Case No. D17/18

Salaries tax – sections 9(1)(d) and 9(4) of Inland Revenue Ordinance – relevant time and the amount of the gain from the exercise of the option – tax a notional gain, rather than an actual gain – subscription price in determining the value of share – discount on the value of shares for such pre-emptive rights, and other restrictions on sale – no variation in terms of policy in giving discount across different types of shares

Panel: Chow Wai Shun (chairman), Yvonne Fong and Law Chung Ming Lewis.

Date of hearing: 31 July 2018.
Date of decision: 27 November 2018.

The Appellant accepted the offer of employment from Company A. The Appellant was granted options to purchase shares of common stock of Company B at the fair market value. Before the date of the termination of the employment, the Appellant exercised the option to purchase Class B shares of Company B and those shares were allotted to him on 9 July 2015. The Appellant then converted the Class B shares to Class A shares which were listed on the Stock exchange and were transferred to the brokerage account of the Appellant. Save as voting power, Class A shares and Class B shares were identical on value.

The Assessor raised salaries tax and considered the restriction on sale of the shares during the lock-up period and the market value of the shares when calculating the share option gain. The Assessor applied an annual account of 5% to reflect the lock-up period in arriving at the market value of the shares.

The Appellant submitted that he could only realize his share upon expiry of lock-up period and he had not realized any gain when he exercised his option. It was only fair and justified if the share option gain was calculated according to the real gain realized price after the lock-up period. There was no market for those shares before the lock-up period. The subscription price could be a reference to the price of those shares. As the Appellant could sell his shares with the same year of assessment, it was only fair to him to use the price of those shares on that day in computing his share option gain. As an alternative, the Appellant would have withdrawn his appeal if the Respondent would agree to apply the 25% discount to this case. The issues of the appeal are (a) the relevant time for ascertaining the gain realized by the Appellant by the exercise of the option; and (b) the amount of the gain from the exercise of the option.

Held:

1. For the purposes of section 9(1)(d), section 9(4) provides that the gain

shall 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. The gains refers to a notional gain. The absence of any share certificate does not negate the acquisition of the shares, and hence, the viability of a notional sale (D14/90, IRBRD, vol 5, 131, D43/99, IRBRD, vol 14, 448, D128/99, IRBRD, vol 15, 16, D120/02, IRBRD, vol 18, 125, D62/06, (2006-07) IRBRD, vol 21, 1154 and D66/06, (2006-07) IRBRD, vol 21, 1183 followed).

2. Section 9(4)(a) of the Ordinance seeks to tax a notional gain, rather than an actual gain. As a matter of law, it is irrelevant that there is no actual sale of shares or realization of the gain in the sense of converting the shares into cash. The notional gain is calculated on the date when the shares were acquired by the taxpayers. The fact that a taxpayer might not be in a position to sell the shares upon acquisition is not relevant in determining the relevant time for ascertaining such notional gain.

3. The Board do not accept the subscription price in determining the value of share. The subscription price is just a price applicable to the transaction between the employer and the appellant as an employee. It does not reflect the value of those shares which 'a person might reasonably expect to obtain from a sale in the open market'.

4. Discount on the value of shares for such pre-emptive rights, and other restrictions on sale, has been given in previous decisions of this Board. There has been no variation in terms of policy in giving such discount across different types of shares. As a result, we do not see any good reason to deviate from previous decisions of this Board.

5. The Board suggest to the IRD to publish their prevailing practice in this regard and review it given that the situation now in Hong Kong may be quite different from the UK 16 years ago on which the degree of discount has been based upon.

Appeal dismissed.

Cases referred to:

D14/90, IRBRD, vol 5, 131
D43/99, IRBRD, vol 14, 448
D128/99, IRBRD, vol 15, 16
D120/02, IRBRD, vol 18, 125
D62/06, (2006-07) IRBRD, vol 21, 1154
D66/06, (2006-07) IRBRD, vol 21, 1183

Appellant in person.
Lo Hok Leung Dickson, Chiu Ming Wai and Leung Ching Yee, for the Commissioner of Inland Revenue.

Decision:

1. This is an appeal against the determination of the Deputy Commissioner of Inland Revenue dated 7 March 2018 ('the Determination') which revised the Salaries Tax Assessment for the year of assessment 2015/16 on the Appellant.

2. The Appellant gave oral evidence before this panel at the hearing.

Facts

3. We do not find any oral or documentary evidence given by the Appellant contrary to the facts upon which the Determination was arrived at and so we hold the following facts relevant to this case:

(a) By a letter dated 29 May 2014, Company A ('the Employer') offered to employ the Appellant with effect from 9 June 2014. The Appellant accepted the offer.

