

**Case No. D21/16**

**Salaries tax** – whether dividend received on restricted shares awarded by the employer during the restricted period are income from employment – correct approach to consider all the facts to the receipt of the income – Back End Approach – vested interest in employee share trust – whether or not the true nature of the sums is earnings but not income arising from investment

Panel: Wong Kwai Huen (chairman), Choi Kwan Wing Kum Janice and Sanjay Arjan Sakhrani.

Date of hearing: 5 May 2016.

Date of decision: 9 August 2016.

The Appellant was employed by Company B. The Appellant was eligible to participate in Company B's Short-Term Incentive Performance-Base Plan to be provided in cash or in deferred Company B shares or a combination of both. Under the said plan, the Appellant could not deal in the shares until the end of the restriction period. During the period of the restriction, the shares allocated to the Appellant would be held in trust for the Appellant by the Trustee. The trustee was Company C. The allocated shares would be eligible for cash dividends from the time they were allocated to the Trustee on behalf of the Appellant. The Allocation Date was the date that the shares were allocated to the Appellant and the Milestone Date was the earliest date that the Appellant could access the shares.

The Appellant has objected to the Salaries Tax Assessments. The Appellant claimed that dividends he received on the restricted shares awarded by his employer (hereinafter referred to as "the Sums") were not income from employment and should not be assessable to salaries tax for the following reasons:

1. The Sums were received by him as the beneficial owner of the shares which gave him the voting right at shareholder meetings and the right to receive dividends.
2. The Sums were income from investment and not income from employment.
3. The Appellant's employment was not real or effective cause of the payment of the Sums to him, but only an incidental factor concerning the payment. The Sums were not paid to him as rewards for his services. The Appellant relied on Hochstrasser v Mayes [1960] AC 376 and Shilton v Wilmshurst [1991] 1 AC 684.

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4. The Sums were not remuneration or reward or return for his services; hence they were not income from employment under section 9(1)(a) of the Ordinance and not income assessable under section 8(1) of the Ordinance.

The Appellant is not disputing the taxability of the shares. It is not disputed that once the shares have been fully vested in the Appellant i.e. upon the Milestone Date, they would be deemed to have been received by the Appellant and become chargeable to tax.

The issue is whether the Sums paid on those shares should be chargeable to salaries tax during the period between the Allocation Date and the Milestone Date.

**Held:**

1. The correct approach is to consider all the facts to the receipt of the income. This requires the court not to be restricted to the legal form of the source of the payment but to focus on the character of the receipt in the hands of the recipient. It is trite law that substance prevails over form (PA Holdings Ltd v Revenue and Customs Commissioners [2012] STC 582 followed).
2. The Board finds it reasonable and proper for the Respondent to adopt the Back End Approach in the tax assessment of the shares which formed the basis of deciding the nature of the Sums. That approach decides the timing of the full vesting of the shares in the Appellant. Once the shares have been fully vested in the Appellant, the matter will be put beyond doubt i.e. any dividends paid on the tax after vesting should be income from investment. But until then, the question whether the Sums are taxable still requires further examination.
3. In any employee share trust, vesting is the process by which an employee accrues non-forfeitable rights over an employer-provided share incentive scheme. The vesting schedule which is set up by the company determines when the employee acquires full ownership of the shares. A vested interest means the right, interest or title to some present or future possession of a legal estate which can be transferred to any other party. A vested right is an absolute right that has been accrued and cannot be taken away. The Board finds that vesting time is a more crucial factor than voting right or entitlement to dividends in this case.
4. The Board finds that the Sums had the character of a perquisite akin to an extra bonus to the Appellant. The exact amount of that extra perquisite happened to be tied in with the amount of dividends paid on the shares. Substance is more important than form. The true nature of the Sums is not income arising from investment but is earnings as found in the PA Holdings Ltd case.

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5. The Board finds that the Appellant has failed to discharge his onus of proof under section 68(4) of the Ordinance and that the Sums are correctly concluded as the Appellant's assessable income for the years of assessment.

**Appeal dismissed.**

Cases referred to:

Hochstrasser v Mayes [1960] AC376  
Shilton v Wilmshurst [1991] 1 AC684  
PA Holdings Ltd v Revenue and Customs Commissioners [2012] STC 582

Appellant in person.

Chow Cheong Po and Wong Pui Ki, for the Commissioner of Inland Revenue.

**Decision:**

**Agreed facts**

1. At the beginning of the hearing, both parties agreed to the following facts:
  - (1) Mr A ('the Appellant') has objected to the Salaries Tax Assessments for the years of assessment 2010/11 to 2012/13 raised on him. The Appellant claims that certain sums he received on the restricted shares awarded by his employer were not income from employment and should not be assessable to salaries tax.
  - (2) The Appellant commenced employment with Company B on 2 October 2008. According to the terms of employment, he was eligible to participate in Company B's Short-Term Incentive Performance-Base Plan ('STI Plan'). The STI Plan might be provided in cash or in deferred Company B shares ('STI Deferral Shares') or a combination of both.
  - (3) Company B's STI Deferral Share Offer Guides for 2010, 2011 and 2012 ('the Share Offer Guides') contained the following particulars:
    - (a) Company B Group's STI Plans included the provision of incentive deferral amounts in the form of shares. Such shares were called 'STI Deferral Shares'.
    - (b) (i) 'Allocation Date' was the date that the shares were

allocated to the participant.

(ii) 'Milestone Date' was the earliest date that the participant could apply to access the shares.

(iii) The trustee was Company C ('the Trustee').

(c) Allocation of the STI Deferral Shares

The STI Deferral Shares were provided under the Company B Staff Share Ownership Plan, which set out the terms and conditions of the share award. Following allocation, the shares would be held in trust for the participant by the Trustee.

