Case No. D7/15

Salaries tax – termination of employment – payment in lieu of a discretionary bonus – notional share option gain – relevant date for the computation of the notional gain – sections 8(1) and 9 of the Inland Revenue Ordinance

Panel: Liu Man Kin (chairman), Chow Mun Wah Anna and Ng Wan Yee Wendy.

Dates of hearing: 12 to 13 February 2014.
Date of decision: 16 June 2015.

[Remarks: The identity of the Appellant is not disclosed according to section 68(5).]

In 1999, the Taxpayer commenced employment and entered into the Service Agreement with the Company.

In 2008, the Company and the Taxpayer entered into the Separation Agreement and ended the employment.

Under the Separation Agreement, the Taxpayer was paid certain sums and conferred with certain benefits.

The issues in this appeal are:

- Whether the payment in lieu of a discretionary bonus for the Financial Year ending a date in 2008 ('Sum D') is taxable;

- Whether the notional gain derived from the share options conferred ('the Share Option Gain') is taxable;

- If the Share Options Gain is taxable, what is the relevant date for the computation of the notional gain?

Held:

1. The Taxpayer has not surrendered or forgone any right under the Service Agreement by agreeing to the Separation Agreement.

2. The opportunity to be considered for discretionary bonus stemmed from the Service Agreement. Sum D also stemmed from the Service Agreement is income from employment.

3. The Taxpayer had not yet acquired the shares when he exercised the Relevant Options. He only acquired the shares when the Company decided to allot the shares to him.

4. The relevant time for the computation of the Share Option Gain is the time when the Company allotted the shares to the Taxpayer.

Appeal dismissed.

Cases referred to:

Fuchs v CIR (2011) 14 HKCFAR 74
Henley v Murray (1950) 31 TC 351
CIR v Elliot [2007] 1 HKLRD 297
Murad v CIR [2009] 6 HKC 478
Mairs (Inspector of Taxes) v Haughey [1994] 1 AC 303
D120/02, IRBRD, vol 18, 125
D51/09, (2009-10) IRBRD, vol 24, 952
D43/99, IRBRD, vol 14, 448
D84/03, IRBRD, vol 18, 832
D66/06, (2006-07) IRBRD vol 21, 1183

Barrie Barlow, Senior Counsel, instructed by Simmons & Simmons, for the Appellant.
Stewart Wong, Senior Counsel, instructed by Department of Justice, for the Commissioner of Inland Revenue.

Decision:

The Appeal

1. The Taxpayer appeals against the Salaries Tax Assessment in the 2008/2009 year of assessment.

2. In 1999, the Taxpayer and his former employer ('the Company') entered into a service agreement (the 'Service Agreement'). The employment commenced in 1999. Pursuant to the Service Agreement, the Taxpayer was employed as Group Chief Financial Officer and Executive Director of the Company and/or its associates.

3. In 2008, the Company and the Taxpayer entered into a separation agreement (the 'Separation Agreement') and ended the employment on the same day.

4. Upon the cessation of the employment, the Company paid the Taxpayer certain sums and conferred on the Taxpayers some benefits.

5. The issues in this appeal are:

(a) Whether the sum ('Sum D') provided in Clause 4.1.4 of the Separation Agreement, i.e. payment in lieu of a discretionary bonus for the Financial Year ending a date in 2008 is taxable;

(b) Whether the notional gain derived from the share options conferred by the Company on the Taxpayer ('the Share Option Gain') is taxable;

(c) If the Share Options Gain is taxable, which date is the relevant date for the computation of the notional gain, i.e. the date of the exercise of the share options (which would be a date in August 2008) or the date of allotment of the shares by the Company to the Taxpayer (which would be on date later than the above date of the exercise of the share options).

6. The Commissioner of Inland Revenue ('CIR')'s determination on these issues are:

(a) Sum D is taxable.

(b) The Share Option Gain is taxable.

(c) The relevant date for the computation of the Share Option Gain is the date of allotment of the shares by the Company to the Taxpayer.

7. The Taxpayer disagrees. His position on these issues are:

(a) Sum D is not taxable.

(b) The Share Option Gain is not taxable.

(c) If the Share Option Gain is taxable, the relevant date for the computation of the Share Option Gain is the date of the exercise of the share options.

And hence the Taxpayer lodged an appeal to this board.

The Agreed Facts

8. The facts agreed by the Taxpayer and the CIR which are relevant to the issues to be determined in this appeal are as set out below.

9. The Company was incorporated and registered as an exempted company under the Companies Act of Country X. It was registered as an overseas company in Hong Kong under Part XI of the Companies Ordinance.

10. The shares of the Company have been listed on The Stock Exchange of Hong Kong Limited.

11. In 1999, the Company and the Taxpayer entered into the Service Agreement.

12. The Taxpayer's employment under the Service Agreement commenced in 1999.

13. The Taxpayer participated in a share option scheme adopted by the Company in 2001 ('the Share Option Scheme').

14. By letters issued in November 2003 (the '2003 Letter'), November 2004 (the '2004 Letter') and February 2007 (the '2007 Letter') (collectively the 'Grant Letters'), the Company offered the Taxpayer options to subscribe for shares in the Company subject to the terms of the rules of the Share Option Scheme.