(b) Company B informed the Appellant on 29 May 2014 that their management would recommend to their Board of Directors (the 'Board') that the Appellant be granted an option to purchase up to 7,000 shares of common stock of it (the 'Common Stock') under its Amended and Restated 2007 Stock Plan (the 'Plan') at the fair market value of the Common Stock, as determined by the Board on the date of the Board's approval of such grant. The option granted would be subject to the following vesting conditions: ¼ of Company B's option shares would vest at the end of the first anniversary of the Appellant's date of grant and an additional $1/48^{th}$ of the shares would vest each month thereafter, so long as the Appellant remained employed by Company B or one of its subsidiaries or affiliates. Company B and the Employer were, at the relevant times, affiliates.

(c) Company B carried out two-for-one and three-for-two share split on 18 September 2014 and 26 April 2015 respectively. Thereafter, the Appellant was entitled to exercise an option to subscribe up to 21,000 shares of Company B (the 'Option') subject to the vesting conditions of the Plan.

(d) Company B listed its Class A shares on the City C Stock Exchange in 2015. In its prospectus dated 17 June 2015, Company B explained

the difference between its Class A and Class B shares as follows:

'We have two classes of common stock, Class A common stock and Class B common stock. The rights of the holders of Class A common stock and Class B common stock are identical, except voting and conversion rights. Each share of Class A common stock is entitled to one vote. Each share of Class B common stock is entitled to ten votes and is convertible at any time into one share of Class A common stock.'

(e) By a letter dated 11 June 2015, the Employer confirmed discussion with the Appellant that his employment would terminate on 31 July 2015. The Appellant exercised the Option on 9 July 2015 and 5,688 Class B shares of Company B were allotted to him. He converted the Class B shares into 5,688 Class A shares on 9 December 2015. The Class A shares were transferred to his brokerage account on 15 December 2015.

(f) The Employer filed a notification in respect of the Appellant reporting the following particulars:

(i)	Capacity in which employed	:	Position D
(ii)	Period of employment	:	01-04-2015 to 31-07-2015
(iii)	Income particulars		
	Salary / Wages	:	$322,816
	Leave pay	:	56,896
	Other rewards, Allowance or Perquisites	:	1,905,277
			2,284,989

(g) The above 'Other rewards, Allowance or Perquisites' included share option gain of $1,761,530, which was computed by the Employer as follows:

Total number of shares	(A)	5,688
Market value of share at the date of exercise [Closing price of Company B Class A share at City C Stock Exchange ('SE') on 9 July 2015]	(B)	US$42.25
Cost of exercise	(C)	US$2.2933
Exchange Rate	(D)	7.7507
Share option gain [(B)-(C)]x(A)x(D)		$1,761,530

(h) In his Profits Tax Return – Individuals for the year of assessment 2015/16, the Appellant declared the below income:

		$
(i)	Salary from the Employer for the period from 1 April 2015 to 31 July 2015	322,816

		$
(ii)	Share option gain	1,195,766
(iii)	Lump sum payments	200,643
Total		1,719,225

(i) The Appellant computed the above share option gain as follows:

Total number of shares	(A)	5,688
Market value of share after the lock up period [Average price of Company B Class A share at SE on 15 December 2015]	(B)	US$29.51
Cost of exercise	(C)	US$2.2933
Exchange Rate	(D)	7.75
Gross share option gain [(B)-(C)]x(A)x(D)		$1,199,766
Less: Bank and courier charges		4,000
Net share option gain		$1,195,766

(j) The Assessor raised on the Appellant the following Salaries Tax Assessment for the year of assessment 2015/16:

	$
Income (paragraph 3(f))	2,284,989
Less: Deductions	62,000
	2,222,989
Less: Allowances	380,000
Net Chargeable Income	1,842,989
Tax Payable thereon	281,308

(k) The Appellant objected to the above assessment.

(l) The Assessor considered the restriction on sale of the shares during the lock-up period and the market price of Company B Class A shares should be taken into account when calculating the share option gain. As such, the Assessor applied an annual discount of 5% to reflect the lock-up period in arriving at the market value of the shares. The Assessor considered the Salaries Tax Assessment for the year of assessment 2015/16 be revised as below:

(a) Revised share option gain

Total number of shares	(A)	5,688
Market value of share at the date of exercise [Closing price of Company B Class A share at SE on 9 July 2015]	(B)	US$42.25
Cost of exercise	(C)	US$2.2933
Discount	(D)	2.1918%[Note]
Exchange Rate	(E)	7.7507

	$
Market value of shares acquired after discount [(A)x(B)x[1-(D)]x(E)]	1,821,807
Less: Consideration [(A)x(C)x(E)]	101,102
Bank and courier charges (paragraph 3(i))	4,000
Revised share option gain	1,716,705

