HCIA 1/2006

IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE

INLAND REVENUE APPEAL NO. 1 OF 2006

BETWEEN

THE COMMISSIONER OF INLAND REVENUE Appellant

and

SAWHNEY, SUBHASH CHANDER Respondent

Before: Deputy High Court Judge Muttrie in Court
Date of Hearing: 22 March 2006
Date of Judgment: 28 April 2006

J U D G M E N T

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1. The Inland Revenue Board of Review heard an appeal by Mr Sawhney, Subhas Chander ("the Taxpayer") against determinations of the Deputy Commissioner of Inland Revenue dated 28 January 2005 confirming salaries tax assessments against the Taxpayer for the years 1996/1997, 1998/1999 and 2000/2001. On 8 August 2005, the Board handed down its decision,

annulling all three assessments. The Commissioner appeals against the Board's decision by way of case stated in the following terms:

> "Whether the Board of Review erred in law in holding that the gains realised by the Taxpayer by the exercise of rights to acquire shares in a corporation (obtained by him during the period when he was an employee of another corporation but exercised by him after he had retired from employment of that second-mentioned corporation) was not chargeable to Salaries?"

The Facts

2. The facts are undisputed and are set out at paragraphs 3-12 of the Case Stated. The essential points are as follows:

(1) On 1 September 1988, the Taxpayer commenced employment in Hong Kong with Philip Morris Asia Incorporated ("PMAI"). PMAI offered stock option plans to reward employees. If granted, the employee had to exercise the option within 10 years from the date of grant, or within 3 years after employment, whichever was earlier.

(2) The Taxpayer was granted 5 stock options at various times. The right under the stock options was to subscribe for shares in PMAI's related company, Philip Morris Companies Incorporated ("PMCI") at fixed prices. The Taxpayer would gain from exercising a stock option if, at the time of exercising it, the market value of the shares was higher than the fixed prices at which the option was granted.

(3) On 15 September 1994, the Taxpayer exercised one of the stock options and made a gain from it. The Inland Revenue Department ("the IRD") assessed this gain to tax, and the Taxpayer did not object. (The tax on the gain from the exercise of this option is not in issue in this appeal).

(4) On 30 September 1994, the Taxpayer's employment was terminated and on 30 October 1994, he left Hong Kong. He now resides in India.

(5) The Taxpayer subsequently exercised two of the remaining stock options in the year of assessment 1996/1997, one in the year of assessment 1998/99, and one in the year of assessment 2000/01. On each occasion, he made a gain.

(6) The Commissioner assessed these gains to tax in the relevant years of assessment. In the year of assessment 1996/1997, the tax payable was

$306,976; in the year of assessment 1998/99 it was $176,847; and in the year of assessment 2000/2001, it was $121,563.

(7) The Taxpayer objected to the assessments. His primary objection was that by the time he exercised the share options, his employment with PMAI had terminated and he had left Hong Kong.

The Board's Decision

3. The Board gave the following reasons for its decision:

"(l) Section 8(l)(a) provides that:

'(1) Salaries tax shall, subject to the provisions of this Ordinance, be charged for each year of assessment on every person in respect of his income arising in or derived from Hong Kong from the following sources:

(a) any office or employment of profit...'

(2) It is plain from the clear wording of section 8(1) that a person must derive income from employment (office or pension) before salaries tax is chargeable.

(3) Sections 11B and 11C provide that:

'11B The assessable income of a person in any year of assessment shall be the aggregate amount of income accruing to him from all sources in that year of assessment.

11C For the purpose of section 11 B, a person shall be deemed to commence or cease, as the case may be, to derive income from a source whenever and as often as he commences or ceases:

(a) to hold any office or employment of profit...'

(4) It is plain from the clear wording of sections 11B and 11C that in computing the assessable income of a person, that person shall be deemed to cease to derive income from a source whenever and so often as he ceases to hold any employment.

(5) The Taxpayer ceased to hold any employment as from 1 October 1994. On his cessation to hold employment by his former employer, he is deemed by

sections 11B and 11C to cease to derive income from this source, i.e. his employment by his former employer. The Taxpayer had no source of employment income in any of the 3 relevant years of assessment, i.e. 1996/97, 1998/99 and 2000/01 and there is no basis for any salaries tax to be charged or assessed on any gain realised by the exercise of his options after cessation of his employment.

(6) We should add that proviso (ii) to section 11D(b) which provides that:

'11D For the purpose of section 11B ...

(b) income accrues to a person when hebecomes entitled to claim payment thereof:

Provided that:

(i) ...