15. The subscription prices and the vesting periods in respect of the options are as follows:

	Date of the Grant Letters	Subscription price per share	No. of shares	Vesting date
(a)	2003 Letter	$24.20	360,000	A date in November 2004
			360,000	A date in November 2005
			360,000	A date in November 2006
			360,000	A date in November 2007
			360,000	A date in November 2008
			1,800,000	
(b)	2004 Letter	$42.58	360,000	A date in November 2005
			360,000	A date in November 2006
			360,000	A date in November 2007
			360,000	A date in November 2008
			360 000	A date in November 2009
			1,800,000	
(c)	2007 Letter	$83.00	160,000	A date in February 2008
			160,000	A date in February 2009
			160,000	A date in February 2010
			160,000	A date in February 2011

Date of the Grant Letters	Subscription price per share	No. of shares	Vesting date
		160,000	A date in February 2012
		800,000	

16. The Taxpayer signed the Grant Letters to signify his acceptance of the Company's offers.

17. One day in 2008, the Company and the Taxpayer entered into the Separation Agreement and brought the employment to an end on the same day.

18. Clause 4 of the Separation Agreement provides:

> ' The Company shall on its own behalf …… pay to [the Taxpayer] the sums specified below as compensation in respect of possible claims of the type referred to in clause 6 below within 7 days of the Separation Date. That sum was made up of the following components:
>
> ……
>
> (d) payment in lieu of a discretionary bonus for the financial year ending [a date in] 2008 ['Sum D']; and
>
> ……'

19. Clause 5 of the Separation Agreement provides:

> The Company and the Taxpayer agreed that, notwithstanding the cessation of employment and without any admission of any liability whatsoever, the Taxpayer should be entitled to exercise his stock options as set out below (the 'Relevant Options'), in whole or in part, on or after the Separation Date by delivering to the Company the requisite documents together with a bank draft for $39,369,600 (or the applicable partial amount), and upon receipt of such the Company should procure the delivery within 7 days of the relevant share certificates for those 1,080,000 shares (Clause 5.1 and Annexure 2):

	Date of the grant letters	Number of options to be vested	Subscription price per share	Total Subscription Price	Vesting date	Exercise Period
1.	2003 Letter	360,000	$24.20	$ 8,712,000	Separation Date	3 months from vesting date

	Date of the grant letters	Number of options to be vested	Subscription price per share	Total Subscription Price	Vesting date	Exercise Period
2.	2004 Letter	360,000	$42.58	$15,328,800	Separation Date	3 months from vesting date
3.	2004 Letter	360,000	$42.58	$15,328,800	Separation Date	3 months from vesting date

For the avoidance of doubt, the Taxpayer should be entitled to exercise those 160,000 options granted under the 2007 Letter and which vested on a date in February 2008 no later than a date in October 2008 (Clause 5.2).

For the avoidance of doubt, all other unvested options granted under the Share Option Scheme or otherwise which were not expressly referred to in the Separation Agreement should lapse on the Separation Date, and vested options must be exercised no later than a date in October 2008 (Clause 5.3).

20. By two notices both issued in August 2008 (i.e., the date of the exercise of the share options) each enclosing a bank draft for payment of subscription money, the Taxpayer respectively exercised the Relevant Options to subscribe for 360,000 shares in the Company at $24.20 per share and 720,000 shares in the Company at $42.58 per share (collectively the 'Option Shares').

21. In August 2008 (i.e., the date of allotment of the shares by the Company to the Taxpayer), the Company's Board resolved to allot the Option Shares to the Taxpayer on the same day.

22. The closing share prices of the Company on the date of the exercise of the share options and the date of allotment of the shares by the Company to the Taxpayer were $73.15 and $76.50 respectively.

Evidence

23. Apart from the facts agreed by the parties, the Taxpayer himself and the solicitor giving him advice while he was negotiating with the Company on the terms of the Separation Agreement ('the Solicitor') have given evidence during the hearing before this Board.

24. We accept that the Taxpayer is a truthful witness. How his evidence would affect the outcome of this appeal would be analysed below.

25. We also accept that the Solicitor is a truthful witness. However, with respect to the Solicitor, her evidence may not be of much assistance to this Board in the determination of this appeal.

(a) The Solicitor is a practising solicitor in Hong Kong specializing in employment law and related areas. She gave evidence under the caveat that she was not authorized by the Taxpayer to waive the legal professional privilege attaching to the advice given by her to the Taxpayer. As a lawyer specialised in employment law, the Solicitor gave her comments on some questions relating to the Hong Kong employment law. However, on the questions of Hong Kong law, this Board would and should be assisted by submissions from the parties and not by any 'evidence' given by any lawyer. This Board would make its own decisions on those questions after hearing submissions. The Board would have no need to hear 'evidence' on Hong Kong law.

(b) The Solicitor was asked during re-examination whether she considered herself to have expertise in the area of company law relating to company's constitution. The Solicitor answered that she did not have in-depth expertise. She said her area of practice was employment law and not company law. We also note that the Company is a company incorporated under the Companies Act of Country X. If interpretation of the Company's constitution is relevant in this appeal, the law concerning this issue should be Country X law. However, the Solicitor is a practicing solicitor in Hong Kong. She did not claim any expertise in Country X law.

Sum D and the Share Option Gain

The Law

26. Inland Revenue Ordinance (Chapter 112) ('IRO'), section 8(1) provides:

> ' *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****; and*
>
> *(b) any pension.*' (Emphasis added)

27. 'Income' is widely defined in IRO section 9 and includes 'any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite, or allowance.'