(d) The restriction period

The participant could not deal in the shares until the end of the restriction period. The restriction period ended on the earlier of the Milestone Date and the date that the participant was notified that certain 'events' occurred (e.g. the date of a takeover bid, etc.).

(e) At the end of the restriction period

As long as the participant's interest in the shares had not been forfeited, at the end of the restriction period, the participant could choose to leave the shares in the trust (continued to be held on the participant's behalf by the Trustee) or request the Trustee to sell the shares or request the Trustee to transfer the shares to the participant's name.

(f) Forfeiture conditions

Until the Milestone Date, the participant's STI Deferral Shares would be forfeited if:

(i) the participant resigned from the Company B Group; or

(ii) the participant's employment with the Company B Group was terminated by the employer (except in circumstances of retrenchment/redundancy or where the Board exercised its discretion that the shares should not be forfeited); or

(iii) the participant failed the compliance gateway or equivalent; or

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- (iv) the allocation of the STI Deferral Shares was made in error or the participant's performance outcome had changed; or
- (v) the Board, in its absolute discretion, determined that all or some of the shares would be forfeited. Such a determination might be made in relation to the Company B Group as a whole, a business unit, an executive committee, specific role or individual.

(g) Why the STI Deferral Shares were held in trust?

A trust was a simple mechanism used by many companies to place restrictions on trading in shares provided under employee share plans and to enforce forfeiture conditions placed on those shares.

(h) Dividends

Company B's dividends were generally paid twice a year. However, the payment of dividends depended on a number of factors including Company B's profitability and dividend policy.

The STI Deferral Shares would be eligible for cash dividends from the time they were allocated to the Trustee on behalf of the participant.

Dividend is defined in the Share Offer Guides as:

'A dividend is a portion of a company's profits (after company tax) which is distributed to its shareholders. Whether a dividend is paid, and the amount of any dividend, is determined by the Board taking into account the performance and profitability of the company as well as its need for capital.'

(i) Participation in rights issues and bonus issues

The participant would also be entitled to any bonus shares or other rights to acquire shares in respect of Company B shares. Bonus shares were also held in trust for the remainder of any restriction period applying to the primary shares. They were subject to the same forfeiture conditions.

(j) Voting at shareholder meetings

While the STI Deferral Shares were held by the Trustee, the participant could instruct the Trustee in writing how to vote on his/her behalf. If no instruction was received by the stipulated time, the Trustee could exercise the voting rights as it saw fit.

(k) Tax summary – Hong Kong

The Share Offer Guides provided a general guide to the Hong Kong salaries tax implications for the allocation of STI Deferral Shares to employees who were Hong Kong tax resident and were employed under a Hong Kong employment contract for Hong Kong salaries tax purposes. The participants were reminded that the summary did not constitute tax advice for the individual participants.

On the basis of the revised Departmental Interpretation and Practice Notes No. 38 [‘DIPN 38’] issued by the Inland Revenue Department (‘the Department’) in March 2008, Company B had sought clarifications with the Department that the taxing point of the STI Deferral Shares would be the year of assessment of the ‘Milestone Date’ when the shares were vested. The taxable value of the shares would be the market value on the Milestone Date.

Dividends paid on the Company B shares held in trust on the participant’s behalf before the Milestone Date would be regarded as employment income and subject to salaries tax in the year of receipt. Dividends paid after the Milestone Date would be non-taxable.

(l) Tax summary – Country D

The Share Offer Guides were intended to provide a brief overview of certain Country D tax consequences that might be applicable to employees who participated in the STI Plan. The participants were reminded that the overview was general in nature which was not meant to be a personal tax advice and could not be relied upon for that purpose.

In Country D, shares awarded to employees during a Country D employment were taxable.

All foreign-source income received in Country D by a Country D resident individual on or after 1 January 2004 was exempt

from tax in Country D. Participant should not be subject to tax on dividends received in respect of his/her Company B shares.

(m) Trust Deed

The STI Deferral Share offer was subject to a formal set of rules. Those rules were set out in the Company B Staff Share Ownership Plan Trust Deed ('the Trust Deed') and summarized in the STI Deferral Share Offer Guides.

(4) The Trust Deed contained the following particulars:

(a) The parties to the Trust Deed were Company B and the Trustee.

(b) Company B wished to establish the trust to assist in the retention and motivation of employees of the Company B Group.

(c) Allocation of shares

The Trustee would allocate to the participant shares held by the Trustee (not already held for a participant) to be held for the benefit of that participant.

(d) Registration in name of Trustee

The shares should be registered in the name of the Trustee and be held on the terms of the Trust Deed by the Trustee on behalf of the participant who was the beneficial owner of the shares.

(e) Rights of Company B – shares

Nothing in the Trust Deed conferred or was intended to confer on Company B, any charge, lien or any other proprietary right or proprietary interest in the shares.

(f) Rights attaching to shares

(i) The participant was entitled to receive all cash dividends paid on the shares.

(ii) The participant was entitled to any bonus shares which accrued to shares held by the Trustee on his/her behalf. The bonus shares should be registered in the name of the

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Trustee and held in trust by the Trustee on behalf of the participant, who was the beneficial owner of the bonus shares.

- (iii) The Trustee would send a notice to the participant of any Rights (defined to be any rights to acquire shares or securities issued or to be issued by Company B) which accrued to shares held by the Trustee on behalf of the participant. The participant was entitled to instruct the Trustee to sell the Rights or to acquire shares to which the Rights related. In the absence of a notice by the participant, the Trustee was entitled to sell the Rights. The Trustee had to distribute the proceeds of the sale to the participant.
- (iv) A copy of the notice of all general meetings of shareholders of Company B received by the Trustee should be forwarded to the participant if he/she stipulated in the prescribed form that he/she wished to receive a copy of all notices. The participant might give the Trustee a written notice to vote and the Trustee had to exercise the voting rights attaching to the shares in accordance with the prior written instructions of the participant.
- (v) Each share was held by the Trustee for the participant in accordance with the terms of the Trust Deed absolutely entitled to the share as against the Trustee.
- (g) The Board of Company B should determine the restriction period during which the participant should not deal with the shares.
- (h) Forfeiture of shares

The Board of Company B should determine that the terms of issue of shares provide in certain circumstances determined by the Trustee that a participant would forfeit any interest in the shares and the shares would in those circumstances be treated as an accretion to the Trust.

