

Case No. D10/08

Salaries tax – share allotment by virtue of employment – discount for moratorium period – sections 8(1)(a), 8(1A)(c), 9(1), 11B, & 68(4) of the Inland Revenue Ordinance ('IRO').

Panel: Colin Cohen (chairman), Thomas Woon Mun Lee and James Mailer.

Date of hearing: 18 March 2008.

Date of decision: 16 May 2008.

In recognition of his efforts and contribution to the employer company, the taxpayer was offered shares of its holding company (Company B) before the listing of Company B on 16 July 2004, at a nominal consideration but with a 24-month moratorium requirement. The trading of the shares was suspended during the moratorium period. The assessor raised on the taxpayer salaries tax on the values of the shares, but allowing a discount of 10% to reflect the 24-month moratorium period imposed on the shares. The taxpayer objected to the assessment and claimed that the value of the shares award assessed was excessive.

Held:

1. It is clear that the shares that were allotted to the taxpayer were arising in or derived from his employment. It is also clear that the shares were advantages that were convertible into money and indeed, the shares by their nature, money's worth and are capable of being converted into money. On acquisition of the shares, the taxpayer became a legal owner and he was entitled to dividend and voting rights identical to all other shares of Company B. However, his right to sell the shares was curtailed during the moratorium period. The bundle of rights were valid and subsisting rights. However, those rights are of value although they may not be as valuable as rights which are totally unfettered. Our conclusion is quite clear that the perquisite arising from the allotment of the shares should be assessed.
2. In our view it is quite clear that no account should be taken of events that actually transpired after the 16 July 2004. Indeed, if the price of Company B increased to new heights or indeed had fallen dramatically, then the value of the bundle of rights (together with the two-year sale restriction) in the shares which were allotted on the 16 July 2004 would still have remained the same. We therefore accept that the suspension in trading is an irrelevant factor. We also accept that in the Determination, a discount of 10% was given for the share price on the 16 July

(2008-09) VOLUME 23 INLAND REVENUE BOARD OF REVIEW DECISIONS

2006 taking into account the two-year sale restriction. Again, we accept that it is not rule of thumb that a 5% discount should be given for each year of a sale restriction, however, no compelling evidence was adduced by the taxpayer on how the shares were to be valued.

Appeal dismissed.

Cases referred to:

David Hardy v Commissioner of Inland Revenue 3 HKTC 245
Abbott v Philbin 39 TC 82
Ede v Wilson 26 TC 381
D120/02, IRBRD, vol 18, 125
D65/06, IRBRD, vol 21, 1174

Taxpayer in person.

Wong Ki Fong and Chan Wai Lin for the Commissioner of Inland Revenue.

Decision

Introduction

1. This is an appeal by Mr A ('the Taxpayer') against the Determination by the Deputy Commissioner of Inland Revenue dated the 3 December 2007 whereby the Deputy Commissioner overruled an objection by the Taxpayer against a salaries tax assessment for the year of assessment 2004/05, showing a net chargeable income of \$347,096 with tax payable thereon of \$58,619 but reduced this to a net chargeable income of \$318,643 with tax payable thereon of \$52,928.

2. The issue for us to determine is whether or not the Taxpayer should be assessed on the shares of Company B which were allotted to him by virtue of his employment with Company C.

3. The facts of this case are not in dispute and indeed they are straightforward. The parties sensibly put forward to us agreed facts upon which the Determination was arrived at and we now set these out:

- '(1) Mr A ['the Taxpayer'] has objected to the Salaries Tax assessment for the year of assessment 2004/05 raised on him. The Taxpayer claims that the value of the shares award assessed was excessive.

(2008-09) VOLUME 23 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (2) By a letter dated 26 November 1999, the Taxpayer was employed by [Company C] as Senior Project Engineer with effect from 20 January 2000.
- (3) By a letter dated 19 May 2004, [Company C] informed the Taxpayer that a new investment holding company, [Company B], would be incorporated for a listing exercise on the Stock Exchange. [Company C] would then be held by [Company B] which listing was anticipated to be by the end of July 2004. In recognition of his efforts and contribution to [Company C], the Taxpayer was offered 135,336 shares in [Company B] [‘the Shares’] at a nominal consideration. The terms of the offer were as follows:
 - (a) The Taxpayer had to confirm in writing that he would not dispose of his share entitlement in [Company B] within a period of two years following the date of transfer [“the Moratorium Requirement”].
 - (b) The Taxpayer’s name would be registered in the register of members of [Company B] maintained in [Country E]. Apart from the Moratorium Requirement, his dividend entitlement and voting right attached with the Shares would be identical to all other shares of [Company B].
 - (c) The share certificate of the Shares would be kept by the company secretary of [Company B] during the two-year moratorium period.
- (4) The Taxpayer signified his acceptance of the offer referred to in Fact (3) by a Confirmation and Acceptance dated 19 May 2004 and agreed to pay Country D’s currency \$1 as the consideration for the Shares.
- (5)
 - (a) By an Instrument of Transfer entered into between [Company F], as the transferor, and the Taxpayer, as the transferee, on 24 May 2004, the Shares were transferred at a consideration of Country D’s currency \$1.
 - (b) [Company B] was listed on the [Country D] Stock Exchange on 16 July 2004.
- (6) By a letter dated 23 July 2004, [Company B] forwarded the share certificate for the Shares to the Taxpayer. On the share certificate, it was stated, inter alia, the following:
 - (a) “THE SHARES COMPRISED HEREIN DO NOT CONSTITUTE GOOD DELIVERY UNTIL AFTER 15 JULY 2006”.

