

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D43/99

**Salaries Tax** – the material time for determining the gain arising from the exercise of a share option – assessment of gain at the material time so determined – section 10B of the Interpretation and General Clauses Ordinance (Chapter 1) – Inland Revenue Ordinance sections 9(1)(d) and 9(4)(a).

Panel: Audrey Eu Yuet Mee SC (chairman), Douglas C Oxley and Gerald To Hin Tsun.

Date of hearing: 20 July 1999.

Date of decision: 10 August 1999.

The taxpayer was the vice-chairman of a listed company ('the Company'). Subject to the conditions of the relevant share option scheme, he was granted a share option in respect of the relevant shares ('the Option Shares'). It was common ground that the taxpayer exercised his option to purchase the Option Shares on 23 June 1993 and requested that all the shares be registered in the name of Company A. Subsequently, upon the allotment of the Option Shares has been processed by the Central Registration of Hong Kong Limited on 6 July 1993, on about 9 July 1993, the Company arranged to take delivery of the new share certificates concerned and a Company B issued a receipt for the Option Shares concerned.

This was an appeal by the taxpayer against the determination of the Commissioner of Inland Revenue dated 21 January 1999 in respect of his additional salaries tax assessment for the year of assessment 1993/94. The dispute related to the tax on the gains arising from the exercise of certain share options. There was no dispute that the taxpayer, having exercised his share option, was liable for income tax on his gain. The dispute was how this gain was to be ascertained.

The issues in this appeal were firstly, what was the material time for determining the gain arising from the exercise of the option and secondly, what was the gain assessed at the material time so determined.

#### **Held:**

- (1) Whatever was the meaning of section 9(4)(a), one thing was clear. It was referring to a notional gain assessed in the way defined by the section. It was not referring to the actual gain. The actual gain could be much more, much less, it could even be a loss.
- (2) Section 9(4)(a) defined the gain to be the difference between two amounts:

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- (i) the amount of the consideration given for the shares ('the consideration amount'), this would not normally give rise to any dispute and there was no such dispute in the present case;
  - (ii) the amount which a person might reasonably expect to obtain from a sale in the open market ('the sale amount').
- (3) The sale amount depends on two factors:
  - (i) the material time for the purpose of the sale ('the material time factor') and;
  - (ii) the reasonable amount to be obtained at the time of such sale ('the reasonable expectation factor').
- (4) Applying section 10B of the Interpretation and General Clauses Ordinance (Chapter 1) and having regard to the object and purposes of the Ordinance, the Board came to the view that the material time was the time when the shares were acquired. Even though the section is contemplating a notional sale, it makes better sense to fix the notional sale at a time when (and not before) the shares are acquired.
- (5) As to when the option shares were acquired on the facts of this case, the taxpayer contended it being the date when the share certificates were received by Company B, that is, 9 July 1993. No evidence was adduced as to what happened between 6 and 9 July 1993. On 6 July 1993, the Company was informed that the share certificates were available for collection. There was no explanation as to why delivery was not taken until 9 July 1993. It was not alleged that the taxpayer was unaware of the letter. The Board noted that the taxpayer remained a director of the Company during that time. In any case, section 9(4)(a) does not refer to the receipt of the share certificates.
- (6) In D14/90, it was theoretically possible for the taxpayer to have given instructions for the shares to be sold as soon as possible and that would be 5 October 1987. Thus there could be a notional gain on a notional sale of the shares acquired on that date.
- (7) In this case, there was clear evidence that the share certificates were available earlier than 9 July 1993. The onus was on the taxpayer and he has not discharged the onus to persuade the Board that he could not have sold the shares even on a notional basis until 9 July 1993. Thus the Board had no hesitation in rejection 9 July 1993 as the material date.
- (8) Equally the Board had no hesitation in rejecting 23 June 1993 as the material date. The Board agreed that this was the date when the option was exercised

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but, for reasons given above, it found that the material date to be when the shares were acquired. On the evidence, the Company only passed a board resolution to authorise the allotment of the Option Shares on 25 June 1993. The shares could not possibly be acquired before that date.