- (5) Company B filed employer's returns in respect of the Appellant for the years of assessment 2010/11 to 2012/13, which showed the following particulars:



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|                            | <u>2010/11</u>             | <u>2011/12</u>             | <u>2012/13</u>                  |
|----------------------------|----------------------------|----------------------------|---------------------------------|
| Capacity in which employed |                            | ← Position E →             |                                 |
| Period of employment       | 01-04-2010 -<br>31-03-2011 | 01-04-2011 -<br>31-03-2012 | 01-04-2012 -<br>31-03-2013      |
| Particulars of income -    | \$                         | \$                         | \$                              |
| Salary                     | 962,500                    | 1,012,499                  | 1,063,125                       |
| Bonus                      | 407,194                    | 371,250                    | 318,938                         |
| Company shares             | 6,669                      | 139,233                    | 120,590                         |
| Dividends ('the Sums')     | <u>3,713</u>               | <u>8,954</u>               | <u>12,411</u> <sup>[1]</sup>    |
| Total                      | <u>1,380,076</u>           | <u>1,531,936</u>           | <u>1,515,064</u> <sup>[1]</sup> |

<sup>[1]</sup> See the subsequent amendment in paragraph (16) below.

- (6) In his Tax Returns – Individuals for the years of assessment 2010/11 to 2012/13, the Appellant declared his income from Company B as follows:

|              | <u>2010/11</u>   | <u>2011/12</u>   | <u>2012/13</u>   |
|--------------|------------------|------------------|------------------|
|              | \$               | \$               | \$               |
| Salary       | 962,500          | 1,012,499        | 1,063,125        |
| Cash Bonus   | 407,194          | 371,250          | 318,938          |
| Bonus shares | <u>6,669</u>     | <u>139,233</u>   | <u>120,590</u>   |
| Total        | <u>1,376,363</u> | <u>1,522,982</u> | <u>1,502,653</u> |

- (7) In accordance with the employer's returns, the Assessor raised on the Appellant the following Salaries Tax Assessments for the years of assessment 2010/11 to 2012/13:

|                                   | <u>2010/11</u>   | <u>2011/12</u>   | <u>2012/13</u>   |
|-----------------------------------|------------------|------------------|------------------|
|                                   | \$               | \$               | \$               |
| Assessable Income                 | 1,380,076        | 1,531,936        | 1,515,064        |
| <u>Less:</u> Charitable donations | -                | -                | 100              |
| Outgoing and expenses             | <u>2,377</u>     | <u>2,393</u>     | <u>2,587</u>     |
| Net Assessable Income             | 1,377,699        | 1,529,543        | 1,512,377        |
| <u>Less:</u> Basic allowance      | 108,000          | 108,000          | 120,000          |
| Dependent parent allowance        | <u>30,000</u>    | <u>36,000</u>    | <u>38,000</u>    |
| Net Chargeable Income             | <u>1,239,699</u> | <u>1,385,543</u> | <u>1,354,377</u> |
| Tax Payable thereon               | <u>192,748</u>   | <u>211,542</u>   | <u>208,244</u>   |

- (8) The Appellant objected to the 2010/11 to 2012/13 assessments on the grounds that the Sums should be excluded from his assessable income.
- (9) The Assessor considered that the Sums were income derived from employment. She issued a letter to the Appellant to explain her view and invited the Appellant to withdraw the objections.
- (10) The Appellant provided the following information on the Sums:

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- (a) 'According to individual performance, employees may be entitled to performance bonus. Instead of paying cash only, Company B would pay a portion of the bonus in shares under [the STI Plan]. Company B's financial year end is on 30 September. Shares would be allocated to employees on the Allocation Date (usually in November) and held on behalf of employees in the name of [the Trustee]. After the Milestone Date ... employees could choose to transfer shares out from [the Trustee] account. With the allocated shares, employees were entitled to (i) voting by instructing [the Trustee], (ii) receiving dividend, etc.'
  - (b) 'Under [the STI Plan], shares allocated can be forfeited before the Milestone Date, if employees resign or employment is terminated by Company B. Milestone Date is 1 year after Allocation Date. Before the Milestone Date, employees are also not able to sell/deal in the shares.'
  - (c) 'Dividend was received in December by all shareholders. The same dividend rate applies to shares held by ordinary shareholders and under [the Trustee].'
  - (d) The dividends in questions (i.e. the Sums) were all paid on shares obtained from the STI Plan.
  - (e) He did not have the share certificates.
  - (f) If the shares were forfeited, he would not be compensated with cash for the forfeited shares.
- (11) In response to the Assessor's enquiries, Company B provided the following information:
- (a) The Sums reported in the employer's returns were all derived from the STI Plan.
  - (b) The Sums were paid to the Appellant by cheque in Country F dollars mailed directly from Company G in Country F to the Appellant's correspondence address as recorded in the system.
  - (c) As accepted by the Department, the Company B shares offered under the STI Plan would be reported in the year of assessment of the Milestone Date and would be valued at the market value of the shares on the Milestone Date. Dividends paid on the shares held in trust on the employees' behalf before the Milestone Date would be treated as employment income. Dividends paid after the Milestone Date would be

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treated as investment income and would not be reported in the employer's return.