28. The leading authority on salaries tax is the Court of Final Appeal's decision in Fuchs v CIR (2011) 14 HKCFAR 74. In Fuchs, Ribeiro PJ said (all other members of the Court concurred):

> ' *17. In my view, the same approach should be adopted in the construction of section 8(1) of the Ordinance.* ***Income chargeable under that section is likewise not confined to income earned in the course of employment but embraces payments made …… "in return for acting as or being an employee"****, or (in Lord Templeman's terms)* ***"as a reward for past services or as an inducement to enter into employment and provide future services"****. If a payment,* ***viewed as a matter of substance and not merely of form*** *and without being "blinded by some formulae which the parties may have used", is found to be derived from the taxpayer's employment in the abovementioned sense, it is assessable. This approach properly gives effect to the language of section 8(1).*
>
> *18. It is worth emphasising that a payment which one concludes is "for something else" and thus not assessable, must be a payment which does not come within the test. As Lord Templeman pointed out, it is* ***only*** *where* ***"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 reason, [that] the emolument is not received 'from the employment'."*** *Thus,* ***where a payment falls within the test, it is assessable and the fact that, as a matter of language, it may also be possible to describe the purpose of that payment in some other terms, eg, as "compensation for loss of office", does not displace liability to tax.*** *The applicable test gives effect to the statutory language and* ***other possible characterisations of the payment are beside the point if, applying the test, the payment is "from employment"****.*
>
> ……
>
> *22. In situations like those considered above, since the employment is brought to an end, it will often be plausible for an employee to assert that his employment rights have been "abrogated" and for him to attribute the payment received to such "abrogation", arguing for an exemption from tax. It may sometimes not be easy to decide whether such a submission should be accepted. However,* ***the operative test must always be the test identified above, reflecting the statutory language: In the light of the terms on which the taxpayer was employed and the circumstances of the termination, is the sum in substance "income from employment"? Was it paid in return for his acting as or being an employee? Was it an entitlement earned as a result of past services or an entitlement accorded to him as an inducement to enter into the employment? If the answer is "Yes", the sum is taxable and it matters not that it might linguistically be acceptable also to refer to it as***

> ***"compensation for loss of office" or something similar. On the other hand, the amount is not taxable if on a proper analysis the answer is "No"'. As the "abrogation" examples referred to above show, such a conclusion may be reached where the payment is not made pursuant to any entitlement under the employment contract but is made in consideration of the employee agreeing to surrender or forgo his pre-existing contractual rights.*** *In the present appeal, the principal dispute between the taxpayer and the Revenue involves rival contentions along the aforesaid lines.*' (Emphasis added)

29. Previous authorities suggesting that payments received as compensation for loss of office would not be taxable, for example, Henley v Murray (1950) 31 TC 351 and CIR v Elliot [2007] 1 HKLRD 297, must now be read subject to Fuchs.

30. As said by Chung J in Murad v CIR [2009] 6 HKC 478:

> ' *26. The main plank of the taxpayer's case in this appeal is that the taxed sums were "compensation for loss of office".*
>
> *27. I agree with the commissioner that this is not the true test for deciding if a sum paid on earlier termination of an employment contract should be taxed.*
>
> *28. First, disputes of this kind always involve a "loss of office".* ***Sum(s) paid on such an occasion is/are often described as "compensation" as a matter of common language. Thus, so understood, the phrase "compensation for loss of office" is apt for all such cases irrespective of whether the sum(s) should or should not be taxable.***
>
> *29. Further, as can be seen from the passages in the judgments quoted above ……, this is not the test propounded by the authorities. The test was worded as whether the payment was for the "total abandonment of … contractual rights", "total abrogation … of … contract of employment", "damages for the breach of it", "consideration [for] the surrender … of … rights in respect of the office" or "[waiving] or [releasing] an existing obligation". Hence, the emphasis is consistently on the abandonment or abrogation of contractual rights.*' (Emphasis added)

31. We have to apply the law as stated by the Court of Final Appeal in Fuchs in deciding this appeal.

Whether the Taxpayer has surrendered or forgone any right under the Service Agreement by agreeing to the Separation Agreement?

32. We first consider whether the Taxpayer has surrendered or forgone any right under the Service Agreement by agreeing to the Separation Agreement. The answer to this question would shed light on whether payments and benefits provided to the Taxpayer can be regarded as consideration for abrogation of the Taxpayer's contractual right under the Service Agreement.

33. Clause 2.2 of the Service Agreement provided:

> ' [The Taxpayer's] employment will begin on or before [a date in 2000] and will continue, subject to the terms of this Agreement, for a term of two years and thereafter until terminated by either party giving to the other not less than 6 months' written notice.'

34. It is common ground between the parties that pursuant to the Employment Ordinance (Chapter 57) section 7, either party may make a payment in lieu of 6 months' notice to bring the employment under the Service Agreement immediately.

35. It is not disputed that the Company has made a payment to the Taxpayer to bring the employment to an end in 2008. For the avoidance of doubt, that payment does not form any part of Sum D nor any part of the Share Option Gain.

36. The Taxpayer did not enjoy any tenure under the Service Agreement. The Company could at any time invoke Employment Ordinance (Chapter 57) section 7 to terminate the Service Agreement, and the Company did so in 2008.

37. The Taxpayer argued that by agreeing to the Separation Agreement, he has surrendered or forgone his right to put the issue of removing him from the directorship to the vote of the shareholders of the Company. In paragraph 21 of his Witness Statement, the Taxpayer said:

> ' …… I said the company could not remove me as director, just by a Board resolution, for under the bye-laws and [the Companies Act of Country X], I had a right to have the matter put to the vote of shareholders and to be heard by the shareholders.'