(ii) subject to proviso (i), any payment made by an employer to a person after that person has ceased or been deemed to cease to derive income which, if it had been made on the last day of the period during which he derived income, would have been included in that person's assessable income for the year of assessment in which he ceased or is deemed to cease to derive income from that employment, shall be deemed to have accrued to that person on the last day of that employment.'

does not assist the respondent because option gains computed in accordance with section 9(4) is not 'payment made by an employer to a person after that person has ceased or been deemed to cease to derive income'.

(7) Mr Austin GRADY relied on section 9(l)(d) and section 9(4). In our decision, neither provision assists the respondent. Section 9(1) lists items included as income. Section 9(4) is a provision on determining the amount of gain. Neither section 9(1)(d) nor section 9(4) is concerned with when a source of employment income is deemed to commence or cease.

(8) Our decision on the interpretation of sections 8, 11B and 11C is sufficient to dispose of the appeal in favour of the Taxpayer. It is thus not necessary for us to deal with any of the points raised on behalf of the Taxpayer, many of which are bad, some are unarguably bad and one is misleading."

The Issue

4. The issue for decision here is whether the Taxpayer's gains from the exercise of the four share options, which were obtained during his employment, but exercised after he had retired from employment, are assessable to Salaries Tax under section 8(l) of the Inland Revenue Ordinance ("the IRO"). Nothing turns on the fact that the Taxpayer was not resident in Hong Kong when he exercised the share options.

The Taxpayer's Submissions

5. Before me, the Taxpayer was neither present nor represented. He had written to the court to the effect that his stand was that he could not be subject to salaries tax under section 8 of the IRO without an employment in Hong Kong, and his stand had been vindicated by the decision of the Board, on which he relied. He enclosed a copy of the written arguments of his accountant, which he had put before the Board, as well as copies of the Burmese and Indian authorities on which he had relied.

6. The Board's decision related entirely to the interpretation of sections 8, 11B and 11C of the IRO, and so does this appeal. It was not necessary for the Board to deal with any of the points raised on behalf of the Taxpayer, and it is not necessary for me to do so either.

The Commissioner's Submissions

7. The Commissioner appeared by counsel, Ms Yvonne Cheng. Her submissions were long, detailed and erudite. She did not appear before the Board, and it does not appear that the points which she now raises were put before the Board for its consideration. Her submissions may be distilled, I hope without doing injustice to them, as follows:

Principles of Interpretation

8. In construing a statutory provision, the court must apply the principle of informed interpretation, which requires it to have regard to the context of the provision, including its legislative history, and statements recorded in *Hansard* as made by the promoter of the bill, which disclose the mischief at which the provision is aimed or the underlying legislative intention, and which are clear. The court must also construe the legislation purposively, so as to remedy the mischief at which the provision is aimed. There is a presumption that the legislature does not intend to alter the law by a side wind, and a presumption that where that appears to happen, the court will apply a rectifying construction to avoid such a result. Further, the court will avoid construction of a provision which leads to an artificial result.

Legislative History – the Inland Revenue Ordinance, 1950

9. The relevant legislative history begins with the 1950 edition of the IRO. At the time, salaries tax was assessed on the preceding year basis. The relevant section was section 11. The taxpayer would be taxed in any year on the income earned in the previous year. However, there were additional rules specifying a different basis of assessment for taxpayers who had just started or ceased to receive income. The precise dates of a taxpayer' s receipt of income were significant, because they could affect the way in which his tax was assessed.

10. At that time, assessment was complicated because of the various provisions but there was no restriction against taxing a taxpayer' s income received after the cessation of his employment. In 1952, a committee was appointed to consider and advise on amendment of the IRO. Its findings were set out in the Report of the Inland Revenue Ordinance Committee in December 1954. The committee took the view that the problem with section 11 was that it did not provide for the taxpayer who had several sources of income which were acquired or lost at different times. It was therefore recommended that the IRO be amended so as to assess each source of income individually. But the committee, at paragraph 14 of the report, recommended that the income of a person for a year of assessment shall be the income which accrues to him (as opposed to the income received by him) during the basis period of that year of assessment, but the tax shall not be charged on any portion until it is received, and that the Ordinance be so amended that a sum which is available to a person but not drawn by him shall be deemed to have been received.

The Inland Revenue (Amendment) Ordinance 1955

11. The committee' s recommendations were taken up in the Inland Revenue Amendment Ordinance of 1955. The preceding year basis of assessment was retained, and the rules on commencement and cessation were amended to apply to each source of income individually.