- (d) During the relevant period, the Appellant was allocated with the following Company B shares under the STI Plan:

| <u>Share Plan</u>  | <u>Allocation Date</u> | <u>Milestone Date</u> | <u>No. of deferral shares allocated</u> |
|--------------------|------------------------|-----------------------|---|
| 09/10 STI Deferral | 10-11-2010             | 10-11-2011            | 666                                     |
| 10/11 STI Deferral | 09-11-2011             | 23-11-2012            | 612                                     |
| 11/12 STI Deferral | 07-11-2012             | 07-11-2013            | 520                                     |

- (e) Breakdown of the Sums (as reported in the employer's returns):

| <u>Year of assessment</u> | <u>Dividend pay-out date</u> | <u>No. of unvested deferral shares</u> | <u>Dividend rate</u><br>Country F Dollars | <u>Amount of dividend</u><br>HKD   |
|---------------------------|------------------------------|--|---|--|
| 2010/11                   | 17-12-2010                   | 665                                    | 0.78                                      | <u>3,713</u> <sup>[1]</sup>  |
| 2011/12                   | 06-07-2011<br>19-12-2011     | 666<br>611                             | 0.84<br>0.88                              | 4,613 <sup>[2]</sup><br><u>4,341</u> <sup>[3]</sup><br><u>8,954</u>                    |
| 2012/13                   | 16-07-2012<br>18-12-2012     | 612<br>1,132 <sup>[6]</sup>            | 0.90<br>0.90                              | 4,318 <sup>[4]</sup><br><u>8,093</u> <sup>[5, 6]</sup><br><u>12,411</u> <sup>[6]</sup> |

[1] (665 shares x Country F Dollars 0.78) at 7.158 = HKD3,713

[2] (666 shares x Country F Dollars 0.84) at 8.2452 = HKD4,613

[3] (611 shares x Country F Dollars 0.88) at 8.0744 = HKD4,341

[4] (612 shares x Country F Dollars 0.90) at 7.8395 = HKD4,318

[5] (Country F Dollars 0.90 x 1,132) at 7.9444 = HKD8,093

[6] See subsequent amendment in Fact (16)

- (f) An internal notification would be sent to all Company B Hong Kong based employees in around May each year about how their shares and dividend were reported to the Department for tax purposes.

- (12) The Department's practice on the taxation of share award benefits is stated in DIPN 38, paragraphs 58 to 61. In general, there are two broad approaches in assessing share awards.

(a) Paragraph 58 stated:

‘... While share or stock award plans vary in details, the points which need to be addressed are –

- When does the perquisite accrue to the employee?
- What value should be attached to the perquisite when it has accrued to the employee?

The first question can be considered in the light of section 11D(b) of the Ordinance, which provides that income accrues to a person when he becomes entitled to claim payment. While this section uses the term “entitled to claim payment”, in the situation of share award, this phrase is taken to mean “entitled to ownership of the shares”. Section 11D(a) provides that income which has accrued to a person but which has not been received by him shall not be included in his assessable income until such time as he shall have received such income. Further, income which has been made available to an employee to whom it has accrued or has been dealt with on his behalf or according to his directions, will be regarded as received by him. In regard to the second question, the fair value of the perquisite at the time of accrual should be ascertained.’

(b) Paragraph 59 stated:

‘For salaries tax purposes, the time at which the shares accrue to the employee can be determined by reference to the terms of the award plan. Generally, there are two approaches in assessing such awards. These are (1) “Upfront”, i.e. at the time when the employer makes an award of shares to the employee, and (2) “Back End”, i.e. when the shares are actually vested in the employee free of any conditions ...’

(c) Paragraph 60 stated:

(i) ‘Upfront’ approach

‘Under this approach, the award is assessed to tax at the time of grant by the employer. The award granted may or may not be subject to certain restrictions. The most common restriction is a restriction to sell, e.g. the employee is not allowed to sell the shares awarded

within a certain period of time ... Other than this restriction, the employee's name would be entered in the shareholders' register, he would be entitled to vote in general meetings, receive dividends, pledge the shares to banks for loans, etc. In short, he has all the rights of a normal shareholder, except the freedom to sell during the restriction period ... In such situation, the Department takes the view that the employee has received a perquisite in the form of shares at the time of grant and he would be chargeable to tax at this point of time (i.e. upfront).'

(ii) 'Back End' approach

'Under this approach, certain conditions have to be satisfied before the shares are vested in the employees. The most common conditions include completing a period of employment with the same employer/group, the company attaining certain level of financial or operational results, etc. Before fulfilment of these conditions, the shares are simply not vested in the employee. The shares might be allotted and held by a trustee but they are liable to be forfeited if the conditions are not fulfilled, or in the event that the employee resigns or is dismissed due to misconduct, etc. Normally, the employee does not have rights of a shareholder, he is not registered as a shareholder, he is not allowed to vote or to receive dividend, etc. It is only at the expiry of the vesting period that the employee would receive all shares together with dividend or dividend shares, or bonus shares distributed during the vesting period. In this situation, the Department takes the view that at the time of grant, the employee only receives a promise with respect to the shares. It is only when the shares are vested in the employee (or when the employee is entitled to ownership of the shares) free of any restriction that the employee is taken as having received the perquisite. It is then that the share award will be chargeable to tax (i.e. back end).'

(d) Paragraph 61 stated:

'... Generally speaking, if shares granted are subject to forfeiture by reason of termination of employment or some future events, the "Back End" approach is more appropriate in assessing the shares. There is more certainty under this

approach as the employee is entitled to the shares free of any condition. No doubt, there must be many factual scenarios more complicated than those highlighted above. It is more appropriate to examine the terms of the award to ascertain the point of time that the shares accrue to the employee for salaries tax purposes ...’