38. The Taxpayer relied upon the Companies Act of Country X, section 93:

> ' Removal of directors
>
> (1) Subject to its bye-laws the members of a company may at a special general meeting called for that purpose remove a director:

> Provided that notice of any such meeting shall be served on the director concerned not less than fourteen days before the meeting and he shall be entitled to be heard at such meeting:
>
> Provided further that nothing in this section shall have effect to deprive any person of any compensation or damages which may be payable to him in respect of the termination of his appointment as a director or of any other appointment with the company.
>
> (2) A vacancy created by the removal of a director at a special general meeting may be filled at that meeting by the election of another director in his place or in the absence of any such election by the other directors.'

39. We are unable to accept the Taxpayer's argument.

40. The plain meaning of this Country X legislation is that the members of the Company may remove a director in accordance with that section. However, the section does not suggest that a director has the right to put the issue of removing him from directorship to the vote of the shareholders.

41. The Taxpayer also referred to the Company's bye-laws sections 86 and 90. Suffice for us to say that we do not see how these bye-laws would confer a right on the Taxpayer to put the issue of removing him from directorship to the vote of shareholders.

42. Further, Clause 14.6 of the Service Agreement provided:

> ' On the Date of Termination (for whatever reason) [as defined by Clause 1 of the Service Agreement, this is the date on which the employment of the Taxpayer terminates] [the Taxpayer] will promptly:
>
> a) at the request of the Company resign (if he has not already done so) from all offices held by him in the Group; and
>
> b) deliver up to the Company all books, papers, lists of customers and suppliers, correspondence, documents, credit cards and other property belonging to or relating to any member of the Group which may be in his possession or under his control.
>
> and [the Taxpayer] irrevocably authorises the Company in his name and on his behalf to execute all documents and do all things necessary to effect the resignations referred to above, in the event of his failure to do so.'

43. So at the time of entering into the Service Agreement, the Taxpayer has already agreed that upon cessation of his employment (for whatever reason), he would at the

request of the Company resign from all offices held by him in the Company and/or its associates.

44. Accordingly, when the Service Agreement was terminated by the Company in accordance with the Employment Ordinance (Chapter 57) section 7, the Taxpayer had a contractual obligation to resign from directorship at the request of the Company. He did not have the right to put the issue of removal to the vote of the shareholders of the Company.

45. The Taxpayer has not surrendered or forgone any right under the Service Agreement by agreeing to the Separation Agreement.

The true nature Sum D

46. Sum D is 'payment in lieu of a discretionary bonus for the Financial Year ending [a date in] 2008' (see Clause 4.1.4 of the Separation Agreement).

47. In order to understand the term 'discretionary bonus', we have to go back to the Service Agreement. Clause 4.3 Service Agreement provided: 'In addition to the Salary, [the Taxpayer] will be eligible to participate in the Senior Management bonus scheme ("Annual Bonus") on such terms and at such level as [the board of directors of the Company] may from time to time determine.'

48. The Taxpayer in his oral evidence told us that after the end of a financial year, the Company's auditor would prepare the audited accounts. The executives of the Company would look at the audited results and make suggestion to the remuneration committee, and this was done probably in August each year. The remuneration committee would then make a recommendation further up to the board of directors.

49. The Taxpayer got bonus under the bonus scheme from 1999 to 2007.

50. As to the purpose of Sum D, the Taxpayer in paragraph 27 of his Witness Statement said:

> ' The award of discretionary bonuses by [the Company] (which usually only took place in September) was entirely discretionary. The Service Agreement conferred no right to any bonus. The sum under clause 4.1.4 of the Separation Agreement [(Sum D)] was a figure, arbitrarily arrived at by negotiations, intended to **eliminate any possible claim and lawsuit advance against the company for depriving me of the opportunity to be considered for discretionary bonus**. ……' (Emphasis added)

51. The Solicitor in paragraph 18 of her Witness Statement said:

> ' …… [the Company]'s Chairman was concerned to secure [the Taxpayer]'s resignations, both as an employee and director of the company and as a

> director of its many subsidiaries and associated companies. In particular, [the Company]'s Board wanted to avoid a disruptive and long-drawn out battle and to secure [the Taxpayer]'s co-operation and acquiescence in the termination of [the Taxpayer]'s offices. The clause 10 covenants and restrictions and the agreed statements set out in the Annexures to the executed Separation Agreement reflect this. In exchange for this, [the Company]'s Board was prepared to make concessions on matters such as compensating [the Taxpayer] **for the loss of the opportunity to be considered by his employer later that year (after the 2007/2008 annual results had been audited and announced) for a potential bonus** and **for the loss of share options that had not vested** (which would lapse upon termination unless [the Company]'s Board decided otherwise). [The Taxpayer] had no right to demand payment of a bonus or to require the early vesting of share options; the sums and benefits provided for in clause 4.1.4 and clause 5 of the Separation Agreement were secured by hard negotiations and in consideration for [the Taxpayer]'s agreement to the terms of the Separation Agreement.' (Emphasis added)

52. The opportunity to be considered for discretionary bonus ('the Opportunity') stemmed from Clause 4.3 of the Service Agreement. Without that clause in the Service Agreement, the Taxpayer could not say that he was entitled to have the Opportunity.

53. The Opportunity did not stem from the Separation Agreement.

54. Put it simply, the purpose of Sum D is to buy the Opportunity from the Taxpayer. As the Opportunity stemmed from the Service Agreement, Sum D is also a sum stemmed from the Service Agreement.

