

Case No. D2/19

Salaries tax – share incentive plan – appellant employed by two different companies – first employment outside Hong Kong – both companies under the same group – shares awarded under first employment held by nominee until end of retention period – whether value of shares and dividends chargeable to salaries tax in Hong Kong – whether share benefits included in calculation of value of residence provided by employer – sections 8(1), 9, 11B, 11C, 11D, 68(4) of the Inland Revenue Ordinance (‘IRO’)

Panel: Lo Pui Yin (chairman), Clark Douglas Stephen and Richard Zimmern.

Date of hearing: 11 December 2018.

Date of decision: 3 May 2019.

The appellant had been an employee of Group C (‘Group’) since 1988. From 1988 to 2001, the appellant was employed by a Group’s company in Country P. From 2002 to 2005, the appellant was employed by Bank G (‘Bank G’), also being a Group’s company, in Country B. Since 2005, the appellant had been employed by Bank G to oversee the Group’s banking operations in Asia. During his employment with the Group, a share incentive plan (‘Plan’) was operated whereby forfeitable shares and conditional awards might be made to employees of the Group. The Plan was governed by a set of rules (‘Rules’) set out in a document.

Between 2012 and 2014, the appellant was awarded forfeitable shares under Special Shares R1 Award (‘R1 Shares’) for his good financial performance while employed by Bank G in Country B. The R1 Shares awarded were held by Company L (‘Nominee’) on behalf of the appellant for his sole and absolute benefit until the end of the retention period. The Plan provided, *inter alia*, that if the appellant ceased to be an employee before the release dates of the R1 Shares, he would immediately forfeit the relevant R1 Shares and would have no entitlement thereunder. Upon release, the R1 Shares ceased to be forfeitable but the appellant was not able to transfer or dispose of the R1 Shares until the end of the retention periods.

Between 2012 and 2013, the appellant was granted conditional award of shares (‘R2 Shares’) as an incentive to foster good future performance and to retain him. The R2 Shares would vest in the appellant, provided, *inter alia*, that he remained employed by the Group. The R2 Shares would continue to be held by the issuing company for the appellant until the end of the retention period. Until the vesting dates, the appellant could not transfer or dispose of the R2 Shares and was not entitled to receive dividends or to exercise voting rights.

On 30 June 2014, the appellant’s employment with Bank G was terminated. On 1 July 2014, his employment with Company M (‘Company M’) commenced.

Company M was also a Group's company, though carrying on business in Hong Kong instead of Country B. Under the employment contract, the appellant's remuneration included benefits from a discretionary bonus scheme based upon the R1 Shares model.

For the tax years of 2015/16 and 2016/17, the appellant filed tax returns and declared employment income with Company M (including share option gain). The Assessor took the view that the share benefits should be taken into account for computing salaries tax and the value of residence provided. The appellant objected to the proposal. The Deputy Commissioner rejected the appellant's objections ('Determination'). The appellant appealed against the Determination, contending that: (1) the R1 Shares were not perquisites accrued to the appellant in the said years of assessment, and not part of his income arising in or derived from his Hong Kong employment ('Ground 1'); and (2) all gains from R1 Shares ought to be excluded from the 'income' for the purpose of calculating rental value under section 9(2) of IRO ('Ground 2'). The appellant accepted the chargeability to salaries tax of the portion of the share benefits attributed to the R2 Shares. The focus of the appeal was on the R1 Shares awards.

Held:

Ground 1

1. The R1 Shares were held by the Nominee on the terms of the Plan and subject to the Rules until the end of the retention period. It was only on the release date that the R1 Shares ceased to be subject to forfeiture, and only at the end of the retention period that the tranche was free of any restrictions under the Plan.
2. Those tranches which ceased to be subject to forfeiture in the tax years of 2015/16 and 2016/17 necessarily became so due to the appellant's continuing employment with the Group in Hong Kong; those R1 Shares became truly the appellant's as a result of his continuing employment in Hong Kong with a member of the Group. In the relevant retention period, there were some restrictions on disposal and transfer. The Board therefore rejected the appellant's submission that he was vested with, became entitled to, or otherwise received the value of the R1 Shares before he began his employment in Hong Kong. While the R1 Shares were awarded by deed, it was expressed on the award certificates that the appellant had a right to enforce against the grantor for the R1 Shares, such right must be considered on the terms of the Rules, award letters and certificates.
3. Section 11D of IRO was not relevant to the issues involved, given that the proviso to section 11D(a) did not apply outside the context of section 11D(a) itself, which concerned income accrued to a person during the basis period but which had not been received by him in such basis period. Also, none of the provisos to section 11D(b) applied in the appeal. Finally, since the time at which the shares were no longer subject to

forfeiture was the release date, the time that he became entitled to the value of a tranche of the R1 Shares was the release date and this was the time when the value of that tranche accrued to him as income for the purpose of section 11B.

4. Regarding dividends, they were paid to the appellant during the basis period. The appellant was entitled to be paid the dividends not only because of the relevant award of the R1 Shares but also because the R1 Shares was not forfeited or reduced during the basis period and one of the reasons that was so was that he was in continuing employment in Hong Kong with a member of the Group. The values of the R1 Shares and the dividends were income from the appellant's employment in the nature of perquisites.

Ground 2

5. The values of the R1 Shares and the dividends for each financial year were income from the appellant's employment in Hong Kong in the nature of perquisite. The appellant accepted that the values of the R2 Shares were also income from the appellant's employment in Hong Kong in the nature of perquisite. It followed that the share benefits for the relevant financial years were income of the appellant arising in or derived from Hong Kong from his employment and chargeable to salaries tax.

Appeal dismissed.

Mike Lui, Counsel, instructed by Reed Smith Richards Butler, for the Appellant.

John Brewer, Counsel, instructed by the Department of Justice, for the Commissioner of Inland Revenue.

Decision:

Introduction

1. This Appeal was lodged by the Appellant/Taxpayer, Mr A, against the Determination of the Deputy Commissioner of Inland Revenue dated 9 July 2018 rejecting the Taxpayer's objections to the Salaries Tax Assessment for the years of assessment 2015/16 and 2016/17 raised by the Assessor of the Revenue and confirming the Assessor's assessment for the year of assessment 2015/16 and revised assessment for the year of assessment 2016/17 ('the Determination').

2. The Taxpayer's Notice of Appeal, which he lodged with the Clerk to the Board of Review in person, refers to the objections he had raised before the Commissioner for Inland Revenue. The Taxpayer contends in the Notice of Appeal that the two

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

assessments were incorrect in including as chargeable to Salaries Tax the value of a category of shares known as Special Shares R1 awarded to him under a share incentive scheme and dividends on those Special Shares R1. The Taxpayer says that the Special Shares R1 awarded were a form of bonus awarded for performance ‘by a previous employer for actual work done in [Country B] and financial performance achieved in [Country B]’. The Taxpayer particularly contends that the Deputy Commissioner erred in relying on the rules governing the award of the Special Shares R1 in coming to the conclusion that the Special Shares R1 released in the years of assessment resulted directly from his employment in Hong Kong. The Taxpayer also relied on a letter of his employer to the Revenue confirming that the Special Shares R1 awards ‘were made in prior years by [his] [Country B] employer for financial performance in [Country B] operations and listed business unit financial performance against bonus awards by year’. The Taxpayer therefore contends that the value of Special Shares R1 should not form part of Salaries Tax for the calculation of the value of residence provided and that in any event, that does not meet the definition of a perquisite under the Inland Revenue Ordinance (Chapter 112). As a result, the dividends earned from Special Shares R1 should also not be subject to taxation in Hong Kong.

3. This Board held the hearing of this Appeal on 11 December 2018. Both the Taxpayer and the Revenue were legally represented.