- (13) The Assessor issued a letter to the Appellant to explain that the STI Deferral Shares would be assessed with the ‘Back End’ approach and that the ‘dividends’ received during the vesting period (i.e. the Sums) were taxable as the Appellant’s employment income since he was only entitled to the shares at the end of the vesting period. The ‘dividends’ were not ‘real’ dividends since the Appellant was not the shareholder. However, dividends received after the Milestone Date would be treated as investment income and not taxable.
- (14) The Appellant put forth the following contentions:
- (a) ‘Key questions for the non-taxable claims are:
    - (i) Whether the dividend income is assessable under s.8(1) of the Inland Revenue Ordinance (‘Ordinance’) as income arising in or derived from employment of profit?
    - (ii) Whether the dividend income is income from employment under s.9(1)(a) of the Ordinance (i.e. perquisite ...)?’
  - (b) ‘Taxability of bonus shares does not imply taxability of collateral or subsequent benefits such as dividend income. The nature of dividend income should also remain the same before or after the time when shares are (i) allocated, (ii) vested or (iii) treated as taxable income, if applicable, in a particular year of assessment. I find it difficult to understand the legal grounds on which your Department would consider dividend income (being a repeating return) non-taxable after a particular point of time, while taxable before that arbitrary point of time.’
  - (c) ‘I believe it is a well-established principle that dividend income is investment income that is non-taxable. Dividend income is distribution of a company’s earnings to its shareholders as a return on equity capital provided. Availability of dividend income depends solely on the profitability of the company and its dividend policy, and not my employment.’

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- (d) ‘Reference should also be made to the case Tyrer v Smart (1979) for the guiding principle of determining assessable gain or income: was there an advantage afforded to the recipient in return for acting as or being an employee. In my case, the dividend I received was at the same dividend payout rate as other ordinary shareholders.’
- (e) ‘Ascertaining whether shares are allocated is only helpful in determining the timing of assessment of such shares under s.11D of the Ordinance but not taxability of the shares (which needs to be established in the first place), let alone taxability of subsequent dividend payout.’
- (f) ‘I do not have the share certificate. This is no different from a normal situation in which a person buys at a brokerage house or a bank that holds the shares for the principal. Availability of share certificate is irrelevant as proof of ownership or a determining factor of taxability of dividend income.’
- (g) ‘I would like to reiterate that DIPN mentions explicitly on their cover pages the following:
  - (i) “These notes are issued for the information of taxpayers. ... They contain the Department’s interpretation and practices in relation to the law ...” [from DIPN 38, etc.]
  - (ii) “They have no binding force and do not affect a person’s right of objection or appeal to the Commissioner, the Board of Review or the Courts.” [from DIPN 13, 41, etc.]’
- (h) ‘DIPN are simply not the laws nor the guiding principles. ... the relevant laws are [the Ordinance], and particularly s.8(1) and s.9(1)(a) of [the Ordinance]. The subject dividends in dispute are capital investment return and therefore non-taxable under s.8(1) and s.9(1)(a). I would also like to reiterate that the subject objection is in relation to dividend, not the underlying shares.’
- (i) ‘Paragraphs 58 and 59 of DIPN 38 discuss ‘the time at which the shares accrue to the employee can be determined by reference to the terms of the award plan.’ The concepts of ‘Front End’ and ‘Back End’ are conceived to address this accrual issue in the light of s.11D(b) of [the Ordinance]. The paragraphs discuss the time when shares are considered accrued to a person, that in turn determines the time of

assessment. Your Department must be aware that s.11D(b) is not a charging section. It only addresses timing issue (after establishing a particular income item is assessable). In addition, the paragraphs only mention shares accrued, but not any collateral and subsequent benefit that is not derived directly from employment, such as dividend income.’

- (j) ‘I find it unfortunate that your Department seems to apply the Front End / Back End approaches to establish taxability of dividend income. As explained above, s.11D(b) and your Department’s interpretations evolved (Front End / Back End approaches) are not useful in determining taxability of dividend and are only useful in determining the timing of assessment after such taxability is established. Causality is important and should not be confused.’
- (k) ‘Paragraph 60 of DIPN 38, under “Back end” approach, mentions that “Normally, the employee does not have rights of a shareholder, he is not registered as a shareholder, he is not allowed to vote or to receive dividend, etc. It is only at the expiry of the vesting period that the employee would receive all shares together with dividend ...” Clearly, Back End approach must have considered ‘not having received any dividend’ as a crucial factor in deciding that it is a Back End approach.’
- (l) ‘[The Share Offer Guides] explicitly states that:
- “You may also receive notices of any meeting of shareholders of [Company B] ...”
  - “You may instruct the Trustee how to vote on your behalf at a shareholder meeting ...”

Obviously, the above rights are only granted to shareholders of a company. To argue that a person with such rights are not shareholder is simply ignoring the facts and the fundamental concept of corporation.’

- (m) ‘Staff are entitled to and receive dividend under [the STI Deferral Shares], in addition to their voting rights. Back End approach obviously does not apply to [the STI Deferral Shares]. Conversely, one cannot rely on a Back End approach to test chargeability of dividend, nor to determine timing of assessment, as any Back End share scheme (by definition) will not entitle its employee to any dividend in the first place.’