- (9) Although section 9(4)(a) does not refer to the share certificate, the Taxpayer had given evidence that he could not have sold the shares before he had the share certificate. It was not disputed that short selling was not permitted by the rules of the Stock Exchange at that time and no broker would be prepared to do it. The Inland Revenue Department did not suggest that there was any method by which the taxpayer could or would reasonably have sold the shares before the share certificate was even issued. Even if it was held that the shares were acquired at the time the Company resolved to allot the shares, that was on 25 June 1993, there could not be a notional sale and thus no notional gain when the share certificate had not been issued.
- (10) There was evidence that the share certificate for the Option Shares was issued and available for collection on 6 July 1993. The Board had no evidence as to whether this was an unduly long lapse of time from 23 June 1993 when the option was exercised. Thus, on the evidence of this case, the earliest time the taxpayer could theoretically have sold his shares was as soon as the share certificate was available and that was 6 July 1993.
- (11) Following D4/91, assuming the taxpayer had given instructions before or at the time of the exercise of the option, to sell the Option Shares as soon as possible, that would be when the share certificate was issued and available for collection on 6 July 1993. In the circumstances, the Board found 6 July 1993 to be the material date and it believed this to be in accordance with the object and purpose of the Inland Revenue Ordinance.
- (12) Upon the Board ruled that the material date was 6 July 1993, as to the assessment of the reasonable sale amount of the Option Shares, the Board, which was not prepared to decide on it without hearing evidence and arguments thereon, was of the view that this outstanding issue was to be remitted to the Commissioner of Inland Revenue.

**Appeal allowed.**

Cases referred to:

D14/90, IRBRD, vol 5, 131  
D4/91, IRBRD, vol 5, 542  
D66/94, IRBRD, vol 9, 373  
D46/95, IRBRD, vol 10, 308

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Fung Chi Keung for the Commissioner of Inland Revenue.  
Ho Chi Ming instructed by Messrs Ernst & Young for the taxpayer.

### **Decision:**

#### **The appeal**

1. This is an appeal by the Taxpayer against the determination of the Commissioner of Inland Revenue dated 21 January 1999 in respect of his additional salaries tax assessment for the year of assessment 1993/94. The dispute relates to the tax on the gains arising from the exercise of certain share options.

#### **Background facts**

2. The background facts are not in dispute.

3. The Taxpayer was the vice chairman of a listed company ('the Company'). According to the Company's 1993 annual report, it had 1,073,125,001 issued and fully paid shares of \$0.25 each in 1992. On 19 February 1991, the Company granted share options pursuant to the share option scheme of the Company to certain employees of the group. This included the Taxpayer who was granted an option in respect of 10,800,000 shares ('the Option Shares').

4. The conditions of the share option scheme are produced. The option has to be exercised within 3 years from the commencement date upon which the relevant option is deemed to be granted and accepted in accordance with the scheme, provided that in the event a grantee leaves the service of the group, the grantee may exercise the option up to his entitlement within the period of 3 months following the date of such cessation.

5. It is common ground that the Taxpayer exercised his option to purchase the Option Shares on 23 June 1993.

6. We are provided with an agreed list of the share prices of the Company as from 1 June 1993 to 3 August 1993.

7. The parties are unable to reach agreement on the discount to be applied to the value of the shares on a notional sale. The Revenue is prepared to accept a 3% discount *inclusive* of the reasonable selling expenses which the Revenue estimates to be around 0.45% of the selling price. However this is only on the basis of the shares being valued as at 23 June 1993. Mr Ho for the Taxpayer is willing to accept a 3% discount but *exclusive* of the 0.45% selling expense. In any case, both parties wish to reserve their position as to the

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appropriate discount if the Board should decide that some date other than 23 June 1993 is applicable.

### **The issues**

8. There are two issues in this appeal:
- (1) what is the material time for determining the gain arising from the exercise of the option;
  - (2) what is the gain assessed at the material time so determined.

### **The evidence**

9. The Taxpayer gave a written statement which was adopted in his oral evidence. He produced various documents which disclose the following chronology.

