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Hong Kong Tax Update

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New laws passed to enable re-domiciliation of non-Hong Kong open-ended corporate and limited partnership funds to Hong Kong from 1 November 2021

On 30 September 2021, the Securities and Futures (Amendment) Bill 2021 and Limited Partnership Fund and Business Registration Legislation (Amendment) Bill 2021 passed their third readings in the Legislative Council (the new laws).

The new laws introduce new fund re-domiciliation mechanisms for existing funds set up in corporate or limited partnership form outside Hong Kong to re-domicile to Hong Kong as open-ended fund companies (OFCs) or limited partnership funds (LPFs) respectively. The re-domiciliation mechanisms will come into operation on 1 November 2021.

Upon re-domiciliation, the continuity of the fund, including contracts made and property acquired, will be preserved. The mechanisms do not operate to create a new legal entity (which will necessitate dissolution procedures of the original fund). The fund would have the same rights and obligations as any other newly established OFCs or LPFs in Hong Kong. The fund will be required to deregister in its original place of establishment upon re-domiciliation.

Furthermore, like other funds operating in Hong Kong, the re-domiciled funds may enjoy profits tax exemption under the unified fund exemption regime if they meet the definition of “fund” under section 20AM of the Inland Revenue Ordinance (IRO); or under section 26A(1A) of the IRO if they are SFC-authorized funds.

The Government is confident that the new re-domiciliation regimes, together with the profits tax exemption regimes for funds, would further enhance the tax competitiveness of Hong Kong as an international asset and wealth management hub.

Inland Revenue Department (IRD) further updated the Tax Guide for Charitable Institutions and Trusts of a Public Character

On 13 September 2021, the IRD published a further updated version of the subject tax guide. See June 2020 Issue of this Newsletter for the report on the last updated version.

The latest version clearly states that a charity must not engage in or support any acts or activities which are unlawful or contrary to the interests of national security. Any charitable organization found to have engaged in, supported or promoted activities that are identified as violations of national security laws, or if it is deemed to have changed its charitable purposes after a comprehensive review, will be withdrawn from the tax exemption list.

Hong Kong Tax Case

Zarin v CIR [2021] HKCFI 1846 (date of judgement 29 June 2021)

The Taxpayer was employed by HSBC Markets (Asia) Ltd as Managing Director, Head of Direct Principal Investment Asia. Under the employment contract, the Taxpayer was provided with a "guaranteed bonus" and eligibility to participate in a "discretionary bonus scheme". As part of his guaranteed bonus for 2010, on 15 Mar 2011, he was granted a restricted share award of shares in HSBC Holdings plc ("the 2011 Shares"). These shares were to vest as to 33%, 33% and 34% in March 2012, 2013 and 2014 respectively.

In addition, as part of his discretionary bonus for 2011, on 12 Mar 2012, he was granted another restricted share award of HSBC Holdings plc shares (the "2012 Shares"). The 2012 Shares were to vest as to 33%, 33% and 34% in March 2013, 2014 and 2015 respectively.

The Taxpayer's employment was terminated on the grounds of redundancy by a letter dated 21 January 2013. A Termination Agreement was reached on 21 June 2013 whereby:

1. the 2011 Shares would vest on the same terms as stated in the letter awarding them;
2. any release of the 2012 Shares would be conditional on the Taxpayer having not committed a breach of any of the terms of the Termination Agreement;
3. additional remuneration would be paid for his assistance in connection with a litigation case in which the Company was involved ("the Litigation");
4. the Taxpayer would be obligated for a period of up to five years to provide reasonable assistance in proceedings and any matter with which he was dealing during his employment in relation to which he had relevant knowledge, as well as specifically the Litigation; and
5. other conditions including releasing and discharging the Company and related parties from all claims etc. in connection with the employment or the cessation of the employment and confidentiality provisions.

The IRD assessed the value of shares released after the date of termination: (a) part of the 2011 Shares (Sum A and Sum B1); (b) part of the 2012 Shares (Sum B2 and Sum C); (c) remuneration paid to the Taxpayer for 4 days of work performed by him in relation to the Litigation (Sum D).