4. The Taxpayer’s legal representatives reformulated the Taxpayer’s grounds of appeal. At the hearing of this Appeal, having heard from Mr Lui, counsel for the Taxpayer, and from Mr Brewer, counsel for the Revenue, this Board consented to the reformulated grounds standing as an amendment to the Taxpayer’s Notice of Appeal. The reformulated grounds are:

- (1) On proper application of sections 11B and 11D of the Inland Revenue Ordinance, the Special Shares R1 are not perquisites accrued to the Taxpayer in the relevant years of assessment, and not part of his income arising in or derived from his Hong Kong employment pursuant to section 8(1) of the Ordinance. All gains derived from the Special Shares R1 (including the dividends declared on them) are therefore not taxable.
 - (a) The Special Shares R1 were awarded to the Taxpayer by his employer in Country B for his actual work done in Country B before July 2014. They had accrued to the Taxpayer before his Hong Kong employment started in July 2014.
 - (b) Upon receiving the awards and prior to release of the Special Shares R1, the Taxpayer had become entitled to the exercise of core rights, and receipt of pecuniary benefits, arising from the ownership of the Special Shares R1.
 - (c) Assessing the facts in their totality, it is immaterial and/or irrelevant that there were narrow restrictions imposed on

transfer, assignment or otherwise disposal of the Special Shares R1 or limited conditions to be fulfilled before release. For the purpose of sections 11B and 11D, accrual does not mean the Taxpayer's entitlement to the Special Shares R1 must be free of any restriction. Any contention otherwise is contrary to the authorities.

- (2) All gains derived from the Special Shares R1 ought to be excluded from the 'income' for the purpose of calculating rental value under section 9(2) of the Ordinance. If the Taxpayer prevails on (1), it follows that all gains derived from the Special Shares R1 were not income 'as described in' section 9(1)(a).

5. The Taxpayer testified on oath before this Board and was cross-examined by the Revenue.

6. This Board has heard submissions from counsel of the Taxpayer, Mr Lui, and counsel of the Revenue, Mr Brewer. The principal points in Mr Lui's submissions are stated in the three particulars following Ground (1), reproduced in paragraph 4 above.

7. In the sections of this Decision that follow, this Board shall set out the agreed facts and make reference to the undisputed documents. Then this Board shall have regard to the Determination. Thereafter, this Board shall consider the Taxpayer's evidence and make findings of fact. Lastly, the submissions of the Taxpayer and the Revenue shall be considered in the light of the facts and evidence before this Board.

The Agreed Facts and Undisputed Documents

8. The Taxpayer and Revenue have reached agreement on certain matters of fact and submitted a set of Agreed Facts to this Board. This Board finds these Agreed Facts as facts.

9. The Agreed Facts are:

- (1) Group C is an international banking and asset management group. The Taxpayer has been an employee of the Group since 1988.
- (2) In 2002, the Taxpayer was relocated from the office of the Group in City D to City E, serving in the positions of international and divisional heads. From 2002 to 2005, he was a Position F of Bank G in Country B. Since 2005, he had been responsible for overseeing the growth of the Group's specialist banking operations in Asia. On 30 June 2014, his employment with Bank G was terminated and on 1 July 2014 his employment with Company H commenced.
- (3) Company J, one of the companies within the Group, operated a share incentive plan ('Plan') whereby awards of forfeitable shares

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

and conditional awards might be made to employees of group companies as approved by the remuneration committee. The rules of the Plan are set out in a document entitled ‘Company J – Share Incentive Plan’ (version dated 2 June 2010).

- (4) By a letter of 13 June 2012, the Group confirmed the Taxpayer was awarded under Special Shares R1 Award, forfeitable shares in Company K listed on the City E Stock Exchange, at nil cost under the Plan:

<u>Award date</u>	No. of shares <u>awarded</u>	<u>Tranche</u>	No. of shares <u>released</u>	Release <u>date</u>	<u>Retention period</u>	Proportion subject to <u>clawback</u>
29-05-2012	151,977	1st	60,791	29-05-2012	29-05-2012 - 29-11-2012	Nil
		2nd	30,395	29-05-2013	29-05-2013 - 29-11-2013	100%
		3rd	30,395	29-05-2014	29-05-2014 - 29-11-2014	100%
		4th	30,396	29-05-2015	29-05-2015 - 29-11-2015	100%

- (5) By a letter of 6 June 2013, the Group confirmed that the Taxpayer was awarded similar forfeitable shares in Company K at nil cost under the Plan as follows:

<u>Award date</u>	No. of shares <u>awarded</u>	<u>Tranche</u>	No. of shares <u>released</u>	Release <u>date</u>	<u>Retention period</u>	Proportion subject to <u>clawback</u>
04-06-2013	326,798	1st	160,043	04-06-2013	04-06-2013 - 04-12-2013	Nil
		2nd	55,585	04-06-2014	04-06-2014 - 04-12-2014	100%
		3rd	55,585	04-06-2015	04-06-2015 - 04-12-2015	100%
		4th	55,585	04-06-2016	04-06-2016 - 04-12-2016	100%

- (6) By a letter of 28 May 2014, the Group confirmed that the Taxpayer was awarded similar forfeitable shares in Company K at nil cost under the Plan as follows:

<u>Award date</u>	No. of shares <u>awarded</u>	<u>Tranche</u>	No. of shares <u>released</u>	Release <u>date</u>	<u>Retention period</u>	Proportion subject to <u>clawback</u>
27-05-2014	446,016	1st	135,380	27-05-2014	27-05-2014 - 27-11-2014	Nil
		2nd	103,544	27-05-2015	27-05-2015 - 27-11-2015	100%
		3rd	103,544	27-05-2016	27-05-2016 - 27-11-2016	100%
		4th	103,544	27-05-2017	27-05-2017 - 27-11-2017	100%

- (7) The shares awarded under the Special Shares R1 Awards described in (4) to (6) above (‘Special Shares R1’) were transferred to, and held by, Company L (‘Nominee’) on behalf of the Taxpayer for his sole and absolute benefit until the end of the relevant retention period. Each of the award letters referred to in (4) to (6) and the award certificates for the Special Shares R1 specified the Nominee.

- (8) Ever since the award dates, the Taxpayer had all the rights of a shareholder in respect of the Special Shares R1 subject only to the

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

provisions of the Plan. In particular, he had the right to demand payment of all dividends declared on, and the right to vote and direct the Nominee how to vote, the Special Shares R1 (Rule 4.1 of the Plan).

- (9) The Special Shares R1 Awards had to be granted by deed, and the award certificates could be such deeds (Rules 2.4 and 2.8 of the Plan). The award certificates for the Special Shares R1 were specified to be such deeds.
- (10) Bank G as the grantor had the contractual obligation to procure that with effect from the award dates, the Special Shares R1 were transferred to the Taxpayer, or to another person to be held for the Taxpayer's absolute benefit, on the terms of the Plan (Rule 2.11.1 of the Plan). The Special Shares R1 were transferred to the Nominee.
- (11) The Plan contains specific provisions on how the rights of the Taxpayer *qua* shareholder would be varied in case of variations in the share capital of Company K and of takeover or merger (Rules 4.3 and 4.4 of the Plan).
- (12) The Plan provides that before the dates of release, the Taxpayer may not transfer, assign or otherwise dispose of the Special Shares R1 or any rights in respect of them except upon his death, or with permission of the Committee (which is defined in Rule 1.1 of the Plan) (Rule 4.2 of the Plan).
- (13) The Plan provides that if the Taxpayer ceases to be an employee (which is defined in Rule 5.4 of the Plan) for any reason before the release dates of the Special Shares R1, he will immediately forfeit the relevant Special Shares R1 and will have no entitlement under the Plan except in case of disability or death, or the Committee deciding otherwise (Rules 5.1 to 5.3 of the Plan).
- (14) Upon their release, the Special Shares R1 ceased to be subject to forfeiture but the Taxpayer was not able to transfer or dispose of the Special Shares R1 until the end of the retention periods.
- (15) The Special Shares R1 Awards were subject to clawback or performance adjustment which permitted Bank G to reduce awards before release dates in specified circumstances (Appendix 2 to each award letter).
- (16) By a letter of 21 June 2012, the Taxpayer was granted conditional award, under the June 2012 Conditional Award, of shares in Company K at nil cost under the Plan:

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

<u>Award date</u>	No. of shares <u>awarded</u>	<u>Tranche</u>	<u>Performance period</u>	<u>Vesting date</u>	<u>Retention period</u>
29-05-2012	300,000	1st: 75%	01-04-2012 - 31-03-2015	29-11-2015	29-11-2015 - 29-05-2016
		2nd: 25%	01-04-2015 - 31-03-2016	29-11-2016	29-11-2016 - 29-05-2017

- (17) By a letter of 19 June 2013, the Taxpayer was granted conditional award, under the June 2013 Conditional Award, of shares in Company K at nil cost under the Plan:

<u>Award date</u>	No. of shares <u>awarded</u>	<u>Tranche</u>	<u>Performance period</u>	<u>Vesting date</u>	<u>Retention period</u>
04-06-2013	125,000	1st: 75%	01-04-2013 - 31-03-2016	04-12-2016	04-12-2016 - 04-06-2017
		2nd: 25%	01-04-2016 - 31-03-2017	04-12-2017	04-12-2017 - 04-06-2018