- |           |  |
|-----------|--|
| 23-6-1993 | The Taxpayer wrote to the company secretary in the exercise of his option. It is common ground that this letter enclosed a cheque in payment of the Option Shares. The letter requested that all the shares should be registered in the name of Company A.           |
| 25-6-1993 | A board meeting of the Company was held (attended by the Taxpayer) whereby it was resolved to allot various shares to respective persons, including the Option Shares to the Taxpayer.   |
| 28-6-1993 | The chairman of the Company wrote to Central Registration Hong Kong Limited enclosing the board resolution and requested that the respective share certificates be issued immediately.   |
| 6-7-1993  | The Central Registration of Hong Kong Limited wrote to the Company confirming that the allotment has been processed accordingly. The letter states 'Please arrange to take delivery of the following new certificates from our office at your earliest convenience'. |
| 9-7-1993  | Company B issued a receipt for the Option Shares.  |

This chronology was not challenged by the Revenue and we accept that as our findings of fact.

10. The Taxpayer said that he could not sell the shares until 9 July 1993 when Company B received the shares. He relied on some extract of business briefings to the effect that short selling was prohibited by the Stock Exchange of Hong Kong prior to 1994. This was not challenged by the Revenue.

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11. In addition, we were provided with two newspaper announcements at the time. The first one was dated 15 June 1993. This announced that a representative of an independent party had made an approach to the chairman of the Company with a view to their becoming materially involved in the expansion of the Company's business. The Taxpayer said that he was travelling at the time and he was advised by the company secretary sometime after the announcement not to deal in the shares of the Company. In fact, the Taxpayer did not have any shares in the Company at that point of time.

12. The second announcement was dated 28 June 1993. This announced that the chairman of the Company had reported that he had had no further meaningful discussion with the representative of the independent party. Sometime after this second announcement, the Taxpayer was told by the company secretary that the earlier warning not to deal in shares was no longer effective.

13. The agreed list of share prices shows that the prices rose sharply during the time of the two announcements. According to the Taxpayer, the price of the shares had always remained around 30 odd cents per share. It rose to over 40 cents on 7 June, peaked at around 67 and 68 cents on 28 June and gradually dropped back to 30 odd cents in the second week of July. Thus, the time for assessing the gain from the exercise of the share option becomes crucial to this case.

14. The Taxpayer said that his exercise of the option was not motivated by the events referred to in the announcements. He had devoted a lot of time to the Company from 1989 to 1992 and turned the Company around. But he was not under any service contract and he received no emoluments. Since 1992 he was spending more time as the managing director of another listed company. To avoid any possible conflict of interest arising from the holding of directorships in various unrelated companies, he decided to resign from the Company. Thus he exercised the share option prior to his departure.

### **The relevant charging sections in the ordinance**

15. Section 9(1)(d) provides:

*'Income from any office or employment includes:*

*any gain realized by the exercise of, or by the assignment or release of, a right to acquire shares or stock in a corporation obtained by a person as the holder of an office in or an employee of that or any other corporation.'*

16. There is no dispute that the Taxpayer, having exercised his share option, is liable for income tax on his gain. The dispute is how this gain is to be ascertained. For this, we turn to section 9(4)(a):

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*‘the gain realized by the exercise at any time of such a right as is referred to in paragraph (d) of that subsection shall be taken to be the difference between the amount which a person might reasonably expect to obtain from a sale in the open market at that time of the shares or stock acquired and the amount or value of the consideration given whether for them or for the grant of the right or for both;’*

17. Whatever is the meaning of section 9(4)(a), one thing is clear. It is referring to a notional gain assessed in the way defined by the section. It is not referring to the actual gain. The actual gain can be much more, much less, it can even be a loss.

### **The cases**

18. We have been referred to three cases for the interpretation of section 9(4)(a).

19. The first case D14/90, IRBRD, vol 5, 131 was decided by a panel with Mr Turnbull as the chairman. The taxpayer was employed by A Limited. He was granted an option to purchase shares in a company X Limited registered in England. It was common ground that the share option was exercised on 5 October 1987. Unknown to the taxpayer, X Limited had applied in advance to the Stock Exchange in London for admission of the shares and the Stock Exchange had granted the necessary permission. The taxpayer had applied for permission to deal in the shares and written permission was granted to him on 5 October 1987. Unknown to the taxpayer, the shares were allotted and issued to him on 5 October 1987 and a share certificate was issued on the same day. The certificate was sent by post and the taxpayer did not receive it until 17 November 1987 in Hong Kong. He could have given instructions to brokers in London to sell the shares at any date on or after 5 October 1987 though for practical purposes this was impossible because neither his employer, nor X Limited had informed him of this and, being a resident in Hong Kong, no broker or agent in Hong Kong would have accepted his instructions without his having available the share certificate certifying that he was the owner of the shares. To the best of the information and belief of the taxpayer, he could not sell the shares until he received the share certificate in Hong Kong. Immediately upon receipt of the share certificate, the taxpayer gave instructions to sell the shares. The shares were eventually sold in January 1988 at a loss. Between 5 October 1987 and 17 November 1987, the share price plunged sharply. On the question of the material time, the Board said this:

*‘The word “time” must refer to a specific moment in time and in relation to the exercise of a share option or the acquisition of shares, this must relate to a specific date. We have then considered whether the date (or time) could refer, as suggested by the Taxpayer, to the date on which the Taxpayer received the shares certificate. On the facts before us, we cannot accept any date other than 5 October 1987 as being the relevant date. That was the date on which the Taxpayer was deemed to have exercised the option, the date on which and with effect from which he had permission to deal in the shares, and the date on which the shares were actually issued and allotted to him. The date of receipt of the*

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*share certificate cannot be said to be the time when the Taxpayer exercised the right to acquire the shares.*

*The Inland Revenue Ordinance makes no reference to the Taxpayer being able to deal in shares. Instead section 9(4)(a) specifically refers to “the exercise at any time of such a right” and then relates the notional sale back to that time. Accordingly the wording of the Ordinance is quite clear and the notional gain must be calculated as at the date when the Taxpayer exercised the share option to which he was entitled. That was clearly 5 October 1987 and no other date.’*

The panel considered it wrong that the taxpayer could be taxed on the notional benefit which he did not and could not receive but that appeared to be the meaning of the Ordinance and he was taxed as if he sold the shares on 5 October 1987. It called for a change in the law but that call was not heeded.

20. The second case was D4/91, IRBRD, vol 5, 542. The same panel chairman presided. The case concerned shares in Hong Kong. The taxpayer said that when he exercised his option, he had informed X Limited that he wished to liquidate the shares in their entirety upon receipt thereof and had authorised X Limited to sell all of the shares ‘at best’. He said that the shares had actually been issued to him on Friday 9 September 1988 and had been sold on the earliest possible date thereafter, namely Thursday, 15 September 1988, which was only 3 working days later and was in his opinion a reasonable time for processing between the issue date and the sale date. The Board said at page 547 of the report:

*‘... the notional gain is not an academic gain but is stated by the Inland Revenue Ordinance to be the amount which a person might reasonably expect to obtain from a sale in the open market at the time when he exercised the option. The section of the Ordinance does not relate to the date on which the option is exercised. It relates to the “time” as opposed to the word “date” and the inclusion of the words “which a person might reasonably expect to obtain” mean that one is to take a realistic attitude and not a theoretical attitude. One is to look at the question in reality and in substance. One must decide what a person could reasonably expect to have received if he had exercised the option and sold the shares as quickly as possible in the open market. In the present case, we are of the opinion that the Taxpayer actually realised what the Ordinance lays down as the notional amount. There can be no better test of what a person might reasonably expect to receive by the sale of shares received by him when he exercises an option than if he in fact does sell the shares immediately when he exercises the option. It is clearly impossible to sell the shares on the same day that the option is exercised because the recipient of the shares has not actually received them. However, there is nothing to stop the Taxpayer, as he did in fact in this case, from giving instructions to the person providing shares, the employer in this case, to sell the shares immediately in the open market. This he did and we agree with him that three working days is not*

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*an unreasonable period of time for the said shares to be sold. Apparently the price which he received for the shares when he sold them in the open market was less than the quoted price on the day when the option was exercised. We do not know the reason for this and it is not necessary for us to speculate. However, we would draw attention to the fact that if a substantial number of shares are placed in the market when such shares are thinly traded or where there is only a nominal price being quoted, the actual price which may be received can be significantly less than the price previously appearing on the board at the stock exchange. We only mention this point as being one of many possible reasons why a person is unable to realise a quoted price for the shares which he has received even if he sells them as quickly as possible in the open market. Clearly the Inland Revenue Ordinance intends to try to tax a taxpayer on a profit on the value of the benefit which he receives and which approximates the profit which he would make if he sold the shares as quickly as possible. In this case, the Taxpayer did sell the shares as quickly as possible and there were no unusual circumstances which would lead us to decide that the price actually received by the Taxpayer was anything other than the amount which under section 9(4)(a) of the Inland Revenue Ordinance a person might reasonably expect to have received if he had sold the shares at the time that he exercised the option.'*

Unfortunately this does not refer to the earlier decision of D14/90.