55. Further, if the Taxpayer is paid discretionary bonus for the Financial Year ending a date in 2008, undoubtedly the discretionary bonus would be taxable. As Sum D is a payment in lieu of the discretionary bonus, the character of Sum D should be same as the character of the discretionary bonus. As said by Lord Woolf in Mairs (Inspector of Taxes) v Haughey [1994] 1 AC 303 at 319D:

> ' *It is inevitable that if a payment is made in substitution for a payment which might, subject to a contingency, have been payable that the nature of the payment which is made in lieu will be affected by the nature of the payment which might otherwise have been made. There will usually be no legitimate reason for treating the two payments in a different way.*'

Further at 323B:

> ' *As already indicated, payment made to satisfy a contingent right to a payment derives its character from the nature of the payment which it replaces.*'

56. We conclude that Sum D is income from employment and is therefore taxable.

The true nature of the Share Option Gain

57. In respect of the Share Option Gain, Inland Revenue Ordinance (Chapter 112) section 9(1)(d) is of particular relevance:

> ' *Income from any office or employment includes-*
>
> *(d) any gain realized by the exercise of, or by the assignment or release of,* ***a right to acquire shares or stock in a corporation obtained by a person as the holder of an office in or an employee of that or any other corporation.***' (Emphasis added)

58. By the operation of that section, if the Share Option Gain falls within the ambit of that section, the Share Option Gain would be income from office or employment and would be subject to Salaries Tax.

59. The Company implemented the Share Option Scheme in 2001. The Rules of the Share Option Scheme provided:

> Clause 1.1
>
> ' In this Scheme the following expressions have the following meanings:
>
> ……
>
> "Eligible Person" - any person who satisfies the eligibility criteria in clause 5
>
> ……'
>
> Clause 2.1
>
> ' This Scheme is **a share incentive scheme** and is established **to recognise and acknowledge the contribution that Eligible Persons had made or may make to the Group.**' (Emphasis added)
>
> Clause 2.2
>
> ' This Scheme will provide the Eligible Persons with an opportunity to have a personal stake in the Company with the view to achieving the following objectives:
>
> (a) **motivate the Eligible Persons** to optimise their performance and efficiency for the benefit of the Group; and

(b) **attract and retain or otherwise maintain ongoing business relationship with the Eligible Persons** whose contributions are or will be beneficial to the long term growth of the Group.' (Emphasis added)

Clause 5.1

' The Board may at its discretion grant Options to: (i) any Director, Employee, consultant, customer, supplier, agent, partner or adviser of or contractor to the Group or a company in which the Group holds an interest or a subsidiary of such company ("Affiliate"); or (ii) the trustee of any trust the beneficiary of which or any discretionary trust the discretionary objects of which include any Director, Employee, consultant, customer, supplier, agent, partner or adviser of or contractor to the Group or an Affiliate; or (iii) a company beneficially owned by any Director, Employee, consultant, customer, supplier, agent, partner, adviser of or contractor to the Group or an Affiliate.

In order for a person to satisfy the Board that he is qualified to be (or, where applicable, continues to qualify to be) an Eligible Persons, such person shall provide all such information as the Board may request for the purpose of assessing his eligibility (or continuing eligibility).'

60. While the Taxpayer was an employee of the Company, the Taxpayer was an Eligible Person under the Share Option Scheme.

61. The Relevant Options were granted by the Company to the Taxpayer while the Taxpayer was the Company's employee pursuant to the Share Option Scheme. However, in respect of the options relating to 360,000 shares granted by the 2003 Letter, the vesting date originally was a date in November 2008. In respect of the options relating to 720,000 shares granted by the 2004 Letter, the vesting date in respect of the options relating to 360,000 shares originally was a date in November 2008, and the options relating to the remaining 360,000 shares originally was a date in November 2009. By the Separation Agreement, the vesting date of all the Relevant Options was advanced to the Separation Date as defined in the Separation Agreement, i.e. a date in July 2008.

62. The Relevant Options stemmed from the Share Option Scheme.

63. Under cross-examination, the Taxpayer accepted that the Relevant Options were the right to acquire shares obtained by him as an employee of the Company.

64. The Taxpayer however argued that the Relevant Options were subject to vesting, and as a matter of fact the Relevant Options were vested upon him because the Separation Agreement accelerated the vesting of those options. So, the Taxpayer argued, he obtained the Relevant Options from the Separation Agreement and as a result the Share Option Gain was not taxable.

65. We are unable to accept this argument.

66. Clause 1.1 of the Share Option Scheme contains the following definitions:

> ' Option – a right to subscribe for Shares granted pursuant to this Scheme, including both Vested Option and Unvested Option'
>
> ' Unvested Option – an Option that is not exercisable pursuant to the terms of the 2001 Share Option Scheme and the terms on which the Option is granted'
>
> ' Vested Option – an Option that is exercisable pursuant to the terms of the 2001 Share Option Scheme and the terms of which the Option is granted'
>
> ' Vesting Period – such period of time, as may be determined by the Board in its absolute discretion and set out in the terms of the grant of the Option, during which the right to exercise the Option in respect of all or some of the Share to which the Option relates will vest subject to and in accordance with the terms and conditions of the grant of the Option'

67. As said above, the Relevant Options were granted by the Company to the Taxpayer by the 2003 Letter and the 2004 Letter. At the time of the grants, all the Relevant Options were 'Unvested Options'. The respective vesting dates of these Options were set out in the 2003 Letter and the 2004 Letter. On the date of the Separation Agreement, the original vesting dates of these options had not yet arrived.