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- (n) ‘[The Share Offer Guides] explicitly state that “This summary is a general guide to Hong Kong salaries tax implications for the allocation of STI Deferral shares to employees. ... this summary does not constitute tax advice for the individual participants”.’
- (o) ‘The 3 conditions ... (i) vesting period, (ii) shares in Trustee’s name, (iii) shares will be forfeited, in effect can be consolidated into one factor of consideration – vesting time. At best, this factor is useful in deciding the timing of assessment of shares, but not whether dividend income is taxable under salaries tax. Vesting time is also not the only deciding factor in choosing Front / Back End approaches. There are more crucial factors, such as voting rights and entitlement of dividend. Without prejudice, if such binary criteria (Front/Back End) must be used, one would suggest [the STI Deferral Shares] is closer to Front End, rather than Back End approach for the shares.’
- (p) ‘Again, I would reiterate that s.11D nor DIPN is the charging section for salaries tax. Dividend income is capital return and hence not taxable under salaries tax. The nature of dividend income is always investment income and does not change from employment income at an arbitrary point of time (such as milestone day). [The STI Deferral Shares] is not a match to the criteria described under the Front/Back End approaches. It requires case-by-case judgment, rather than pigeonholing.’
- (q) ‘I do not agree to [your] conclusion ... that “The dividends are not real dividends.” May I ask what is a “real” dividend if I have the right to vote and entitlement to dividend distribution same as all the other shareholders of the bank? All the dividend distributions are managed by [Company G], the investor services company that acts for all the shareholders. My employer having the right to forfeit my shares does not mean that I am not a “real” shareholder before such forfeiture, if ever happens.’
- (r) ‘Without prejudice, there are other situations that your Department would apply a different assessment interpretation. For example, your Department will assess upfront any joining /sign-on bonus of an employee, despite the requirement that such joining bonus will be forfeited if that employee does not fulfill a certain period of employment. Vesting period is clearly not the only consideration of your Department in

making such “Front End” decision.’

- (15) The Appellant put forth the following contentions for the Deputy Commissioner’s determination:
- (a) ‘Being the agreement between the Trustee and [Company B], the Trust Deed provides that participant of the [Company B] Staff Share ownership Plan is absolutely entitled to the share as against the Trustee. Under common law, by having absolute entitlement, the participant has exclusive right to instruct the Trustee with regard to the management of assets held in trust. The provision of absolute entitlement shows the intention of both the Trustee and [Company B] that the participant should have the rights to the share as shareholder.’
  - (b) ‘Paragraphs 58 to 61 of DIPN 38 (Revised) illustrate the Department’s view to assessing perquisite in the form of shares and determining when the perquisite has accrued to the employee. The legal grounds of assessing subsequent distribution (including dividends) are in absence.’
  - (c) ‘The source of income is a matter of fact. In [Country D], [Company B] [Country D] Branch participates in the auto-inclusion scheme for employment income set up by the [Inland Revenue Authority of Country D]. Dividends from [Company B] shares are regarded as foreign-sourced and non-taxable. Obviously, reference is made by [Inland Revenue Authority of Country D] to the capacity as a shareholder of foreign shares, rather than an employee under the [Country D] employment that must be [Country D-sourced].’
  - (d) ‘[Company B] sought clarifications in 2010 with [the Department] on the timing of taxation of the [Company B] shares offered under the STI Plan for the purpose of Employer’s Return. [Company B] employees, including the Appellant, were not parties involved in such clarifications, were not informed by [the Department] of any decision or agreement, and did not express any opinion (agreement or disagreement) on such decision or agreement.’
- (16) On 13 January 2014, Company B filed a revised employer’s return for the year of assessment 2012/13 in respect of the Appellant to amend the amounts of dividends and total income as follows:

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(a) Dividends

| <u>Year of assessment</u> | <u>Dividend pay-out date</u> | <u>No. of unvested deferral shares</u> | <u>Dividend rate</u><br>Country F Dollars | <u>Amount of dividend</u><br>HKD |
|---------------------------|------------------------------|--|---|----------------------------------|
| 2012/13                   | 16-07-2012                   | 612                                    | 0.90                                      | 4,318 <sup>[1]</sup>             |
|                           | 18-12-2012                   | 520                                    | 0.90                                      | <u>3,717</u> <sup>[2]</sup>      |
|                           |                              |  |   | <u>8,035</u>                     |

<sup>[1]</sup> (612 shares x Country F dollars 0.90) at 7.8395 = HKD4,318

<sup>[2]</sup> (520 shares x Country F dollars 0.90) at 7.9444 = HKD3,717

(b) Total income

|                |                  |
|----------------|------------------|
|                | \$               |
| Salary         | 1,063,125        |
| Bonus          | 318,938          |
| Company shares | 120,590          |
| Dividends      | <u>8,035</u>     |
| Total          | <u>1,510,688</u> |

(17) Taking into account the revised employer's return, the 2012/13 Salaries Tax Assessment should be revised as follows:

|                                   |                  |
|-----------------------------------|------------------|
|                                   | \$               |
| Assessable Income                 | 1,510,688        |
| <u>Less: Charitable donations</u> | 100              |
| Outgoing and expenses             | <u>2,587</u>     |
| Net Assessable Income             | 1,508,001        |
| <u>Less: Basic allowance</u>      | 120,000          |
| Dependent parent allowance        | <u>38,000</u>    |
| Net Chargeable Income             | <u>1,350,001</u> |
| Tax Payable thereon               | <u>207,500</u>   |

**The issue**

2. The issue in the present appeal for the Board to decide is whether the Sums, being dividends paid on the STI Deferral Shares and received by the Appellant should be chargeable to salaries tax. The amounts of the Sums are as follows:

|         |                      |
|---------|----------------------|
| 2010/11 | \$3,713              |
| 2011/12 | \$8,954              |
| 2012/13 | \$8,035 (as amended) |

**The Law**

3. The following provisions of the Inland Revenue Ordinance ('the

Ordinance’) are relevant to the present appeal:

**Section 8(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...’*

**Section 9(1)**

*‘Income from any office or employment includes-*

(a) *any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance, whether derived from the employer or others...’*

**Section 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.’*

**Section 11D**

*‘For the purpose of section 11B-*

...

(b) *income accrues to a person when he becomes entitled to claim payment thereof...’*

**Section 68(4)**

*‘The onus of proving that the assessment appealed against is excessive or incorrect shall be on the appellant.’*

**Grounds of Appeal**

4. At the hearing, the Appellant put forward his arguments based on the Grounds of Appeal which he had previously filed with the Board. These arguments are substantially the same as those he raised to the Assessor as mentioned in paragraph 1(14) above. In short, the Appellant claimed that the Sums should not be chargeable to salaries tax for the following reasons:

(i) The Sums were dividends received by him as the beneficial owner

of the STI Deferral Shares which gave him the voting right at shareholder meetings and the right to receive dividends.