- (18) The shares awarded under the Conditional Awards described in (16) and (17) above ('Special Shares R2') would vest in the Taxpayer provided that he remained in the employment with the Group and to the extent that certain performance conditions were satisfied (Rules 5.1 to 5.3 of the Plan and Appendix 1 to each award letter).
- (19) The Special Shares R2 were subject to clawback which permitted Bank G to reduce the number of the Special Shares R2 before their vesting dates in specified circumstances (Appendix 2 to each award letter).
- (20) The Special Shares R2 to which the Taxpayer became entitled on vesting dates would continue to be held by Company J or its agent for the benefit of the Taxpayer until the end of the relevant retention periods (Appendix 3 to each award letter).
- (21) In respect of each vesting date, there were 30 days allowed for the transfer of the Special Shares R2 to the Taxpayer; and the Committee could decide to pay an equivalent amount in cash to the Taxpayer equal to the market value at the vesting date of the Special Shares R2, instead of transferring the Special Shares R2 to him (Rules 6 and 7 of Schedule 3 to the Plan).
- (22) Until the vesting dates, the Taxpayer could not transfer or dispose of the Special Shares R2, and was not entitled to receive dividends or to exercise voting rights attached to them (Rules 4.1 and 4.2 of Schedule 3 to the Plan).
- (23) By a contract of employment dated 14 June 2014 ('the Employment Contract'), Company M, a company of the Group incorporated and carrying on business in Hong Kong, employed the Taxpayer as Position Q with effect from 1 July 2014.

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

(24) The Employment Contract stated (*inter alia*) that the Taxpayer's remuneration included benefits from a discretionary bonus scheme based upon the Special Shares R1 model, and the Group operated a staff share incentive plan and its employees would receive allocations of shares in Company K from time to time on a discretionary basis. The Assessor of the Revenue considered that the Taxpayer's employment with Company M was located in Hong Kong, and had assessed his income received from Company M for the period ended 31 March 2015, which was not disputed by the Taxpayer.

(25) (a) Company M filed employer's returns of remuneration and pensions for the years of assessment 2015/16 and 2016/17 in respect of the Taxpayer reporting, among others, the following particulars:

	<u>2015/16</u>	<u>2016/17</u>
Capacity in which employed	:	Position Q
Period of employment	:	01-04-2015 - 31-03-2016 01-04-2016 - 31-03-2017
Particulars of income	:	
	\$	\$
Salary	12,990,080	13,744,069
Gain realized under share option scheme	<u>29,118,989</u>	<u>17,674,271</u>
Total	<u>42,109,069</u>	<u>31,418,367</u>
		(The correct amount should be \$31,418,340)
Particulars of place of residence provided:		
Nature of the place of residence	House	House
Period provided	01-04-2015 - 31-03-2016	01-04-2016 - 31-03-2017
Rent paid to landlord by Mr A	\$5,500,000	\$4,760,000
Rent refunded to Mr A	\$5,500,000	\$4,760,000

(b) The 'gains realized under share option scheme' reported were actually composed of: (i) values of those Special Shares R1 and Special Shares R2 released to the Taxpayer during the years, which were computed by basing on the market prices of them on the vesting dates; and (ii) amounts of dividends paid during the years in respect of the Special Shares R1 granted but not released to the Taxpayer. They were as follows:

	<u>2015/16</u>	<u>2016/17</u>
	\$	\$
Value of shares vested on vesting dates	28,465,048	17,454,737
Dividends derived from Special Shares R1 Awards before vesting dates	<u>653,941</u>	<u>219,534</u>
	<u>29,118,989</u>	<u>17,674,271</u>

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (c) Company M computed the taxable share values attributable to the period of the Taxpayer's employment in Hong Kong by reference to the number of days of his employment in Hong Kong during the vesting period. The attributable amounts were as follows:

	<u>2015/16</u>	<u>2016/17</u>
	\$	\$
Value of shares attributable to the period of employment in Hong Kong –		
Special Shares R1 ('Values of Special Shares R1')	9,159,708	7,197,852
Special Shares R2 ('Values of Special Shares R2')	6,103,570	5,590,472
Dividends	<u>653,941</u>	<u>219,534</u>
Total ('Share Benefits')	<u>15,917,219</u>	<u>13,007,858</u>

- (26) On divers dates, the Taxpayer filed his Tax Returns – Individuals for the years of assessment 2015/16 and 2016/17 and declared the following employment income:

	<u>2015/16</u>	<u>2016/17</u>
	\$	\$
Income from Company M	<u>28,907,299</u>	<u>26,532,393</u>
Comprising –		
Salary	12,990,080	13,744,069
'Share option gain'	15,917,219	12,788,324
Place of residence provided – rent paid and refunded	5,500,000	4,760,000

- (27) The Assessor of the Revenue, based on the information provided by Company M, raised on the Taxpayer the following Salaries Tax Assessment for the year of assessment 2015/16:

Income	\$ 42,108,069
Value of residence provided (Salary of \$12,990,080) x 10%	<u>1,299,008</u>
	43,408,077
<u>Less: Retirement scheme contributions</u>	<u>6,000</u>
Net Income	<u>43,402,077</u>
Tax Payable thereon at standard rate (after tax reduction)	<u>6,490,311</u>

- (28) The Taxpayer objected to the assessment on the grounds that: it was excessive; only the Share Benefits for the year should be taxed in Hong Kong; and the other portion had been reported to Country B tax authority and should not be taxed in Hong Kong.

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (29) The Assessor of the Revenue accepted the amount computed by Company M was taxable but took the view that the Share Benefits should be taken into account for computing the value of residence provided. He proposed to the Taxpayer that the assessment for the year of assessment 2015/16 should be revised as follows:

	\$
Income –	
Salary	12,990,080
Share Benefits	<u>15,917,219</u>
	28,907,299
Value of residence provided	<u>2,890,729</u>
	31,798,028
<u>Less: Retirement scheme contributions</u>	<u>6,000</u>
Net Income	<u>31,792,028</u>
Tax Payable thereon at standard rate (after tax reduction)	<u>4,748,804</u>

- (30) The Taxpayer refused to accept the Assessor's proposal. He considered that the Share Benefits should not be included in the calculation of the value of residence provided in accordance with section 9(2) of the Inland Revenue Ordinance for the following reasons:

- (a) The Share Benefits did not constitute income from employment which was defined in section 9(1)(a) of the Ordinance. They were taxable by virtue of the double-taxation agreement between Hong Kong and Country B ('the DTA'). In the absence of the DTA, they should be fully taxable in Country B and none in Hong Kong.
- (b) The shares were issued to the Taxpayer either as part of a long term share incentive plan or as bonus for work conducted in Country B. They were not related to services rendered by him in Hong Kong for Salaries Tax purpose.
- (c) A dictionary definition of perquisite was 'an incidental payment, benefit, privilege, or advantage over and above regular income, salary or wages'. As the shares were granted to him as bonuses, which constituted his regular income, they were not perquisites as included in section 9(1)(a) of the Ordinance.
- (d) Even if the Share Benefits were considered perquisites, they were not perquisites for the purposes of section 9(1)(a) of the Ordinance because they were not income from his employer in Hong Kong.

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (31) In response to the Assessor's enquiries, Company M stated the following:
- (a) The Special Shares R1 Awards for the years 2012 to 2014 were granted to the Taxpayer for the good financial performance of the business unit in the respective financial years for which the Taxpayer was responsible while he was in the employment of Bank G in Country B.
 - (b) The Taxpayer was granted the Special Shares R2 as part of a regular series of such awards granted to him. He had been employed by the Group since February 1988 in various locations and various senior capacities. The management had considered the Taxpayer to be amongst a number of employees who should be incentivized to remain within the Group.
 - (c) Special Shares R2 Award was an incentive designed to foster good future performance by employees and to serve as a means to retain key staff, while Special Shares R1 Awards were bonuses for historical financial performance which implied that the financial performance exceeded a minimum expectation and as a result created value for the organization. The Special Shares R1 Awards were related to the Taxpayer's employment and services rendered in Country B.
 - (d) The Special Shares R1 Awards were paid out in one upfront payment and three deferred payments in accordance with the rules pertaining to the Group's bonus schemes. The arrangement was introduced as a direct requirement of the Financial Services Authority in Country B.
 - (e) The deferral of bonuses was intended to promote good long term behavior following the excesses of the global financial crisis in 2008. The requirement of being employed by the Group on the release dates, being a prudent measure, was a means to achieve this objective. The Taxpayer could be employed by other Group entities in other locations, not necessarily in Hong Kong, yet still satisfied the conditions of the deferred bonus awards scheme.
 - (f) The dividends were collected on behalf of the Taxpayer and paid to him according to the terms of the granting of the Special Shares R1 Awards.