68. In respect of 'Unvested Option', there is no provision in the Share Option Scheme providing that once the grantee ceases to be an employee of the Company, all the Unvested Options granted to him would automatically lapse.

69. Each of the 2003 Letter and the 2004 Letter contains the following term:

> ' Unless otherwise agreed by the Board in its absolute discretion (and approved by independent non-executive directors of the Company), the Option will only be granted to [the Taxpayer] in [his] capacity as Group Chief Financial Officer in the Group (the "Position") and **may lapse** if you cease to be in the Position' (Emphasis added)

70. It is worth to note that in accordance with the 2003 Letter and the 2004 Letter, the options granted to the Taxpayer therein *may lapse* (not *shall lapse*) if the Taxpayer ceases to be the Group Chief Financial Officer. In other words, once the Taxpayer's employment is terminated, whether the options granted to the Taxpayer in the said letters would lapse is a matter to be determined by the Company.

71. From the above, we are of the view that:

(a) As defined in the Share Option Scheme, both 'Vested Option' and 'Unvested Option' are rights to subscribe for the Company's shares granted pursuant to the Share Option Scheme.

(b) An 'Unvested Option' will vest on the vesting date specified in the grant letter and become a 'Vested Option'.

(c) The 'Unvested Options' granted to the Taxpayer in the 2003 Letter and the 2004 Letter would not automatically lapse at the termination of the Taxpayer's employment. Whether it would lapse or not depends upon the Company's decision.

(d) Since an 'Unvested Option' is a right granted by the Company to the Taxpayer, at the termination of the employment, unless the Company makes a decision that the 'Unvested Option' shall lapse, the Taxpayer would still have that right after the termination of the employment.

(e) The Relevant Options were granted by the Company to the Taxpayer pursuant to the Share Option Scheme in 2003 and 2004 to motivate the Taxpayer to work for the Company and its associates. The Relevant Options are from the Share Option Scheme and not from the Separation Agreement.

(f) The accelerated vesting provided in the Separation Agreement merely advances the vesting date of the Relevant Options, i.e. enabling the Relevant Options to be exercised at an earlier date.

72. The Relevant Options are rights to acquire the Company's shares obtained by the Taxpayer as an employee of the Company. By the operation of Inland Revenue Ordinance (Chapter 112) section 9(1)(d), the Share Option Gain shall be regarded as income from employment and is taxable.

Consideration to make the Taxpayer go away quietly?

73. By entering into the Separation Agreement, no doubt that the Company and the Taxpayer intended to have a 'clean break' with each other.

74. The 'clean break' is achieved by various provisions in the Separation Agreement, including:

Clause 6

' Settlement and Waiver

6.1 [The Taxpayer] accepts the sums and benefits to be given to him under Clauses 4 and 5 of this Agreement in full and final settlement of all claims and rights of action (whether under statute, common law or otherwise) in Hong Kong, [Country X] or any other jurisdiction in the world (including but not limited to breach of contract or tort, and any Statutory Employment Protection Claim which could be brought) which [the Taxpayer] has or may have against the Company or any other Protected Person arising from or connected with [the Taxpayer]'s employment or holding of any office with the Company or any subsidiary or associate, the termination thereof, or any other matter concerning the Company or any subsidiary or associate PROVIDED THAT this waiver shall not apply to (a) the right of [the Taxpayer] to take any steps to enforce this Agreement or (b) any claim or right of action which arises after the date hereof; or (c) the material facts of which are not known to [the Taxpayer] as of the date hereof. [the Taxpayer] hereby agrees that, except for the sums and benefits referred to in this Agreement, no other sums or benefits are due to him from the Company or any subsidiary or associate.

6.2 The Company on its own behalf and on behalf of all subsidiaries and associates hereby waives all claims and rights of action (whether under statute, common law or otherwise) in Hong Kong, [Country X] or any other jurisdiction in the world (including but not limited to breach of contract or tort, and any Statutory Employment Protection Claim which could be brought) which it or they may have against [the Taxpayer] in any jurisdiction in the world arising from or connected with [the Taxpayer]'s employment or holding of any office with the Company or the termination thereof or any other matter concerning [the Taxpayer] PROVIDED THAT this waiver shall not apply to (a) the right of the Company to take any steps to enforce this Agreement or (b) any claim or right of action which arises after the date hereof; or (c) the material facts of which are and have never been known to any member of the Board of Directors (save for [the Taxpayer]) as of the date hereof and PROVIDED THAT the Company shall continue to maintain and pay for the Company's Directors' and Officers' liability insurance policies that are currently in place.'

Clause 9

' Contract of Employment

[The Taxpayer] hereby confirms that notwithstanding the termination of his employment and [the Service Agreement], he accepts that Clause 11 of [the Service Agreement] shall remain in full force and effect [which restricts the

> Taxpayer to do certain things within some specified timeframes after the termination of the employment] and he shall not take any step to challenge the validity of Clause 11.'
>
> Clause 10
>
> ' [The Taxpayer]'s Ongoing Obligations
>
> In consideration of the sums and benefits to be made by the Company to [the Taxpayer] under this Agreement and the Company's undertakings set out in Clause 11 below, [the Taxpayer] hereby agrees:
>
> ……
>
> 10.4 not to make, or cause to be made, (whether directly or indirectly, orally or in writing) any derogatory or critical comments or statements about the Company, any subsidiary or associate, their officers or their employees
>
> ……'
>
> Clause 11
>
> ' The Company's Ongoing Obligations
>
> In consideration of [the Taxpayer]'s undertakings set out in Clause 10 above, the Company agrees not to make, or cause to be made, (whether directly or indirectly, orally or in writing) any derogatory or critical statement about [the Taxpayer].'