21. The third case was D66/94, IRBRD, vol 9, 373. The taxpayer in this case was contending for the actual gain. That was clearly wrong. According to the report, the taxpayer gave notice to Company A of his intention to exercise his option on 26 May 1992. This was approved by Company A on the same day. On 27 May 1992, the taxpayer paid the full subscription price and Company A gave instructions to its share register to issue share certificate to the taxpayer. The taxpayer did not receive his share certificate until July 1992. The Board referred to D14/90 but was apparently not aware of D4/91. It agreed with the decision in D14/90. It said:

*'On the facts in our case, the relevant date can only be 27 May 1992. On that date, the Company received the notice exercising the option; the option certificates and the subscription price. Clause 7.1 of the scheme expressly provides that to be "the date upon which exercise of an option becomes effective.'"*

Of the three events mentioned, Company A in fact received the notice exercising the option the day before, that is, 26 May 1992. It was not clear from the report when the option certificates were received by Company A but the subscription money was only received on 27 May 1992. Applying clause 7.1 as reproduced in the decision, the option was exercised on 27 May 1992. The Board found that to be the material date for the purpose of section 9(4)(a).

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22. We were also referred to D46/95, IRBRD, vol 10, 308 which is a sequel to the third case. The parties were unable to agree on the sale price which could reasonably be realized on 27 May 1992 and returned before the Board for further decision. There were no argument on the interpretation of the relevant section.

23. It would thus appear from the three cases on section 9(4)(a) that they all refer to the time of the exercise of the option as the material time. In the first case, the share certificate was issued on the same day the option was exercised. Thus, on the peculiar facts of that case, there was no difference between the time of the exercise of the option and the time the shares (as opposed to the share certificates) were acquired. In the second case, the Board still regarded the relevant time to be the time of the exercise of the option, however it had regard to the reasonable amount that could have been obtained by the taxpayer selling the shares as soon as they were acquired. On the facts of that case, the Board accepted that the actual gain represented such reasonable amount. In the third case, the Board adopted the first case in saying that the material time was the time of the exercise of the option. There was apparently no argument that the taxpayer could not have sold the shares until a share certificate was issued or received.

24. Having considered these cases, we now turn to the section.

### **Section 9(4)(a)**

25. Section 9(4)(a) defines the gain to be the difference between two amounts:

- (1) the amount of the consideration given for the shares ('the consideration amount'), this will not normally give rise to any dispute and there is no such dispute in this case;
- (2) the amount which a person might reasonably expect to obtain from a sale in the open market ('the sale amount').

26. The sale amount depends on two factors: the material time for the purpose of the sale ('the material time factor'), and the reasonable amount to be obtained at the time of such sale ('the reasonable expectation factor').

### **The material time factor**

27. Section 9(4)(a) refers to the word 'time' twice. The first 'time' must refer to the time of the exercise of the option. The second 'time' may, at first reading, refer back to the same time because of the words 'at *that* time'. That appears to be how the second 'time' was interpreted in all three earlier cases referred to above. However the whole phrase reads 'at that time of the shares or stock acquired'. The Revenue contends that this means 'at the time of the exercise of the right to the shares *to be* acquired.' But it seems that another way to read that phrase can be 'at the/that time the shares or stocks were acquired'. The same section, in Chinese, reads:

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‘該款(d)段所提述的權利於任何時間被行使而變現所得的收益，須被視為相等於以下差額，即任何人將所得股份或股額於獲取時若在公開市場出售而可合理預期獲得的款額，減去為取得該股份或股額、或為獲授予上述權利、或為兩者而付出的代價款額或價值後所得的款額’

It is clear that the words 「於獲取時」 when used in conjunction with 「股份」 can only mean at the time the shares were acquired, as opposed to the time the option was exercised.