- (ii) The Sums were income from investment and not income from employment. It mattered not whether there were forfeiture conditions attached to those shares. Nor was there any change to the nature of the dividends before or after the Milestone Date. The dividends had all along remained as investment income.
- (iii) The Appellant's employment was not the real or effective cause of the payment of the Sums to him, but only an incidental factor concerning the payment. The Sums were not paid to him as rewards for his services. The Appellant relied on Hochstrasser v Mayes [1960] AC 376 and Shilton v Wilmshurst [1991] 1 AC 684.
- (iv) The Sums were not remuneration or reward or return for his services; hence they were not income from employment under section 9(1)(a) of the Ordinance and not income assessable under section 8(1) of the Ordinance.

### **Deferral Shares**

5. It is common that a company would include in its employee's remuneration package an offer of its shares instead of or in addition to bonus or other benefits as a means to recruit, retain and motivate employees. This type of employee stock incentive schemes takes many shapes and forms including setting up an employee trust just like the one set up by Company B in this case.

6. In this appeal, the Appellant is not disputing the taxability of the STI Deferral Shares. It is not disputed that once the shares have been fully vested in the Appellant i.e. upon the Milestone Date, they would be deemed to have been received by the Appellant and become chargeable to tax. This is the 'Back End' Approach referred to in paragraph 1(12)(c)(ii) above by the Respondent.

7. The question is whether the dividends paid on those shares i.e. the Sums should be chargeable to tax during the period between the Allocation Date and the Milestone Date.

8. According to the Appellant, the Sums, being dividends on shares, are income from investment, and are not chargeable to tax. He argues that as soon as the shares are allocated to him, he is the beneficial owner of the shares and his position is no different from any ordinary shareholders of Company B. He relies on the following grounds:

- (i) In Company B's Employee Trust Dividend Statement, it is stated that 'Shares are held on your behalf in the name of Company H';

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- (ii) The Appellant is entitled to attend the Annual General Meeting of Company B;
- (iii) The Appellant may instruct the trustee in writing how to vote on his behalf;
- (iv) The Appellant is entitled to receive cash dividends and bonus shares, and to participate in rights issues.

9. The Appellant contends that it is wrong for the Respondent to rely on the 'Back End' Approach to hold that he was not fully entitled to the ownership of the shares until after the Milestone Date. It is an arbitrary date adopted by the Respondent.

10. The Appellant further argues that the trust for the STI Deferral Shares is set up in such a way that it should be more appropriate to be subject to the 'Upfront' approach. Presumably, that would have put the ownership of the shares after the Allocation Date beyond argument and the Sums would be income on investment after that date.

11. In any event, the Appellant does not find the Respondent's reliance on the Back End Approach argument particularly relevant to this case. The Upfront or Back End approaches only deal with the timing of assessment of the tax on the vesting of the STI Deferral Shares. They are not relevant to the taxability of the Sums.

12. It is the Appellant's case that the reasoning given by the Respondent in its Determination amounted to holding that as long as the dividends came from the company, they were income of the Appellant's employment by the company. The Appellant referred to the case Hochstrasser v Mayes [1960] AC 376 and Lord Cohen's words '*... it is not enough for the Crown to establish that the employee would not have received the sum on which tax is claimed had he not been an employee. The Court must be satisfied that the service agreement was the causa causans and not merely the causa sine qua non of the receipt of the profit*'. The Appellant also referred to the case, Shilton v Wilmshurst [1991] 1 AC 684, in which Lord Templeman stated '*The authorities are consistent with this analysis and are concerned to distinguish in each case between an emolument which is derived "from being or becoming an employee" on the one hand, and an emolument which is attributable to something else on the other hand, for example, to a desire on the part of the provider of the emolument to relieve distress or to provide assistance to a home buyer. If an emolument is not paid as a reward for past services or as an inducement to enter into employment and provide future services but is paid for some other reasons, then the emolument is not received "from the employment"*'.

13. Regarding the conditions upon which the shares were allocated i.e. the Restriction Period and the Forfeiture Condition as mentioned in paragraphs 1(3)(d), (e) and (f), the Appellant contends that they do not affect his beneficial ownership. It is not uncommon that restrictions on sales of shares or 'lock-up' periods are imposed upon a shareholder under certain shareholders agreements or even the listing rules.

14. As mentioned in paragraph 1(3)(k) above, the Share Offer Guides contained a tax summary to the effect that Company B had sought clarifications with the Respondent in March 2008. There was an understanding that the taxing point of the STI Deferral Shares would be the year of assessment of the 'Milestone Date' when the shares were vested. In the Guides, it was also mentioned that 'Dividends paid on the Company B shares held in trust on the participant's behalf before the Milestone Date would be regarded as employment income and subject to Salaries Tax in the year of receipt. Dividends paid after the Milestone Date would be non-taxable'.

15. The Appellant argues that he is not a party to nor had he been informed of the predetermination of the tax treatments of dividends between Company B and the Respondent. In fact, Company B had always been aware of the objection raised by the Appellant regarding the tax treatment of his dividend income. Further, the Appellant contends that the tax summary stated in the Share Offer Guides does not form part of the trust deed. It is also clearly stated in the Guides that the tax summary does not constitute a tax advice.

### **Finding**

16. The Board finds the ruling in the English Court of Appeal case PA Holdings Ltd v Revenue and Customs Commissioners [2012] STC 582 particularly helpful in this appeal. In that case, it was stated that 'The correct approach is to consider all the facts relevant to the receipt of the income. This requires the court not to be restricted to the legal form of the source of the payment but to focus on the character of the receipt in the hands of the recipient'. It is trite law that substance prevails over form.