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (32) The Assessor raised on the Taxpayer a Salaries Tax Assessment for the year of assessment 2016/17 as follows:

	\$
Income	31,418,367
Value of residence provided (Salary of \$13,744,069 x 10%)	<u>1,374,406</u>
	32,792,773
<u>Less: Retirement scheme contributions</u>	<u>6,000</u>
	<u>32,786,773</u>
Tax Payable thereon at standard rate (after tax reduction)	<u>4,898,015</u>

- (33) The Taxpayer objected to the assessment and claimed as follows:

- (a) Values of Special Shares R1 for both years should not be chargeable to Salaries Tax in Hong Kong as they were awarded for work performed for another employer prior to his employment in Hong Kong, and as a corollary, dividends for both years should also not be assessed to Salaries Tax.
- (b) The Share Benefits should not be included in the computation of the value of residence provided.

- (34) The Assessor then considered that the Salaries Tax Assessment for the year of assessment 2016/17 should be revised as follows:

	\$
Income –	
Salary	13,744,069
Share Benefits	<u>13,007,858</u>
	26,751,927
Value of residence provided	<u>2,675,192</u>
	29,427,119
<u>Less: Retirement scheme contributions</u>	<u>6,000</u>
Net Income	<u>29,421,119</u>
Tax Payable thereon at standard rate (after tax reduction)	<u>4,393,167</u>

10. For ease of reference in this Decision, the parties have referred to the following documents in their submissions, the contents of which are not disputed:

- (1) The rules of the Plan (or the document entitled ‘Company J – Share Incentive Plan’ (version dated 2 June 2010)).
- (2) The Special Shares R1 award letters of 13 June 2012, 6 June 2013 and 28 May 2014 respectively.

- (3) The Special Shares R2 award letters of 21 June 2012 and 19 June 2013.
- (4) The Employment Contract.

The Determination

11. The Deputy Commissioner considered that the issue he had to decide was whether values of the Special Shares R1 and their dividends should be chargeable to Salaries Tax; and whether the Share Benefits should be included in the calculation of the value of the residence provided by the employer under the deeming provision in section 9(2) of the Inland Revenue Ordinance.

12. The Deputy Commissioner considered that the values of the Special Shares R1 and the values of the Special Shares R2 (the part attributable to employment in Hong Kong) should be regarded as income derived from his employment with Company M in Hong Kong and fully chargeable to Salaries Tax under section 8(1)(a) of the Inland Revenue Ordinance. The Deputy Commissioner reasoned that since the shares previously granted to the Taxpayer were released under the Plan when he was employed by Company M in Hong Kong during the years of assessment 2015/16 and 2016/17, and the rules of the Plan and conditions of the grants required the Taxpayer to remain in the employment of the Group before the shares could be released to him, the release of the shares resulted directly from the Taxpayer's employment in Hong Kong. The Deputy Commissioner also referred to the Employment Contract governing the Taxpayer's employment in Hong Kong, which provided for the award of shares under the Plan as part of his remuneration.

13. The Deputy Commissioner considered that the values of Special Shares R1 and the values of Special Shares R2, attributable to the employment in Hong Kong, were perquisites derived by the Taxpayer from Company M and that they were income from employment as defined in section 9(1)(a) of the Inland Revenue Ordinance.

14. The Deputy Commissioner rejected the Taxpayer's objection. The Deputy Commissioner reasoned that the charge of income to Salaries Tax under section 8(1)(a) of the Inland Revenue Ordinance did not depend on whether services were rendered in Hong Kong or other places. According to Company M, the relevant Special Shares R1 were granted after considering the performance factor and for the promotion of 'good long term behavior'. The shares were not released to the Taxpayer unless he remained in the employment on the released date. Hence the Commissioner reasoned that the shares were released to the Taxpayer because of his employment in Hong Kong.

15. The Deputy Commissioner considered that dividends were perquisites derived from the Taxpayer's employment in Hong Kong and should be chargeable to Salaries Tax under sections 8(1)(a) and 9(1)(a) of the Inland Revenue Ordinance. The Deputy Commissioner reasoned that the dividends were paid out of the Special Shares R1 during the vesting period when the Taxpayer were under the employment with Company M in Hong Kong. Although the shares had not been released, the Taxpayer was paid the

dividends as employment benefits under the conditions of grants. The Taxpayer therefore received the dividends as his employment income and not as investment income.

16. The Deputy Commissioner finally considered that the Share Benefits should be included in the 10% computation of the rental value of the place of residence provided by the employer under the deeming provision of section 9(2) of the Inland Revenue Ordinance. The Deputy Commissioner reasoned that since the Share Benefits were chargeable for Salaries Tax under section 8(1)(a) of the Ordinance and were income from employment assessable to Salaries Tax under section 9(1)(a) of the Ordinance, they should be so included.

The Taxpayer's Testimony

17. The Taxpayer adopted his witness statement as part of his evidence in his Appeal and was cross-examined by Mr Brewer for the Revenue.

18. The Taxpayer stated that he had been an employee of the Group since 1988. He was an employee of Bank N in Country P from February 1988 to 2001 and served as a director from 1993 to 2001, and then employed by and served as Position F of Bank G in Country B until 30 June 2014. Both Bank N and Bank G are within the Group.

19. The Taxpayer has been working in Position Q of Company M based in Hong Kong from 1 July 2014.

20. The Taxpayer explained his understanding of Special Shares R1 and Special Shares R2. He stated that his Country B employer awarded two types of share awards to him under the Plan. The Special Shares R1 were known under the Plan as 'forfeitable shares' and were held in the name of and for the benefit of the recipient. Special Shares R1 awarded are a component of bonuses for actual financial performance and were generally granted to employees coming within the regulatory designation of 'material risk takers'. The Special Shares R2 were known under the Plan as 'conditional awards'; they involved a conditional right to acquired fully paid ordinary shares of Company K. They were issued as incentives for employees' prospective performance and conduct whilst remaining in the employment with the Group. Both the Special Shares R1 and the Special Shares R2 were subject to various restrictions before they were released to him.

21. The Taxpayer referred to the advices he received in relation to Country B tax liability around the time he ceased employment in Country B and commenced employment in Hong Kong. He stated that he eventually submitted his Country B tax returns for the years of assessment 2015/16 and 2016/17 based on time apportionment, and was assessed on that basis.

22. The Taxpayer referred to the filed Employer's Returns for the years of assessment 2015/16 and 2016/17, which declared all the gains made from the sales of the Special Shares R1 and the Special Shares R2 released to him as part of his income, claiming that the gains had been realized under 'share option scheme'. He stated that the

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

claims under the line of ‘share option scheme’ were wrong because he had never been granted any share option by Bank G or by Company M and explained that he followed certain guidance from the Employer’s Return in completing his own tax return and at that time, the matter was not scrutinized in detail.

23. The Taxpayer was asked to clarify the argument he raised when he first objected to the Assessor of the Revenue’s assessments. The Taxpayer stated that the assessments included the entire gain and his argument was that portion representing the number of days he spent in Country B under the employment of Bank G divided by the total number of days from the date of award to the date of release should not be included.

24. The Taxpayer was asked to clarify two schedules of computation of taxable share values attributable to the period of the Taxpayer’s employment in Hong Kong. According to the Taxpayer, these schedules showed the apportionment of gains with reference to the number of days he spent in Country B and the number of days he spent in Hong Kong in the periods from the dates of awards to the dates of release. The Taxpayer confirmed that the two schedules were prepared by Company M for Hong Kong tax filing. He added that the number of days attributable to the period of employment in Hong Kong reconciled with what was reported to the tax authorities in Country B for apportionment purposes.

25. The Taxpayer indicated that he did not dispute in this Appeal that the gains from the sale of the Special Shares R2 released to him could be subject to Salaries Tax in Hong Kong based on the appointment with reference to the number of days he spent in Country B and the number of days he spent in Hong Kong in the periods from the dates of awards to the dates of release.

