a pro rata basis (2 out of 29 years).

Both Mr. Fuchs and the Revenue appealed to the CA. The CA unanimously dismissed Mr. Fuchs' appeal and allowed the Revenue's cross-appeal, i.e., both Sums B and C were rightly assessed to tax and no apportionment is allowed.

The case was transferred to the CFA and the judgment was delivered on February 1, 2011.

The analysis

The CFA refers to the basic charging provision, Section 8(1) of the Inland Revenue Ordinance (IRO) in its analysis. Whether a payment received by an employee on termination of his employment is taxable depends on whether those amounts constitute income "from employment."

The CFA stated that Mr. Fuchs had received the payments exactly as stated in the employment contract. The rights that accrued to Mr. Fuchs upon termination were obviously enforceable at law. He could have sued to recover those sums if the Bank had failed to make payment. As such, Sums B and C were paid in satisfaction of the rights which had accrued to Mr. Fuchs under the employment contract and were, therefore, chargeable as income "from his employment".

The CIR agreed that Sum A was a nontaxable compensatory payment and, therefore, was not in issue in the appeal. As commented by the CFI, the fact that there were no contractual provisions for its payment was no doubt a factor.

Consistent with the conclusion of the CFI and CA, the CFA also found that the apportionment argument is wholly untenable. The CFA pointed out that the employment contract says nothing about the 27 years of service rendered by

Mr. Fuchs prior to his Hong Kong employment. As such, there is no basis for attributing Sums B and C to the 27 years of service preceding the Hong Kong employment.

Deloitte's view

Upon termination of employment, the employee may receive payments often referred to as "compensation for loss of office," "severance payment," "termination payment," etc. The taxability of such payments has always been a contentious area for Hong Kong Salaries Tax purposes due to the lack of legislations and IRD guidance. As such, the general taxation principles apply in that an individual is chargeable on income arising in or derived from Hong Kong from any office or employment of profit (Section 8(1)(a) of the IRO).

As evidenced by this case, the CFA relied heavily on the employment contract in determining the nature of the payment. The authorities may have come to a different conclusion if the employment contract does not specify the termination payment. Alternatively, apportionment may be possible if the sums had been linked to Mr. Fuchs' employment with the German bank. It is reasonable that the Bank had actually taken into account Mr. Fuchs' entire career with the group in determining the sums in the event of early termination. However, apportionment has been denied due to the lack of support provided in the employment contract.

It should be noted that if the payment is taxable as income from employment, labeling the payment as "compensation for loss of office" or something similar will not alter the nature of the payment.

It can also be deferred from this case the importance of documentary evidence in the authorities' determination of the taxability of termination payments. In addition to the employment contract, there could be other documentary evidence, such as assignment letter and separation agreement that can be of importance.

It is, therefore, important that the employment contract, separation agreement, and other documents concerning the employment be properly structured and worded. Professional advice should be sought at the planning stage if the situation warrants the need. In the context of expatriate employees who were seconded to work in Hong Kong and were terminated in Hong Kong, the assignment letter can also be an important document for the IRD in determining the taxability of the termination payments.

People to contact

If you have any questions concerning the issues in this GES NewsFlash, please contact one of the tax professionals as follows:

Beijing

Gus Kang
Tel: + 86 (10) 8520 7600

Huan Wang
Tel: + 86 (10) 8520 7510

Dalian

Constant Tse
Tel: + 86 (411) 8371 2777

Guangzhou

Keiichi Itaya
Tel:+ 86 (20) 2831 1379

Hong Kong

Anne Shih
Tel: + (852) 2852 1652

Mona Mak
Tel: + (852) 2852 1051

Stephen Green
Tel: + (852) 2238 7178

Shanghai

Constant Tse
Tel: + 86 (411) 8371 2777

Joyce W. Xu
Tel: + 86 (21) 6141 1178

Tony Jasper
Tel: + 86 (21) 6141 1228

Shenzhen

Jim Chung

Tel: + 86 (755) 3332 1699

This NewsFlash information is also included in our biweekly GES newsletter, *Global InSight*, which you will receive directly if you are on the central distribution list.

If you are not on the central distribution list and received this communication by some other means, you can follow these few simple steps to be added to the central distribution list:

- Go to the Deloitte Subscriptions Page on Deloitte.com
- Make sure that under Step 1 you select “Tax” and “Global Employer Services”

- Under Step 2, select “Global InSight”
- Under Step 3, fill out your contact information and click “Save Profile”

Be sure to visit us at our Web site: www.deloitte.com/tax.

Back to Top

Home | **Security** | **Legal** | **Privacy**

1633 Broadway
New York, NY 10019–6754
United States

Deloitte RSS feeds