Note
Since there were 160 days between 9 July 2015 and 15 December 2015, both dates inclusive, the discount would be:
5% x 160/365days
=2.1918%

(b) Revised Salaries Tax Assessment for the year of assessment 2015/16

	$
Income:	
Salary from the Employer (paragraph 3(f))	322,816
Share option gain per above computation	1,716,705
Lump sum payments (paragraph 3(f))	200,643
	2,240,164
Less: Deductions	62,000
	2,178,164
Less: Allowances	380,000
Revised Net Chargeable Income	1,798,164
Revised Tax Payable thereon	273,687

The issue of this appeal

4. We agree with the Respondent that the issues of this appeal are:

(a) the relevant time for ascertaining the gain realized by the Appellant by the exercise of the Option; and

(b) the amount of the gain from the exercise of the Option.

The law

5. Section 8(1) of the Inland Revenue Ordinance ('IRO') provides that salaries tax shall be charged for each year of assessment on every person in respect of his income arising in or derived from Hong Kong from, *inter alia*, any office or employment.

6. Section 9(1)(d) of the IRO defines income from any office or employment to include any gain realized by, *inter alia*, the exercise 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.

7. For the purposes of section 9(1)(d), section 9(4) provides that the gain shall 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.

8. It is clear from the previous decisions of this Board, as cited by the Respondent, that the gain refers to a notional gain, not to the actual gain: D14/90, IRBRD, vol 5, 131, D43/99, IRBRD, vol 14, 448, D128/99, IRBRD, vol 15, 16, D120/02, IRBRD, vol 18, 125, D62/06, (2006-07) IRBRD, vol 21, 1154 and D66/06, (2006-07) IRBRD, vol 21, 1183. It is also clear from these decisions that the absence of any share certificate does not negate the acquisition of the shares, and hence, the viability of a notional sale.

9. The Board in D62/06 further stated, at paragraph 36 of its decision, that 'an open market' did not confine to a 'stock market' or 'free market' such that the provisions do not limit their application to shares of public companies. As to the fair market value of the shares in D62/06, the Board, in the absence of any evidence to the contrary, adopted the price determined by the board of the taxpayer's employer as the market price of those shares. Having said so, the Board accepted a discount of 25% given by the Commissioner as fair and reasonable under the circumstances, taking into account the facts that the shares were subject to a 5-year vesting schedule and that the transfer of shares were restricted by certain pre-emptive right of his employer. In fact, earlier in the decision in D120/02, the Board considered evidence indicating that the UK Capital Taxes Office was prepared to allow a 25% discount to reflect a 5-year restriction period with early release clauses. The Board chose to follow the English position and increased the 20% discount initially given by the IRD to 25%.

10. Section 68(4) of the IRO provides that the onus of proving that the assessment appealed against is excessive or incorrect shall be on the Appellant.

The Appellant's submission

11. In summary, the Appellant's case is that the price of his Company B shares taken for determining his gain realized by his exercise of the Option for Salaries Tax purpose, should be US$29.51 (as at the first day after the lock-up period), instead of US$42.25 (as at the date of exercise of it). It is so because, according to the Appellant:

(a) The shares allotted to him were Class B shares. For selling his shares, those Class B shares had to be converted into Class A shares, which required Company B's approval.

(b) He could only realize his shares upon the expiry of the lock-up period, which was after 14 December 2015. He had not realized any gain when he exercised the Option.

(c) It was only fair and justified if the share option gain was calculated according to the real gain realized pricing at US$29.51 on 15 December 2015, the price after the lock-up period.

(d) There was no market for Class B shares and therefore no market value for those shares before 15 December 2015. The subscription price of US$2.2933 could be a reference to the price of those Class B shares.

(e) D120/02 was not applicable to this appeal because the lock-up period for that case was 5 years and a discount was given to the taxpayer for tax filing purpose only. As the Appellant could sell his shares with the same year of assessment, it was only fair to him to use the price of those shares on that day in computing his share option gain.

12. As an alternative, the Appellant would have withdrawn his appeal if the Respondent would agree to apply the 25% discount to this case.

The Appellant's evidence

13. The Appellant swore to give oral evidence and was subject to cross-examination by the Respondent. Panel members, from time to time, posed questions to the Appellant. The following two aspects took up most of the time in this regard, which we find relevant.