17. The Board finds it reasonable and proper for the Respondent to adopt the Back End Approach in the tax assessment of the STI Deferral Shares which formed the basis of deciding the nature of the Sums. That approach decides the timing of the full vesting of the shares in the Appellant. Once the shares have been fully vested in the Appellant, the matter will be put beyond doubt i.e. any dividends paid on the tax after vesting should be income from investment. But until then, the question whether the Sums are taxable still requires further examination.

18. In any employee share trust, vesting is the process by which an employee accrues non-forfeitable rights over an employer-provided share incentive scheme. The vesting schedule which is set up by the company determines when the employee acquires full ownership of the shares. The Board finds that the STI Deferral Shares and the trust deed are no different from this common model.

19. A vested interest means the right, interest or title to some present or future possession of a legal estate which can be transferred to any other party. A vested right is an absolute right that has been accrued and cannot be taken away.

20. It is true that certain rights were attached to the STI Deferral Shares; such as the right to receive notices of the general meetings, to instruct the trustee how to vote

and to receive cash dividends, bonus shares or Rights issues. However, the shares could still not be considered to have fully vested in the Appellant until the Milestone Date. As stated in the Shares Offer Guides, the Milestone Date was ‘the earliest date that participant could apply to access the shares’ (see paragraph 1(3)(b)(ii) above). Hence, only until the Milestone Date could the Appellant sell, transfer or in any way deal with the shares. It is correct that under certain circumstances, shareholders’ right in dealing with their shares can be subject to restrictions like a lock-up period. However, the shareholdings of any ‘ordinary shareholder’ cannot be subject to forfeiture by the company which issued them as in this case. The Board finds that vesting time is a more crucial factor than voting right or entitlement to dividends in this case.

21. It should be noted that the conditions upon which Company B can exercise its power to forfeit the shares are not particularly strenuous or difficult to meet. Apart from the resignation of the Appellant, termination of his employment or his failing the compliance gateway, the Board of Company B may in its absolute discretion (emphasis added) determine that all or some of the Appellant’s shares will be forfeited (see paragraph 1(3)(f) above).

22. It is therefore obvious that the Appellant did not have a vested interest in the STI Deferral Shares until after the Milestone Date. The missing link between the position of any Company B ‘ordinary shareholders’ and that of the Appellant is the existence of the forfeiture condition under the scheme. It follows that the Sums cannot be income from the Appellant’s investment between the Allocation Date and the Milestone Date. The STI Deferral Shares in question had not become the Appellant’s investment during that period of time.

23. The question is then ‘what is the nature of the Sums?’

24. In the PA Holdings Ltd case, the employer arranged to establish a company and contributed funds for the purpose of making payment of benefits to employees as their awards. Restricted preference shares were granted to selected employees of PA Holdings Ltd. Dividends on the shares were then declared and paid to the employees. It was held that the dividends paid should be taxable as earnings and subject to income tax.

25. Although the Appellant purported to distinguish his case from the PA Holdings Ltd case, the Board has found the facts in both cases to be very similar. The Sums in this appeal are no different from the dividends in that case. In the context of deciding the nature of the Sums, there is not a great deal of difference between preferred stock dividends and common stock dividends.

26. Judging from the contents of the Trust Deed and the STI Deferral Share Offer Guides, the whole scheme was devised for the purpose of ‘assisting in the retention and motivation of employees of [Company B]’. Prominent and repeated references to participants’ entitlements to cash dividends paid on the STI Deferral Shares were made in both documents. Very obviously cash dividends were part of the major incentives.



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27. As mentioned in paragraph 1(2) above, the Appellant was eligible to participate in the STI Plan which might be provided in cash or in STI Deferral Shares. The Appellant was given a choice to opt in or opt out of the STI Deferral Share offer. Although there is no evidence of whether cash would be offered if any employee of Company B chose to opt out of the scheme, it is clear that cash and shares including dividends on shares were alternate forms of rewards to any employee. Hence, the Board finds that the Sums had the character of a perquisite akin to an extra bonus to the Appellant. The exact amount of that extra perquisite happened to be tied in with the amount of dividends paid on the shares. As already mentioned above, substance is more important than form. The true nature of the Sums is not income arising from investment but is earnings as found in the PA Holdings Ltd case.

28. Another way to look at the STI Plan and the trust for the STI Deferral Share is that if the Sums were not taxable, that would lead to some absurd results. Company B could allocate a large number of shares to an employee so that he might receive substantial cash dividends. Just before the Milestone Date, the company might forfeit most, if not all, of the shares, as it was entitled to under the terms of the trust. The employee could then avoid a lot of salaries tax. This surely cannot be correct.

29. Lastly, the Board finds it disingenuous for the Appellant to argue that he was not bound by the Share Offer Guides and that Company B had not informed him of any decision or agreement of the tax treatment of dividends on the STI Deferral Shares made between Company B and the Respondent.

30. The fact that the Sums would be treated as income and subject to tax is clearly stated in the Share Offer Guides for all three relevant years. Besides offering the choice to opt in or opt out of the offer, the Guides also state that 'Prior to making decisions about the offer, you should read this offer guide, including the **Shares and Tax** (emphasis in the original text) section to consider the financial and tax implications of being allocated the shares'. It is therefore hard to accept that the Appellant having opted to accept the STI Deferral Shares was unaware of and had disagreed to the tax consequences. There is also no evidence to support the Appellant's allegation that he had protested to Company B over its reporting of the Sums in the Employer's Return.

### **Conclusion**

31. In view of the above analysis, the Board finds that the Appellant has failed to discharge his onus of proof under section 68(4) of the Ordinance and that the Sums are correctly concluded as the Appellant's assessable income for the years of assessment 2010/11 to 2012/13.

32. This appeal is dismissed.