28. We have regard to section 10B of the Interpretation and General Clauses Ordinance Chapter 1. This provides:

- (1) *The English language text and the Chinese language text of an Ordinance shall be equally authentic, and the Ordinance shall be construed accordingly.*
- (2) *The provisions of an Ordinance are presumed to have the same meaning in each authentic text.*
- (3) *Where a comparison of the authentic texts of an Ordinance discloses a difference of meaning which the rules of statutory interpretation ordinarily applicable do not resolve, the meaning which best reconciles the texts, having regard to the object and purposes of the Ordinance, shall be adopted.*

29. Applying section 10B and having regard to the object and purposes of the Ordinance, we come to the view that the material time is the time when the shares were acquired. Even though the section is contemplating a notional sale, it makes better sense to fix the notional sale at a time when (and not before) the shares are acquired.

30. Having determined the material time to be the time when the shares were acquired, we now need to consider when the Option Shares were acquired on the facts of this case. The Taxpayer contends for 9 July 1993, this being the date when the share certificates were received by Company B. We have pointed out to Mr Ho for the Taxpayer that he had led no evidence as to what happened between 6 and 9 July 1993. On 6 July 1993, the Company was informed that the share certificates were available for collection. There is no explanation as to why delivery was not taken until 9 July 1993. It is not alleged that the Taxpayer was unaware of the letter. We note that the Taxpayer remained a director of the Company during that time. In any case, the section does not refer to the receipt of the share certificates. In D14/90, it was theoretically possible for the taxpayer to have given instructions for the shares to be sold as soon as possible and that would be 5 October 1987. Thus there could be a notional gain on a notional sale of the shares acquired on that date. In this case, there is clear evidence that the shares certificates were available earlier than 9 July 1993. The onus is on the Taxpayer and he has not discharged the onus to persuade us that he

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could not have sold the shares even on a notional basis until 9 July 1993. Thus we have no hesitation in rejecting 9 July 1993 as the material date.

31. Equally we have no hesitation in rejecting 23 June 1993 which is the material date the Revenue has urged upon us. We agree that this is the date when the option was exercised but, for reasons given above, we find the material date to be when the shares were acquired. On the evidence, the Company only passed a Board resolution to authorize the allotment of the Option Shares on 25 June 1993. The shares could not possibly be acquired before that date.

32. As we said above, section 9(4)(a) does not refer to the share certificate. However, in this case, the Taxpayer has given evidence that he could not have sold the shares before he had the share certificate. Short selling was not permitted by the rules of the Stock Exchange at that time and no broker would be prepared to do it. This was not challenged by the Revenue. The Revenue did not suggest that there was any method by which the Taxpayer could or would reasonably have sold the shares before the share certificate was even issued. Even if we hold that the shares were acquired at the time the Board resolved to allot the shares, that is on 25 June 1993, there could not be a notional sale and thus no notional gain when the share certificate had not been issued.

33. There is evidence that the share certificate for the Option Shares was issued and available for collection on 6 July 1993. We have no evidence as to whether this was an unduly long lapse of time from 23 June 1993 when the option was exercised. Thus, on the evidence of this case, the earliest time the Taxpayer could theoretically have sold his shares was as soon as the share certificate was available and that was 6 July 1993. Following D4/91, assuming the Taxpayer had given instructions before or at the time of the exercise of the option, to sell the Option Shares as soon as possible, that would be when the share certificate was issued and available for collection on 6 July 1993. In the circumstances, we find this to be the material date and we believe this to be in accordance with the object and purpose of the Ordinance.

### **The reasonable sale amount**

34. This remains an outstanding issue to be resolved. Since the parties are unable to agree on the discount factor or the selling expenses to be applied until the material date is determined and since we are not prepared to decide on the reasonable amount without hearing evidence and arguments thereon, the only course is to remit this back to the Commissioner for his further determination or for agreement between the parties. If no satisfactory conclusion is reached, the matter will have to be restored before us for further argument.

### **Conclusion**

35. For reasons given, the appeal is allowed and remitted to the Commissioner on the outstanding issue as to the reasonable sale amount of the Option Shares as at 6 July 1993.

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