12. The rules appear in the replaced section 11, which by subsections (1) and (2) provides that the assessable income of a person charged to salaries tax for any year of assessment shall be the aggregate amount of his assessable income from all sources calculated in accordance with the provisions of the section, and that, save as otherwise provided the assessable income from a source for any year of assessment shall be the amount of income accruing from that source during the preceding year.

13. Subsections (3) to (6) go on to set out the rules relating to commencement and cessation and they are followed by subsection (7) which is a forerunner of the present section 11C. It provides:

> "For the purposes of this section a person shall be deemed to commence or cease, as the case may be, to derive income from a source whenever and as often as he commences or ceases:

(a) to hold any office or employment of profit; or

(b) to become entitled to a pension."

14. Subsection (8) provides that income which has accrued during the basis period of a year of assessment but which has not been received in that period is not to be included in assessable income for that year of assessment until it is received, when an additional assessment is to be raised in respect of it; and subsection (9) provides that income accrues to a person when he becomes entitled to claim payment thereof.

15. The purpose of section 11(7) was to explain the terms the terms "commences to derive income" or "ceases to derive income" in subsections (3) to (6); it has no direct application to subsections (1) and (2); it was not intended to provide that if a person ceased employment, but that employment was the source of income in a subsequent year, without that person resuming employment, such income would not be taxable.

16. The intention of the legislature in amending section 11 was to allow for the taxation of each source of income separately. It was not to allow income received after cessation of employment to escape from taxation; the committee had expressly recommended provisions to prevent that. It would therefore be wrong to construe section 11(7) as allowing such an escape.

The Inland Revenue (Amendment) Ordinance, 1971

17. By this Ordinance, further amendments were made to add, *inter alia*, provision for taxation of gains made on the exercise of share options. This was done by the addition of sections 9(1)(d) and 9(4). It was done to bring the Hong Kong legislation into line with the UK legislation as it had been amended by the Finance Act of 1966. That amendment was made in the light of the decision of the House of Lords in *Abbott v Philbin* [1961] AC 352. Prior to that case, no specific provision had been made for the taxation of share options which had been regarded as a "perquisite" chargeable under the general charging provision. The House of Lords held that the value of such option was to be taken at the time of the grant, rather than the time of the exercise. In consequence, if an employer granted an employee an option to buy shares at a subsequent date, but at the market value prevailing at the time of the grant, the value of the option for tax purposes was nil, because there was no value in an option to buy shares at the market value, which was open to the general public in any event.

18. The changes made by the Finance Act 1966 and by extension in Hong Kong by the 1971 Ordinance were intended to nullify the effect of the decision in *Abbott v Philbin*. The House had disagreed with a submission that a gain obtained on the exercise of a share option constituted income from employment, especially as the option might be exercised many years after its grant. Reference is made to the speeches of Viscount Simonds at 367 and Lord Radcliffe at 379. The enactment was made for the purpose of reversing this view, so the intention must have been that no

matter how many years after grant the option might be exercised, the resulting gain should be taxable.

19. It followed that, under the 1971 Ordinance, gains made by a taxpayer on the exercise of a share option were taxable even after the taxpayer' s termination of employment, and section 11 did not provide otherwise.

The Inland Revenue (Amendment) Ordinance, 1973

20. By this Ordinance the preceding year basis of assessment was phased out and the current year basis was introduced. Section 11 was amended by adding a provision that it was to apply to the years of assessment up to and including 1972/1973. Section 11B was introduced to provide for the current basis of assessment for the years of assessment 1973/1974 and subsequently.

21. Section 11(7) was recast as section 11C(1). It was expressed as applying to section 11, which still contained the provisions regarding the time when the taxpayer "commences to derive income" and "ceases to derive income". It is also expressed as applying to section 11B, though that section does not contain those provisions.

22. The purpose of the 1973 amendments was to change the basis of assessment from the preceding year to the current year, and to add provisions regarding provisional salaries tax and property tax. As may be seen from the speech of the Financial Secretary reported in *Hansard*, the focus was on the change of the assessment basis. It did not include any intention to make income derived after termination of employment not assessable to tax.

The Inland Revenue Amendment (No. 5) Ordinance, 1983

23. This included the removal of the old provisions relating to assessment on the preceding year basis, which did not apply after the year of assessment 1972/1973. Section 11 was repealed. Section 11B had the reference to the year 1973/74 deleted and replaced by a provision applying it to all years. Section 11C(1) had the reference to section 11 removed, and was re-numbered as section 11C, as it now appears. These amendments were minor ones, tagged on to provisions regarding the taxation of married women, which were the real thrust of this amending Ordinance.