75. So in the Separation Agreement, each side offers to the other side some benefits in order to achieve a 'clean break'.

76. One may say that the benefits offered by the Company to the Taxpayer, including Sum D and accelerating the vesting dates of the Relevant Options, are consideration to make the Taxpayer go away quietly. However, that does not mean that Sum D and the Share Option Gain are not taxable.

77. Applying common and commercial sense, when an employer and an employee sign a separation agreement to end the employment, no doubt both of them would intend to have a clean break by virtue of the separation agreement. The employer would pay some consideration to the employee in order to achieve the clean break. However, it cannot be said that since the purpose of the separation agreement is to achieve a clean break, the consideration paid by the employer to the employee under the separation agreement or any part thereof would not be taxable. As said by Ribeiro PJ in Fuchs paragraph 17, the crux is

the substance of the payment made to the employee. If the payment in substance is income from employment, the payment would still be taxable.

78. As analysed above, both Sum D and the Share Option Gain are income from the Taxpayer's employment. That being the case, even if it is possible to describe, as a matter of language, the purpose of such payment and benefit in some other terms, that does not displace liability to tax. Once Sum D and the Share Option Gain are income from the Taxpayer's employment, they are taxable under the Inland Revenue Ordinance (Chapter 112) section 8(1). Other possible characterisations of the payment and the benefit are beside the point. See Ribeiro PJ's judgment in Fuchs at paragraphs 17 and 18.

Computation of the Share Option Gain

79. Inland Revenue Ordinance (Chapter 112) section 9(4)(a) provides:

> '*For the purposes of subsection (1)*
>
> *(a) the gain realized by the exercise at any time of such a right as is referred to in paragraph (d) of that subsection shall be taken to be the difference between the amount which* ***a person*** *might reasonably expect to obtain from a sale in the open market* ***at that time of the shares or stock acquired*** *and the amount or value of the consideration given whether for them or for the grant of the right or for both*' (Emphasis added)

80. The Chinese version of the section is as follows:

> '*為施行第(1)款─*
>
> *(a) 該款(d)段所提述的權利於任何時間被行使而變現所得的收益，須被視為相等於以下差額，即任何人將所得股份或股額於獲取時若在公開市場出售而可合理預期獲得的款額，減去為取得該股份或股額、或為獲授予上述權利、或為兩者而付出的代價款額或價值後所得的款額*' (underline supplied)

81. The difference between the parties on this issue is, for the purpose of computing the Share Option Gain in accordance with the Inland Revenue Ordinance (Chapter 112) section 9(4), whether the relevant time is the date on which the Taxpayer exercised the Relevant Options, or the date on which the Company allotted the shares to the Taxpayer as a result the Taxpayer's exercise of the Relevant Options. The Taxpayer submitted that the relevant time should be the former, while the CIR submitted that the relevant time should be the latter.

82. The Taxpayer cited D120/02, IRBRD, vol 18, 125 and D51/09, (2009-10) IRBRD, vol 24, 952 in support of his contention.

83. In D120/02:

(a) The taxpayer exercised the right to subscribe shares and the shares were allotted to her on 12 July 2000. There was no evidence showing when the taxpayer exercised the right. The taxpayer argued that she did not acquire the shares on 12 July 2000 since she did not receive the share certificates on that day. This contention was rejected by the Board.

(b) The Board noted that on the question of when should be 'that time of shares or stock acquired', there were two conflicting lines of authorities. However, it was unnecessary for the Board to choose between these two lines for the purpose of resolving that appeal. The Board said:

> ' *13. There are therefore two conflicting lines of authorities:*
>
> *(a) The first line of authorities (D14/90; D4/91; D66/94 and D128/99) supports the view that the relevant time in determining the amount which a person might reasonably expect to obtain from a sale in the open market is the time when such right is exercised. The notional sale envisaged by section 9(4)(a) would take place on that date. As the section makes no reference to the taxpayer being able to deal in shares, the absence of any certificate does not prevent the operation of the notional sale.*
>
> *(b) The second line of authorities (D43/99) holds that the relevant time is "when the shares were acquired". It presupposes that no share was acquired at the time when the option was exercised. It maintains that despite the possible acquisition of the shares, the non-availability of any certificate is to be taken into account in determining whether there could be a notional sale.*
>
> *14. As pointed out above, there is no direct evidence as to the precise date when the Appellant exercised her right in this case. It is therefore unnecessary for us to embark upon the unenviable task of choosing between the two conflicting lines of authorities.*'

(c) The Board held that the time of the shares acquired was the time when the taxpayer's name was entered on the company's register of shareholders, not the time when the share certificates were available. The Board said:

> *‘ Did the Appellant acquire any Share on 12 July 2000*
>
> *15. As indicated by paragraph 14.1 of Gore-Browne on Companies:*
>
> *“A share is the interest of a shareholder in the company, measured by a sum of money for the purpose of liability in the first place and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se in accordance with s. 16 of the Companies Act 1962 ... A share is not a sum of money ... but is an interest measured by a sum of money, and made up of various rights contained in the contract”.*
>
> *16. Paragraph 16.7 of Gore-Browne on Companies further pointed out that:*
>
> *“A certificate under the common seal ... is, so far as English law is concerned, prima facie evidence of the title of the person named to the shares ...”.*
>
> *“A share certificate (as opposed to the share itself which is a chose in action) is a personal chattel and can be the subject of a claim in conversion at the suit of someone who has either possession or an immediate legal right to possession at the time of conversion”.*
>
> *17. Given the distinction between a share certificate and a share and the terms of the Plan, we have no doubt that by 12 July 2000 (if not earlier) the Appellant had acquired 76 Shares. She is the legal owner of the 76 Shares. Her name is entered on the Register of Shareholders. She is entitled to the dividends attributable to and the voting rights attached to the Shares. Her right to sell the Shares is however curtailed in that the same may not be sold for five years from the date of her acquisition. This bundle of rights and obligations was vested in the Appellant on 12 July 2000. These are valid and subsisting rights. These rights are of value although they may not be as valuable as rights which are totally unfettered. The non-availability of the share certificate does not prevent the vesting of these rights in the Appellant on 12 July 2000. We therefore reject the Appellant’s contention that she did not acquire the Shares on 12 July 2000.’*

84. We agree with the analysis and conclusion of the Board in D120/02. The ‘*time of the shares or stock acquired*’ in Inland Revenue Ordinance (Chapter 112) section 9(4) is the time when the taxpayer’s name is entered on the company’s register of shareholders.

85. However, this does not support the Taxpayer's contention but in fact support the CIR's position. The Taxpayer's name would be entered on the Company's register of shareholders when the Company decided to allot the shares to the Taxpayer, and that time would be the date of allotment of the shares by the Company to the Taxpayer, not one day earlier in August 2008, being the date of exercise of the Relevant Options.

86. In D51/09:

(a) The taxpayer exercised the options on 6 December 2007. There was no evidence showing when the company allotted the shares to her.

(b) The taxpayer argued that she did not have any actual gain by exercising the options. She in fact had suffered a loss. This was the only ground of appeal.

(c) The Board dismissed the appeal as the Inland Revenue Ordinance (Chapter 112) section 9(4) specified that the gain should be the notional gain as set out in that section.

87. We note that there is no discussion in D51/09 on the true meaning of the '*time of the shares or stock acquired*' in Inland Revenue Ordinance (Chapter 112) section 9(4). It cannot be said that D51/09 is an authority on the issue.

88. The CIR cited the following decisions of this Board in support of his position:

(a) In D43/99, IRBRD, vol 14, 448, this Board said:

'*29. …… we come to the view that the material time is the time when the shares were acquired. Even though the section is contemplating a notional sale, it makes better sense to fix the notional sale at a time when (and not before) the shares are acquired.*'

(b) In D84/03, IRBRD, vol 18, 832, this Board said:

'*37. …… We would add that the relevant time is "the time of the shares or stock acquired". The relevant act in determining the relevant time is the acquisition of shares or stock.*'

(c) In D66/06, (2006-07) IRBRD, vol 21, 1183, this Board said:

'*18. …… This Board also agrees with the previous decisions of the Board referred to above that the relevant date for determination of the notional gain is the date when the shares were acquired by the*

> *taxpayer. As a matter of law, shares are acquired when they are allotted to the shareholder.*'

89. Having considered the parties' submissions and the authorities, we conclude that the '*time of the shares or stock acquired*' in Inland Revenue Ordinance (Chapter 112) section 9(4) is the time when the Taxpayer's name is entered on the company's register of shareholders. Before that time, the Taxpayer has not yet obtained the rights as a shareholder and has not yet acquired the shares.

90. This conclusion is supported by the Chinese text of the section – '於獲取時'. The time of getting the shares is the time when the company allots the shares to the taxpayer, ie putting the taxpayer's name on the company's register of shareholders.

91. Accordingly, the Taxpayer had not yet acquired the shares when he exercised the Relevant Options. He only acquired the shares when the Company decided to allot the shares to him.

92. The Taxpayer in his oral evidence told us that he could sell the shares on the date when he exercised the Relevant Options, i.e. before the Company allotting the shares to him, because he had a stock borrowing agreement. We have no doubt on this. However, in constructing the true meaning of the '*time of the shares or stock acquired*' in Inland Revenue Ordinance (Chapter 112) section 9(4), we have to focus on the meaning of the statute.

93. In D84/03, IRBRD, vol 18, 832 this Board said:

> ' *36. What is at issue is "the amount which a person might reasonably expect to obtain from a sale in the open market at that time of the shares or stock acquired". In our decision, that amount is one which "a person" might reasonably expect to obtain. Significantly, it is not the amount which "the person" or "such a person" or "such person" might reasonably expect to obtain. This suggests that matters personal to the taxpayer are not relevant in computing the gain under section 9(4)(a). This is another reason why the appeal must and does fail.*'

94. We respectfully agree. The personal circumstances of the Taxpayer are not relevant in the construction of Inland Revenue Ordinance (Chapter 112) section 9(4).

95. Accordingly, we conclude that the relevant time for the computation of the Share Option Gain is the time when the Company allotted the shares to the Taxpayer on the date when the Company allotted the shares to the Taxpayer.

Conclusion

96. For the reasons above, we conclude that the CIR's view on the 3 issues as set out in paragraph 6 above is correct.

97. The appeal is therefore dismissed.

98. Lastly, it remains for us to thank counsel for their assistance.