26. The Taxpayer indicated that he disputed in this Appeal the inclusion of any gains made from the sales of the Special Shares R1 released to him and dividends received on those shares as part of his chargeable income in Hong Kong, as well as the inclusion of all gains on the sales of the Special Shares R1 and the Special Shares R2 released to him in the computation of the rental value of the place of residence provided by Company M, his Hong Kong employer.

27. The Taxpayer contrasted the Special Shares R1 and the Special Shares R2 and underlined that a ‘crucial difference’ between them that ‘Special Shares R1 are granted as a component of the bonuses awarded for employees’ past, actual financial performance, whereas Special Shares R2 are awarded with a view to securing employees’ future performance over an extended period giving them incentives to remain in the employment of the Group’. He referred also to the different conditions applicable to awards of Special Shares R1 and applicable to awards of Special Shares R2, and to the accounting treatment for Special Shares R1 and the Special Shares R2. He advanced the point that ‘Special Shares R1 were in almost all cases only issued out of historical earnings’. He stressed that from the award dates of the Special Shares R1, he enjoyed all the rights of a shareholder and received all the dividends associated with them, and he could instruct for them to be sold by the Nominee on his behalf immediately upon release. He illustrated the contrast by drawing attention to the award letters for the Special Shares

R2 and a letter dated 1 June 2012 of Bank G proposing, subject to regulatory approval, the award of a discretionary bonus to him and that discretionary bonus included an award of Special Shares R1. He also stressed that the Special Shares R1 relevant to this Appeal were Special Shares R1 already awarded before his employment in Hong Kong and there was no relation between them and any further Special Shares R1 that may be awarded in his employment in Hong Kong. He mentioned the upfront and deferral practices associated with bonus distributions, which included the deferred release of Special Shares R1, and stated that the practices were mainly imposed by the European Union and implemented by Country B regulators over time to ensure and encourage financial prudence in the management and operations of bank and financial institutions.

28. The Taxpayer was asked about the Special Shares R1 and his understanding that he enjoyed all the rights of a shareholder in respect of them from the award dates; he would from the award dates be entitled to receive dividends declared on the Special Shares R1 and exercise voting rights as a shareholder of them and in his case, very little was required to be done after release because he could instruct that the shares should be sold by the Nominee on his behalf immediately upon release. It was pointed out that there was a retention period of 6 months after each release date and he was not allowed to sell or dispose the relevant shares during the retention period. The Taxpayer agreed that any instruction to sell would not be executed or could not be executed during the retention period if the trustee was to abide by the terms of the Plan. The Taxpayer further explained that as a result of rules imposed by the financial regulators in Country B, employees falling within the category of ‘material risk takers’ were subject to a further 6 months’ period in addition to the standard retention period, during which he could not sell any shares. The Taxpayer stated that nothing happened between the final release date and the end of the retention period and at the end of the retention period, he never took possession of the shares as usually as a consequence of his financial circumstances, he always sold as soon as he could at the end of a release or retention period. Sales took place following both release date and an applicable retention period.

29. The Taxpayer was asked to go through the terms of the Plan. The Taxpayer accepted that the transfer of the shares either into his own name or to the Nominee holding them on his behalf would remain subject to the terms of the Plan, which included terms for forfeiture and clawback. The Taxpayer accepted that if he left employment before the release of certain shares, that would put at risk the shares to be released. The Taxpayer was asked that he did have to do something for the Special Shares R1 to be released to him, namely to remain in employment with the Group and his response was that he saw it as not something he actively had to do (something that was a passive position) since he had been in employment with the Group since 1988. The Taxpayer accepted that if someone had his employment terminated for misconduct because he had not done anything at all at work, the shares in such a situation would be forfeited. The Taxpayer was asked that the remaining in employment condition was not an unusual condition to be found in share award schemes and his response was that that was not surprising, and added that he stated in evidence that the relevant rules in the Plan were, to his understanding, imposed for the Plan to be in line with European regulations.

30. The Taxpayer made the point in evidence that in his experience as a senior manager within the Group over his 31 years of employment with it, the Special Shares R1, once awarded, were seldom forfeited upon an employee's resignation. He was asked about this part of the evidence. He had not heard of any employee who had such shares forfeited upon resignation or for any other reason. He underlined this point stating that he had been in managerial position, had seen many people departing, and had been in a position to make the recommendation for leavers to continue to receive their shares.

31. The Taxpayer also stated that in his knowledge and experience, Special Shares R1 awarded to an employee within the Group would mainly be 'clawed back' in case of a reversal of performance of the business unit in the financial years for which the awards were made to the employee. He had never heard of a case where an award of such shares was forfeited just because there was a decline in the general financial performance of the Group or the relevant business unit in subsequent years. He also stated that such factors about future performance would be relevant to Special Shares R2 awards but not the Special Shares R1 awards.

The Submissions

32. Section 8(1) of the Inland Revenue Ordinance 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) an office or employment of profit ...'.

Relevantly, section 9(1)(a) defines that:

'(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 ...'.

Also, section 11B provides that:

'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.'

For the purpose of section 11B, section 11C provides that:

'a person shall be deemed to ... cease ... to derive income from a source whenever and as often as he ... ceases: (a) to hold any office or employment of profit ...';

and section 11D provides that:

‘For the purpose of section 11B –

- (a) *income which has accrued to a person during the basis period for a year of assessment but which has not been received by him in such basis period shall not be included in his assessable income for that year of assessment until such time as he shall have received such income, when notwithstanding anything contained in this Ordinance, an additional assessment shall be raised in respect of such income:*

Provided that for the purposes of this paragraph income which has either been made available to the person to whom it has accrued or has been dealt with on his behalf or according to his directions shall be deemed to have been received by such person;

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

Provided that –

- (i) *any lump sum payment ... , being a lump sum payment or gratuity paid or granted upon the retirement from or termination of any office or employment or any contract of employment of an employee or a lump sum payment of deferred pay or arrears of pay arising from an award of salary or wages, whether such a payment is paid by an employer to a person during employment or after that person has left his employ, shall upon the application in writing of the person entitled to claim payment thereof within 2 years after the end of the year of assessment in which the payment is made be related back and shall then be deemed to be income which has accrued during the periods in which the services or employment, in respect of which the payment was made, were performed or exercised, or, if the relevant periods of service or employment exceed 3 years, the payment shall be deemed to be income accruing at a constant rate over the 3 years ending on the date on which the person became entitled to claim payment thereof or ending on the last day of employment, whichever is the earlier; and, notwithstanding section 70, an application made by any person under this proviso for the adjustment of an assessment shall, to that extent, be regarded as a valid objection to the assessment under section 64; and*
- (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.'

33. Mr Lui for the Taxpayer submitted on the Taxpayer's case in this Appeal as follows:

- (a) The Taxpayer did not take issue on whether all the gains from the Special Shares R1 (including the dividends paid) were perquisites. In terms of nature, they were perquisites as they were benefits in kind which had a pecuniary or monetary value. They therefore, by nature, could be perquisites.
- (b) The Taxpayer's objection and Appeal was about accrual. If a perquisite had already accrued to him before he started his employment in Hong Kong, then such a perquisite was for services performed in Country B. The dispute between the Taxpayer and the Revenue was about the timing of accrual.
- (c) Under Ground 1, the issue was the point in time that the Special Shares R1 awards accrued. This ground appeared to raise issues that had not been dealt with by the Hong Kong courts before. And the authorities of the Revenue cited also did not really address the issues in this Appeal.
- (d) Section 11D of the Inland Revenue Ordinance, on the receipt of income for the ascertainment of assessable income under section 11B, was relevant. It was submitted that in the Taxpayer's case, he could, at the material times, give instructions to the Nominee to deal with the Special Shares R1 on his behalf and was also paid and received the dividends through the Nominees on his behalf.
- (e) The Special Shares R1 were all awarded by his Country B employer before the termination of the Taxpayer's employment in Country B for his actual work done. They had accrued to the Taxpayer before his Hong Kong employer started in July 2014. So if it was held that the time of accrual was before commencement of the Hong Kong employment, then it must be that the awards were made or granted for his services in Country B and had nothing to do with Hong Kong.
- (f) Upon accepting the awards and prior to the release of the Special Shares R1, the Taxpayer had become entitled to the exercise of the core rights of them and receipt of pecuniary benefits arising from the

ownership of them. It was immaterial and/or irrelevant to the assessment of facts that there were narrow restrictions imposed on the transfer, assignment or otherwise disposal of the Special Shares R1 or limited conditions to be fulfilled before release. For the purpose of sections 11B and 11D, accrual did not mean that the Taxpayer's entitlement to the Special Shares R1 must be free of any restriction.