14. The first aspect was about the conversion of shares from Class B to Class A. The Appellant said that he had just followed the instructions from Company B, by way of an email sent on 4 December 2015 to convert his Class B shares to Class A shares because he had no idea how to go about it. When one of the panel members asked if such conversion might require any approval, the Appellant said yes and elaborated by effectively referring to the lock-up period, which was a different matter. As a matter of evidence, we were reminded by the Respondent of a letter from the Employer to the assessor dated 9 January 2018, confirming that the Appellant could have converted the Class B shares to Class A shares at no cost without mentioning any requirement of approval. We take that to mean that the Appellant could have carried out the conversion at any time before the end of the lock-up period. The Appellant then directed us to the Notice of Irrevocable Election to Convert and said that he had to apply for the conversion. However, again, we see that a procedural requirement rather than a restriction on or approval for the conversion. The Appellant then blamed Company B for their delayed response to his enquiry. Together with what we see from the Prospectus which we refer to in paragraph 16 below, we find, as a matter of fact, that no approval has been necessary for the conversion and so the Appellant was free to have his Class B shares converted to Class A shares at any time, even before 9 December 2015. He had not done so earlier not because he had been barred from doing it but because he did not know the way to do it until he asked and received instructions from Company B.

15. There were also questions and answers on the marketability and value of Class B shares. The Appellant alleged in his Notice and Statement of the Grounds of Appeal that the Class B shares could not be sold in the market and queried if there existed such a market at all for Class B shares when the Respondent suggested the possibility of being approached by someone to acquire those shares. However, we note from the Exercise Notice and Restricted Stock Purchase Agreement that the Appellant might sell the Class B shares to others with prior approval from Company B which had the first right to buy them back. To us, this is no different from an ordinary pre-emptive right.

16. On the value of those Class B shares, the Prospectus provided that the Class A shares and Class B shares were identical except that a Class B share is entitled to 10 votes, whereas a Class A share had only one vote, and is convertible at any time into one Class A share. On such basis, we agree with the Respondent's observation that the fair market value of each Class B share should not be less than that of Class A, subject to any reasonable discount given in light of the pre-emptive right.

Analysis

17. From previous decisions of this Board interpreting section 9(4)(a) of the IRO, it is clear that the statutory provision seeks to tax a notional gain, rather than an actual gain. We agree with the Respondent that as a matter of law, it is irrelevant that there is no actual sale of shares or realization of the gain in the sense of converting the shares into cash. It is also clear that the notional gain is calculated on the date when the shares were acquired by the taxpayers. The fact that a taxpayer might not be in a position to sell the shares upon acquisition is not relevant in determining the relevant time for ascertaining such notional gain.

18. On the facts, the Appellant exercised his right under the Option and 5,688 Class B shares of Company B were allotted to him on 9 July 2015. Irrespective of the conversion and the lock-up period, 9 July 2015 is the relevant date for ascertaining the taxable gain.

19. What would be the value of those B shares allotted to the Appellant which he might reasonably expect to obtain from a sale in an open market on 9 July 2015? First and again, this is premised on a notional sale between willing parties, not an actual sale necessarily at any stock exchange or even free market as such. The Respondent had adopted the value provided by the Employer, which is the same as the closing price of a Class A share at SE, because the Employer knew more about Company B than anyone else and the market value of a Class B share should not be less than that of a Class A share with reference to what appeared on Company B's Prospectus (see paragraph 16 above). On the other hand, the Appellant claimed that there was no such market, and hence no market value, for Class B shares but he suggested the subscription price (US$2.2933) could be a reference to the price of a Class B share.

20. We do not accept the Appellant's contention of referring to the subscription price in determining the value of a Class B share. In our view, the

subscription price is just a price applicable to the transaction between the Employer and the Appellant as an employee. It does not, and cannot, reflect the value of those shares which 'a person might reasonably expect to obtain from a sale in the open market'. We agree with the Respondent on this point but we would also add that, as a matter of fact, the Appellant could have converted the Class B shares into Class A shares at any time after his acquisition, subject to the pre-emptive rights of Company B.

21. Discount on the value of shares for such pre-emptive rights, and other restrictions on sale, has been given in previous decisions of this Board. The discount given to the Appellant has already reflected these. As an alternative, the Appellant in his Notice and Statement of Grounds of Appeal asked for a 25% discount. When prompted, the Appellant in his reply to the Respondent's submission explained that the price of Company B shares, as shares of any high-tech company, had been fluctuating quickly within a relatively short period of time and so should warrant a greater discount to reflect its high volatility. This appeared as an attractive argument at the outset. However, we remind ourselves that a higher risk comes with a higher return while the statutory provision is not taxing on the actual return. Furthermore, assurance was given to us by the Respondent that there has been no variation in terms of policy in giving such discount across different types of shares. As a result, we do not see any good reason to deviate from previous decisions of this Board.

22. Nevertheless, we would suggest to the Inland Revenue Department to publish their prevailing practice in this regard and review it given that the situation now in Hong Kong may be quite different from the United Kingdom 16 years ago on which the degree of discount has been based upon.

Conclusion

23. Accordingly, we dismiss this appeal and confirm the revised assessment as set out in paragraph 3(l) above.