On appeal, the Board of Review found that : (a) Sum A and Sum B1 were derived from the guaranteed bonus which was contractual entitlements under the Employment Contract and, therefore, taxable; (b) Sum B2 and Sum C being derived from the discretionary bonus which provided no guarantee of them or their value, were derived from the Termination Agreement. But this by itself did not determine the sums as being not chargeable to salaries tax. The Board looked at the reason why the Company made the payments and found that Sum B2 and Sum C were paid in return for the Taxpayer “acting as or being an employee” or for his past services. Sum B2 and Sum C were not paid for "something else", even though they were derived from the Termination

Agreement. The disagreement between the Taxpayer and the Company had not gone to the point where litigation was imminent or where the Company was eager to settle to avoid litigation. *Poon Cho Ming* case [2019] HKCFA 38 was therefore distinguished in that these sums were not made to make the Taxpayer go away quietly; and (c) Sum D was correctly taxed.

The Taxpayer sought the leave of the Court of First Instance, High Court, to appeal against the Board's decision. The High Court judge refused to grant leave to appeal against the assessments to Sum A, Sum B1, Sum B2 and Sum C because the said appeals were not reasonably arguable. Nevertheless, he granted leave to appeal against the assessment to Sum D on the ground that the question is arguable since it was derived from the Termination Agreement as he was not obliged to assist the Company on this matter under the terms of his prior employment.

In the substantive appeal, the same judge allowed the Taxpayer's appeal against the assessment of Sum D on the ground that it was paid for a fresh bargain under the Termination Agreement, not being income from the employment. The judged further noted that had the services been provided over more days, or over a longer period, on the facts of the case, remuneration paid for such services would almost certainly have been taxable as income in Singapore, or potentially as income chargeable to tax under section 14 of the IRO in Hong Kong.

As for Sum B2 and Sum C, the Taxpayer appealed to the Court of Appeal in relation to the refusal to grant leave to appeal. The Court of Appeal took the view that the Taxpayer's appeal against
Sum B2 and Sum C is reasonably arguable, thereby granting the Taxpayer leave to appeal and remitting the case to the Court of First Instance to hear the appeal in respect of Sum B2 and Sum C.

(The above is the judgement held in CAMP 4 of 2020 and was also reported in the April 2020 Issue of this Newsletter)

When the case was remitted to the Court of First Instance, the judge noted that the Board of Review made a finding of fact that the 2012 Shares were not released for the purpose of settling potential litigation, because it did not accept that there was in fact sufficient prospect of litigation. However, that finding does not necessarily lead to the conclusion that the purpose of continuing release of the 2012 Shares was "in return for acting or being an employee" or as a "reward for past services" - if there might be another purpose.

The judge then further reflected on the fact that 2012 Share Plan (the Plan) specified that where the rule of good leaver is applied and the participant had entered into a termination agreement in connection with the cessation of employment, the awards would not vest until the participant had complied with that termination agreement. The Plan specifically envisaged that if, as became the fact, the Taxpayer left as a good leaver his awards would vest so long as he complied with any termination agreement entered.

The judged then reasoned that at the time any employee became a participant in and subject to the Plan, it obviously would not be known under what circumstances the employee might cease employment. Nor would it be known, even if the participant were a good leaver, whether the participate might enter into a termination agreement with regard to the cessation of employment, and if so, what those terms might encompass. Yet the Plan identified that the awards would not vest unless and until the participant had complied with, or been released from, whatever obligations might be contained in any termination agreement. So, the Plan envisaged a participant/employee might have to provide perhaps fresh consideration to become entitled to vesting, and such fresh consideration might have nothing to do with the employment.

Ultimately, the judged was persuaded that the terms of this particular Termination Agreement identify that the purpose for releasing the 2012 Shares was, amongst other things, to procure the Taxpayer to provide potentially long-term assistance in the Litigation (where another, but separate, part of the consideration – Sum D, was to compensate the Taxpayer for the 4-day time actually spent and expenses incurred when providing the assistance). On that basis, the judge held that Sum B2 and Sum C was

not “from” the Taxpayer’s “employment”. It was “from something else” and therefore not chargeable to Salaries Tax in Hong Kong.

The CIR has now appealed to the Court of Appeal against the decision of the Court of First Instance on the non-taxability of Sum D, Sum B2 and Sum C under Salaries Tax in Hong Kong.