- (g) The restrictions imposed on the Taxpayer's right to deal with the Special Shares R1 (against him transferring, assigning or otherwise disposing of them) *per se* did not prevent a benefit in kind from being a perquisite for tax purposes. While the imposition of restrictions could in some circumstances as a result deprive one of all the pecuniary benefits arising from the benefit in kind, the relevant question was one of fact of whether the benefit could have been readily turned to pecuniary account or attach pecuniary significance to it. The authorities did not lay down any inflexible rule of law. On the other hand, there was authority suggesting the view that if the employer had a discretion, then the benefit could be sold or disposed of.

- (h) The conditions that the Taxpayer had to fulfil (such as the employment condition) under the Plan related to the vesting of the Special Shares R1. There was no legal definition of 'vesting'. One had to consider the document itself to find out what was 'vesting' and what was the significance of 'vesting' for tax purposes. In the Taxpayer's case, 'vesting', in respect of the Special Shares R1, only meant the transfer of paper title. And little had to be done and little was done for the transfer of title to the Taxpayer. The transfer in respect of the Special Shares R1 was to the Nominee holding them for the Taxpayer. The award certificate did have a clause on a right to enforce against the Nominee. Such a transfer, it was submitted, was not just a contractual notional transfer. It was an actual transfer of ownership, which may be called beneficial ownership. The grantor had the positive contractual enforceable obligation under the Plan to procure the transfer from the award date; see Rule 2.11.1 of the Plan. The Taxpayer had the economic benefits of the Special Shares R1 from the date of the award. The significance of the conditions was simply that if the Taxpayer quit in the middle of his employment before the vesting or there was a claw back before the vesting date, he would not obtain the paper title but all the monetary benefits that he had already obtained would not be recouped or have to be paid back. Even though the benefits in these situations would only be the dividends, the right to dividends was clearly an essential part of the interests and rights of shareholding. Another relevant concept was the "release date" and it was submitted that once the Special Shares R1 were released, they would not be subject to

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

forfeiture. But the restrictions on disposal would continue to apply until the end of the retention period.

- (i) The Plan's provisions allowed for the possibility of the Special Shares R1 being transferred to the participant. This suggested that the Plan did not necessarily indicate that the participant had no right to have his name registered as a shareholder.
- (j) The provisions in the Plan on Special Shares R2 and the terms of the letters awarding them were referred to in contrast to show the very different nature of the Special Shares R1. The Special Shares R2 were performance based and prospective, in the sense that the employee's future performance within the Group mattered both in relation to actual vesting and even to quantum. Also, in relation to the Special Shares R1, the word 'release' was used; whereas, in relation to the Special Shares R2, the word 'vest' was used. It was thus suggested that to explain the use of 'release', one could look to the provisions that the Special Shares R1 were issued at the time of award, and actually transferred to the Nominee. In the result, 'release' only meant transfer of paper title. Moreover, provision had been made for the scenario of Special Shares R2 having to be issued to the employee in question.
- (k) The context of this Appeal was the taxation of income. The focus therefore should be on the pecuniary or monetary benefits arising from the Special Shares R1 awarded, namely the value of the shares released to the Taxpayer and the dividends received by the Taxpayer. It was submitted that what mattered was the pecuniary aspect and not ownership. The authorities showed that ownership itself was not used as the yardstick for defining a perquisite. The question could not be decided simply by looking at ownership, legal or equitable. Rather one should look at whether the Taxpayer actually got the pecuniary or monetary benefits from an award in kind. There was no inconsistency in the submissions that ownership was not conclusive and that all the rights associated with the Special Shares R1 (or forfeitable shares) would only have arisen as a result of ownership. There was a meaningful economic benefit granted to the participant at the time of the award and that benefit could be valued by reference to the award letter which put a value to the shares. The authorities suggested that once accrual was found, the question of valuation would be a matter of evidence for the Revenue, to be done on the basis of certain restrictions.
- (l) The Revenue's Departmental Interpretation and Practice Notes No.38 (DIPN No.38) was of no or little assistance to this Board because it did not inform this Board of the principle. It was submitted that the interpretation of section 11D(b) there by reference

to ‘ownership’ was not based on any authority. Also, in relation to the ‘upfront approach’ and the ‘back end approach’ suggested that for determining the time at which the shares accrued to the employee, it was noted that they not only referred to ownership but also ‘full economic benefits’ (which could be a potential inconsistency) and that more importantly, the reference to ‘ownership’ was not based on or supported by any authority. This Board was also reminded that DIPNs had no force of law and did not bind this Board.

- (m) As to Ground 2, the submission was that if the Taxpayer succeeded on Ground 1, he must succeed also on Ground 2.

34. Mr Brewer for the Revenue made the following submissions –

- (a) To the extent that the Taxpayer was employed by Bank G in Country B prior to taking up the Hong Kong employment with Company M, the Revenue did not dispute that assessable income derived from the Special Shares R1 ought to be apportioned. The Revenue also did not dispute the basis of apportionment drawn up by Company M and reflected in the Deputy Commissioner’s Determination.
- (b) The Taxpayer bore the onus of proving that the assessments disputed in this Appeal were excessive or incorrect. This required more than merely advancing a case or providing sufficient evidence to show that the Deputy Commissioner’s conclusion in the Determination was wrong.
- (c) The term used throughout in the Plan was ‘vest’. The Plan required vesting to take place in different tranches. This Board should draw a distinction between shares which were inalienable on account of not yet being vested and shares which were vested but were subject to conditions as to alienability. The factor to draw the distinction was the extent to which an award of shares had vested.
- (d) Each award of shares was not intended immediately to give economic benefit to the Taxpayer. Were it otherwise, then the employer’s interests (which were reflected in the continued employment or loyal employment obligation) and the regulator’s interests would not have been met. A holder of an award of shares which had yet to vest would be concerned of the restrictions and accordingly, the restrictions would provide the means of motivation on behalf of the employer.
- (e) The key question, it was submitted, was the extent to which shares awarded could be turned into money before any vesting date. And, it

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

was submitted that the Taxpayer could not have been able to instruct or persuade the Nominee to turn them into money before a vesting date. The Taxpayer's evidence was that while he 'could' instruct for shares awarded to be sold immediately upon release, he was not entitled to do so and any instruction followed would render the Nominee in breach of the Plan.

- (f) Although the Revenue accepted that it was not necessary for the Taxpayer to have got legal or paper ownership and the shares could be held by a Nominee, the distinguishing feature the Revenue advanced here was the absence of any indication in the Plan that the participant would be entitled to have his name entered on the share register, albeit by express terms of the Plan, the voting rights, the right to receive dividends were provided in the meantime. And it was suggested that the right to have one own name registered as a shareholder would only arise as and when the retention period had passed.
- (g) It was submitted that the facts that the participant received dividends and had the right to exercise votes in respect of the shares awarded were not determinative.
- (h) The Plan's continuing loyal employment requirement was of particular importance. This requirement was not a formality. Employers included this requirement for good reason. Shares would not vest in the participant until and unless the employee had completed loyal employment through the relevant period of time.
- (i) The Taxpayer accepted in his evidence that he was realistically required much more than simply 'doing nothing' in order for the Special Shares R1 to be released; and that 'doing nothing' would put his continued employment in jeopardy and likely result in loss of any shares then remaining to be released.
- (j) Given that under the Plan, there was no entitlement to the shares which were subject tranches until individual vesting dates, it was inappropriate to speak of accrual of the benefits represented by the shares in that tranche until or unless there was any release date achieved.
- (k) The argument that all meaningful economic benefits and rights as beneficial owner of the Special Shares R1 had been acquired at any time prior to the release dates was not supported by the evidence. The Plan provided conditions some of which remained to be fulfilled by the Taxpayer before he even approached the position of being able to compel delivery to him of any Special Shares R1 awarded. Whatever he was required to do in respect of each award

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

of Special Shares R1 might have been done in full by each of the relevant release dates and prior to the expiry of retention periods but it had certainly not been done in full at the time each award of such shares was made.