Conclusion on Legislative History

24. Ms Cheng concludes that the purpose of section 11C is not to draw a distinction between income earned before and after the cessation of employment. Rather, it was a deeming provision to be applied to the rules regarding the calculation of assessable income, for the purpose of fixing the day on which a taxpayer would be deemed to commence or cease to derive income

from a source. Because of successive amendments to the legislation the original purpose has become obscured. It should not be read literally. An indication that it should not be so read lies in the wording of section 11B, which, if read literally, renders all income, whether derived in Hong Kong or overseas, and whether or not derived from employment, assessable to tax; and that is not correct.

25. Ms Cheng also argues that the Board' s construction of section 11C does not accord with the necessary purposive construction of that section, and that it leads to arbitrary and unsatisfactory consequences, of which she gives some examples, including, last but not least, the promotion of tax avoidance schemes. She says that if gains from share options exercised after cessation of employment are not assessable to tax, employers and employees will devise schemes to escape taxation. There will be a real incentive for employers to offer tax-free share options and for employees to seek them out.

Discussion

26. The Board considered the effect of sections 9(1)(d) and (4) but held that neither was concerned with when a source of employment income is deemed to commence or cease.

27. Section 9(1) provides:

"Income from any office or employment includes:

(d) 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."

Section 9(4) provides:

"For the purposes of subsection (1):

(a) 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; and

(b) the gain realized by the assignment or release of such a right as is referred to in paragraph (d) of that subsection shall be taken to be the difference between the amount or value of the consideration for the assignment or release and the amount or value of the consideration given for the grant of the right,

> (a just apportionment being made of any entire consideration given for the grant of the right to acquire the said shares or stock and other shares or stock or otherwise for the grant of the right to acquire those shares or stock and for something beside):
>
> Provided that neither the consideration given for the grant of the right nor any such entire consideration shall be taken to include the performance of any duties in or in connection with the office or employment by reason of which the right was granted, and no part of the amount or value of the consideration given for the grant shall be deducted more than once under this subsection."

28. A further subsection added by the Inland Revenue Ordinance 1971 is subsection (5), which provides:

> "Where salaries tax may by virtue of subsection (1)(d) become chargeable in respect of any gain which may be realized by the exercise of a right, salaries tax shall not be chargeable under any other provision of this Ordinance in respect of the receipt of the right."

29. It seems to me that if all these provisions are read together, the effect is that the gain is assessable as income; the amount of the gain is calculated when the option is exercised, whenever that may be, on the difference between what the employee pays for the option, and its market value; and where tax may become chargeable in respect of a future gain it is not chargeable under any other provision. This seems to me to add weight to the contention of the Commissioner that the object of these amendments was not simply to bring option gains into the tax net, but to bring them in whenever they might be realised.

30. It seems to me that the conclusions advanced for the Commissioner on the purpose of section 11C must be right, and that it, and section 11(7) which preceded it, were never intended to draw a distinction between income earned before and after the cessation of employment. To read it in that way would be to clash with the legislative purpose of the section 9 amendments made in 1971, and in effect to allow the alteration of the law by a side wind. The court should apply a rectifying construction to avoid this result.

31. It does not appear that the Board had the benefit of the arguments put forward for the Commissioner before me. Without the benefit of Ms Cheng's analysis, I would have been inclined to interpret section 11C in the same way as did the Board.

Conclusion

32. The answer to the question of law for the opinion of this court is in the affirmative. The Commissioner's appeal is therefore allowed.

Costs

33. By section 69 (6) of the Inland Revenue Ordinance, Cap. 112, the court, in an appeal from the Board by way of case stated may make such order as it thinks fit. This seems to me to give a greater discretion than that given by the Rules of the High Court; for by Order 62 Rule 3(2) costs are to follow the event, except when it appears to the court that in the circumstances of the case some other order should be made as to the whole or any part of the costs.

34. In the normal way costs should follow the event. However, the real value of the decision of this court to the Commissioner lies not in his success against the Taxpayer, for the amount concerned is not great, but in obtaining the reversal of a decision of the Board which might be invoked by others in setting up tax avoidance schemes. I also note that the arguments put before me are new, and that the Taxpayer, who simply put forward anew the arguments he had put before the Board, did not seek to address them. In the circumstances, I will make no order as to costs.

(G.P. Muttrie)
Deputy High Court Judge

Ms Yvonne Cheng, instructed by Department of Justice, for the Appellant

The Respondent, in person, absent