- (l) The Taxpayer's evidence did clarify the point in time at which he would be entitled to insist on a sale was the expiry of the retention period.
- (m) Release of Special Shares R1 to the Taxpayer during the years of assessment 2015/16 and 2016/17 could not have taken place unless the Taxpayer had remained in the Group's employ and he had, as employee, refrained from activity which might frustrate the impact of regulatory conditions. Since the employment at the time of vesting of the Special Shares R1 (being later tranches under an award) was with Company M, it was that Hong Kong employment which was the source of the income received from those tranches. The revisions by the Revenue had fully accounted for the fact that the awards were subject to vesting periods the duration of which included both non-Hong Kong employment with Bank G in Country B and Hong Kong employment with Company M in Hong Kong.
- (n) Regarding the application of the proviso to section 11D(a) of the Inland Revenue Ordinance, in terms of the Special Shares R1, they had not been made available to the participant prior to the vesting date and could not be dealt with on his behalf until the end of the retention period. It was also noted that while there was a provision in the award letters permitting sale of sufficient shares to cover tax and other specified liabilities and costs, that was a qualification not broad enough to accommodate other reasons to raise money and the balance of the shares would be subject to the retention period.
- (o) DIPN No.38 was formulated, like every DIPN, with cognizance of the cases of the Board of Review and the courts. The 'upfront approach' and the 'back end approach' regarding assessment of share awards were practical and they were not contradicted by any of the cases cited before this Board. The 'back end approach' should be adopted in cases where certain conditions had to be satisfied in order for shares to be vested. Notwithstanding the fact that an employee may immediately upon a grant begin to enjoy certain rights attached to the shares in question, if there were continuing loyal employment conditions to be met then the shares would not have vested until and unless such conditions were indeed met.

35. Mr Lui for the Taxpayer suggested that the Revenue conceded in its submission that the Revenue would not disagree if the Taxpayer's argument were that he had acquired all meaningful economic benefits attached to the Special Shares R1 along

with rights as beneficial owner prior to the ‘retention dates’. Mr Lui took ‘retention dates’ to mean ‘after release but before the expiry of the retention period’. Mr Lui considered the concession to be that in respect of the duration of the retention period, the Taxpayer had ‘everything’, as the Revenue accepted that the restrictions during the retention period were of limited nature and scope and there was no prospect of such shares being forfeited or otherwise subject to claw back during the retention period; and that the restrictions themselves might affect the valuation of the shares but that would mean an application of a discount against the market price as of the relevant release date. Mr Lui maintained that the Taxpayer’s argument had been that he had economic benefits from the first day, i.e. from the award of the Special Shares R1.

Discussion

36. This Board has set out the Taxpayer’s testimony and the submissions made on behalf of the Taxpayer and the Revenue in detail in the preceding sections of this Decision. This is done not only in deference to the Taxpayer and the efforts of Mr Lui and Mr Brewer before this Board but also for the purpose of identifying the undisputed and disputed matters in this Appeal, as well as elucidating the material issues that need determination for the disposal of this Appeal. The latter exercise is considered to be some utility in the light of Mr Lui’s submission that this Appeal is likely to be the first occasion for certain issues to be subject to determination in Hong Kong and there are no directly relevant authorities on the issues he said are material to the determination of this Appeal.

37. Share awards have become a common component in the remuneration package of officers or senior staff of corporations in recent times. This Appeal arises from the presumably not uncommon case of a member of the senior staff of an international group of companies moving from employment with one corporate entity of the group in one jurisdiction to employment with another corporate entity of the group in another jurisdiction. This Appeal concerns generally, the questions of whether and what gains from shares awards made at a time when this person was in employment in the former jurisdiction are income chargeable to Salaries Tax in the latter jurisdiction. This Appeal concerns particularly the Share Benefits the Taxpayer received from the types of share awards, namely the Special Shares R1 Awards and the Special Shares R2 Awards in the years of assessment 2015/16 and 2016/17, and since the Taxpayer has accepted the chargeability to Salaries Tax of the portion of the Share Benefits attributed to the Special Shares R2 Awards, the focus of this Appeal is on the Special Shares R1 Awards.

38. The Special Shares R1 Awards were made pursuant to the relevant rules in the Plan and further provisions were included in the award letters making them, as well as the award certificates the Taxpayer received for the Special Shares R1 Awards. This Board’s principal task in the determining of this Appeal involves construing the meaning and effect of these rules and provisions.

39. This Board accepts the testimony of the Taxpayer. However, given that the construction of contractual terms is an objective exercise and that in the Taxpayer’s case, there was no allegation of him being treated differently or other than in the ordinary performance of the relevant and applicable contractual terms, this Board, in determining

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

the true construction of the contractual terms, has referred to the working experience the Taxpayer stated in his testimony but is obliged to give that its due weight.

40. Having considered the relevant rules of the Plan and the applicable provisions of the letters awarding the Special Shares R1 that constituted the Share Benefits, this Board finds that the scheme of the awarding of Special Shares R1 involved the following rules and provisions:

- (a) An award of forfeitable shares/ Special Shares R1 must be specified in the letter/deed making the award and matters specified must include: (i) the number of shares comprised in the award, (ii) the date set for the grant of the award, the release date (i.e. the date on which the person holding the award becomes entitled to the forfeitable shares free of any restrictions, as specified in the letter/deed, subject to any changes in accordance with the rules of the Plan), (iii) whether or not the person holding the award will be required to waive the right to receive dividends before the release date, (iv) whether or not the person holding the award will be required to agree not to exercise voting rights in respect of the forfeitable shares before the release date; and (v) any other condition specified at the date set for the grant of the award (which may provide that the shares subject to the award will be forfeited if the condition is not satisfied). An award certificate setting out the terms of the award may be such a deed. [Rules of the Plan, paragraphs 2.4, 2.5, 2.8]
- (b) The grantor will procure that, with effect from the date set for the grant of the award, the relevant number of Special Shares R1 are transferred to the person holding the award, or to another person to be held for the absolute benefit of the person holding award, on the terms of the Plan. [Rules of the Plan, paragraph 2.11]
- (c) Before the release date, in respect of forfeitable shares, a person holding the award will have all the rights of a shareholder in respect of the forfeitable shares from the date set for the grant of the award. In particular, where he has not waived his dividend rights, he will receive any dividends earned on his forfeitable shares after that date. Where he has not waived his voting rights, he will be entitled to vote or to direct the nominee how to vote the Special Shares R1. [Rules of the Plan, paragraph 4.1]
- (d) Before the release date, in respect of forfeitable shares, a person holding the award may not transfer, assign or otherwise dispose of the Special Shares R1 subject to his award or any rights in respect of any of them comprised of the award, except that on his death his Special Shares R1 are transmitted to his personal representative and if the Committee permits, he may transfer the Special Shares R1 to

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

any person approved by the Committee on such terms relating to his continued participation in the Plan as the Committee may specify. [Rules of the Plan, paragraph 4.2]

- (e) If a person holding an award of forfeitable shares ceases to be an employee of the Group before the release date for any reason, he will forfeit the Special Shares R1 in the award immediately and will have no entitlement under the Plan. Exceptions including disability, death or a discretionary decision of the Committee in other circumstances, are provided. [Rules of the Plan, paragraphs 5.3, 5.4]
- (f) On the release date, any award agreement the person has entered into in respect of an award he holds ceases to have effect and the Special Shares R1 comprised in the award cease to be subject to forfeiture and are free of any restrictions under the Plan. Where relevant, the grantor will procure the transfer of the legal title to the Special Shares R1 from the Nominee to the person holding the award, subject to any withholding considered necessary to any liability to taxation or social security contributions or any other levies or withholding, in respect of the award. [Rules of the Plan, paragraphs 6.1, 6.2] However, each of the letters awarding the Special Shares R1 has an Appendix 1 providing that the award is subject to a retention period, so that paragraph 6.1 of the Rules of the Plan will not apply and the Special Shares R1 will continue to be held by the Nominee for the Taxpayer's benefit until the end of the retention period, except in so far as is necessary to discharge any actual or estimated liability to taxation, social security contributions, any other related costs and any other withholdings arising on the vesting, in accordance with paragraph 6.2. As soon as reasonably practicable after the end of the retention period, the grantor will arrange (subject to paragraph 6.2 of the rules of the Plan) for the transfer (including where applicable a transfer out of treasury) or issue to the Taxpayer of the appropriate number of Special Shares R1. Also, each of the letters awarding the Special Shares R1 also has an Appendix 2 providing for clawback since the Taxpayer was identified as meeting the criteria for 'Code Staff' employees as defined in the FSA's Remuneration Code. The provisions in Appendix 2 enables the review of a portion of the award which has not been released, on or before the release date, in order to determine whether or not some or all of the unvested portion of the award should be reduced.
- (g) In respect of each of the awards of Special Shares R1, the Taxpayer received an **award certificate**. Each award certificate had a table setting the tranches of forfeitable shares awarded by number of shares, release date, retention period and the proportion subject to clawback/reduction. Each award certificate certified that 'on the

Award Date specified above, the Participant was granted an Award of Forfeitable Shares in Company K (the Shares) at nil cost (the Award), subject to the rules of the Company J Share Incentive Plan (the Plan). Shares will vest on each of the four Release Dates specified above.’ The award certificate continued to provide that the award was personal to the Taxpayer and is not transferable, except as permitted by the rules of the Plan; that the shares subject to the award will be held on the Taxpayer’s behalf until the end of the applicable retention period by the Nominee on the terms set out in the rules of the Plan, including (i) the Taxpayer would be entitled to receive ordinary dividends payable on the Special Shares R1 subject to the award before the applicable release dates and during the retention period, (ii) the Taxpayer may exercise his voting rights in respect of the Special Shares R1 subject to the award before the applicable release dates and during the retention period by giving an appropriate instruction to the Nominee, (iii) the Taxpayer will not transfer, assign or dispose of the Special Shares R1 or any interest or rights in them before the end of the retention period (except as permitted under the rules of the Plan); that the Taxpayer would bear any liability to income tax and primary (employee’s) National Insurance Contributions, capital gains tax and any other related costs arising in respect of the shares, which could be discharged through the sale of shares or otherwise; that if the shares subject to the award were forfeited under the terms of the Plan, they ceased to be held by the nominee on behalf of the Taxpayer, and the Taxpayer had no interest in them; and the award was granted by way of a deed and created a right which the Taxpayer may enforce against the grantor.

41. From the above provisions, this Board finds the Special Shares R1 were awarded to the Taxpayer in the following manner:

- (a) An award of Special Shares R1 was made to the Taxpayer and he was notified of that by an award letter. At the same time, he received an award certificate relating to the award.
- (b) Although the award letters and the award certificates have not specified the award date of the related award, it is reasonable to take the release date of the first tranche to be the award date of the related award and this Board makes a finding to this effect.
- (c) The Special Shares R1 to which the award related were transferred with effect from the award date found above in (b) to the Nominee, who held the Shares on behalf of the Taxpayer.
- (d) Each of the tranches of the Special Shares R1 relating to an award was subject to clawback at the discretion of responsible board or committee of the Group on or before the release date.

- (e) Each of the tranches of the Special Shares R1 relating to an award would vest on each of the release dates specified in the award certificate. Notwithstanding the provision of ‘vesting’ on a release date, since the award was subject to a retention period, the tranche of the Special Shares R1 in question would not be free of any restrictions under the Plan but would no longer be subject to forfeiture.
- (f) Each of the tranches of the Special Shares R1 relating to an award would be held on the Taxpayer’s behalf until the end of the retention period related to the particular tranche by the Nominee on the terms set out in the rules of the Plan. Such terms include the entitlement to receive ordinary dividends payable on the Special Shares R1, the power to exercise voting rights by giving an appropriate instruction to the Nominee, the prohibition against transfer, assignment and disposal of the Special Shares R1 or any interest or right in them before the end of the retention period (except as permitted under the rules of the Plan), and the liability to forfeiture should the Taxpayer cease to be an employee of the Group before the expiry of that retention period (subject to the exceptions provided in the rules of the Plan).
- (g) Each of the tranches of the Special Shares R1 relating to an award would cease to be subject to forfeiture and be free of any restrictions under the Plan at the expiry of the retention period specified for that particular tranche.

42. Applying the findings in the preceding paragraph to the Special Shares R1 Awards, this Board underlines the point that the Special Shares R1 were held by the Nominee on the terms of the Plan and subject to the rules of the Plan until the end of the retention period, albeit they were held by the Nominee on behalf of the Taxpayer. It was only on the release date that the Special Shares R1 ceased to be subject to forfeiture and only at the end of the relevant retention period that the respective tranche of the Special Shares R1 were free of any restrictions under the Plan.

43. This Board therefore considers that those tranches of the Special Shares R1 that ceased to be subject to forfeiture in the years of assessment 2015/16 and 2016/17 necessarily became so due to the Taxpayer’s continuing employment with the Group in Hong Kong; those Special Shares R1 became truly the Taxpayer’s as a result of his continuing employment in Hong Kong with a member of the Group. In the relevant retention period there were some restrictions on disposal and transfer but the Revenue conceded that these were of limited scope and duration so as not to affect the vesting on the release date.

44. In the result, this Board rejects the Taxpayer’s submission that he was vested with, became entitled to, or otherwise received the value of the Special Shares R1

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

before he began his employment in Hong Kong. While the Special Shares R1 were awarded by deed and it was expressed on the award certificates that the Taxpayer had a right to enforce against the grantor for the Special Shares R1, that right, like other rights and obligations relating to the award, must be considered on the terms of the rules of the Plan, Appendices 1 and 2 to the award letters and the award certificates. The Special Shares R1 only ceased to be forfeitable on the relevant release dates.

45. The Taxpayer relies on section 11D of the Inland Revenue Ordinance. This Board considers that section 11D(a) is not relevant to the issues involved in this Appeal over income said to be received during the basis period for the years of assessment 2015/16 and 2016/17, given that the proviso to section 11D(a) does not apply outside the context of section 11D(a) itself, which concerns income which has accrued to a person during the basis period for a year of assessment but which has not been received by him in such basis period. This Board also considers that none of the two provisos to section 11D(b) applies in this Appeal. This Board lastly considers whether section 11D(b) itself applies and how it applies in the context of this Appeal. This Board finds that since the time at which the shares were no longer subject to forfeiture was the release date (albeit the Taxpayer would only be entitled to insist on a sale at the expiry of the retention period), the time that he became entitled to the value of a tranche of Special Shares R1 awarded to him was the release date and this was the time when the value of that tranche accrued to him as income for the purpose of section 11B.

46. Turning to the dividends, they were paid to the Taxpayer during the basis period for the years of assessment 2015/16 and 2016/17. The Taxpayer was entitled to be paid the dividends not only because of the relevant award of the Special Shares R1 but also because the Special Shares R1 award in question was not forfeited or reduced during the basis period and one of the reasons that was so was that he was in continuing employment in Hong Kong with a member of the Group.

47. There was no serious dispute between parties that all the gains from the Special Shares R1 (their value and the dividends paid) were perquisites in the sense that they were benefits in kind which had a pecuniary or monetary value. This Board finds that the values of Special Shares R1 and the dividends were income from the Taxpayer's employment in the nature of perquisites.

48. By reason of the findings above, this Board rejects Ground 1 of the reformulated grounds of appeal.

49. This Board finds that the values of the Special Shares R1 and the dividends for each of the years of assessment of 2015/16 and 2016/17 were income from the Taxpayer's employment in Hong Kong in the nature of perquisite. The Taxpayer has accepted that the values of the Special Shares R2 were also income from the Taxpayer's employment in Hong Kong in the nature of perquisite. It follows that the Share Benefits for each of the years of assessment of 2015/16 and 2016/17 were income of the Taxpayer arising in or derived from Hong Kong from his employment and chargeable for Salaries Tax.

(2020-21) VOLUME 35 INLAND REVENUE BOARD OF REVIEW DECISIONS

50. This Board having rejected Ground 1 of the reformulated grounds of appeal and made the findings in the preceding paragraph, it follows that Ground 2 of the reformulated grounds of appeal, which applies to the deeming of the rental value of the place of residence provided to the Taxpayer by reference to his income from employment under section 9(1)(a) of the Inland Revenue Ordinance, must also be rejected.

Decision

51. This Board concludes that the Taxpayer has failed to discharge the burden of proof he has under section 68(4) of the Inland Revenue Ordinance to show that the Salaries Tax Assessments for the years of assessment 2015/16 and 2016/17 imposed on him were excessive or incorrect. The Taxpayer's appeal has to be dismissed. The Salaries Tax Assessment for the year of assessment 2015/16 that the Deputy Commissioner of Inland Revenue, by his Determination dated 9 July 2018, had reduced the net income to HK\$31,792,028 with Tax Payable thereon of HK\$4,748,804, is affirmed. The Deputy Commissioner of Inland Revenue, by his Determination dated 9 July 2018, had reduced the net income of the Salaries Tax Assessment for the year of assessment 2016/17 to HK\$29,421,119 with Tax Payable thereon of HK\$4,393,167, is affirmed.

52. This Board makes no order as to costs.