(2008-09) VOLUME 23 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (b) “Given under the Securities Seal of [Company B] on 2ND JULY 2004”.
- (7) (a) [Company C] filed an employer’s return of remuneration and pensions for the year ended 31 March 2005 in respect of the Taxpayer showing, inter alia, the following particulars:
- (i) Capacity in which employed : Senior Manager – Engineering
:
- (ii) Period of employment : 01-04-2004 – 31-03-2005
- (iii) Particulars of income
- | | | |
|------------|---|------------------|
| Salary | : | \$480,000 |
| Bonus | : | 1,000 |
| The Shares | : | <u>117,499</u> |
| Total | : | <u>\$598,499</u> |
- (b) [Company C] later filed an amendment to the employer’s return. The amounts of the Shares and total income were revised to \$98,946 [“The Sum”] and \$579,946 respectively.
- (8) In his Tax Return – Individuals for the year of assessment 2004/05, the Taxpayer declared the same particulars of income as that in Fact (7)(a) above. Against his income, the Taxpayer claimed partial exemption of income from [Company C] of \$125,474 (or RMB 133,200) under section 8(1A)(c) of the Inland Revenue Ordinance [“the Ordinance”].
- (9) The Assessor raised on the Taxpayer 2004/05 Salaries Tax assessment as follows:

Income ¹		\$473,025
<u>Less:</u> Charitable donations	\$ 1,000	
Home loan interest	12,929	
Contributions to recognized retirement schemes	<u>12,000</u>	<u>25,929</u>
Net Assessable Income		447,096
<u>Less:</u> Basic allowance		<u>100,000</u>
Net Chargeable Income		<u>\$347,096</u>
Tax Payable thereon		<u>\$58,619</u>

(2008-09) VOLUME 23 INLAND REVENUE BOARD OF REVIEW DECISIONS

$$^1 \quad \$ (598,499 [\text{Fact (7)(a)}] - 125,474^*) = \$473,025$$

$$^* \quad \text{Income exempted} = \text{RMB}133,200 \div 1.061574 \\ = \underline{\underline{\text{HK}\$125,474}}$$

- (10) The Taxpayer objected to the assessment in Fact (9) on the grounds that the Sum, being the value of the Shares, should be \$98,946 instead of \$117,499 and since he was not allowed to dispose of the Shares until after 15 July 2006, the Shares should not be classified as his income for the year of assessment 2004/05.
- (11) The Assessor revised the Salaries Tax assessment for the year of assessment 2004/05 as follows:

Income ¹		\$454,472
<u>Less:</u> Charitable donations	\$ 1,000	
Home loan interest	12,929	
Contributions to recognized retirement schemes	<u>12,000</u>	<u>25,929</u>
Net Assessable Income		428,543
<u>Less:</u> Basic allowance		<u>100,000</u>
Revised Net Chargeable Income		<u><u>\$328,543</u></u>
Revised Tax Payable thereon		<u><u>\$54,908</u></u>

$$^1 \quad \$ (579,946 [\text{Fact (7)(b)}] - 125,474) = \$454,472$$

- (12) The Taxpayer did not accept the revised assessment in Fact (11) and contended as follows:

“... [Company B’s] share ... is currently on halt at [Country D] stock exchange. As these shares can not be exercise at year 2004-2005 and also do not know how much it will worth eventually (maybe zero). Thus I see no reason to charge me tax for them ...

I am happy to paid tax for these share value based upon the first date and year when they are received and trade-able value....”

- (13) In response to the Assessor’s enquiry, [Company C] provided the following information:
- (a) The Shares were awarded based on length of service and performance.

(2008-09) VOLUME 23 INLAND REVENUE BOARD OF REVIEW DECISIONS

(b) The Taxpayer undertook not to dispose of his share entitlement in [Company B] within a period of two years following the date of transfer.

(c) The value of the Shares, i.e. the Sum, was calculated as follows:

$$\begin{aligned} & \text{Number of shares held x Closing price of the first trading date on 16 July} \\ & \text{2004 x Exchange rate (for Country D's currency)} \\ & = 135,336 \times \text{Country D's currency } \$0.16 \times \text{HK\$}4.5695 \\ & = \underline{\underline{\text{HK\$}98,946}} \end{aligned}$$

(14) The Assessor maintained the view that the Taxpayer should be assessed to tax in respect of the value of the Shares in the year of assessment 2004/05. However, he was prepared to allow a discount of 10% on the Sum to reflect the 24-month moratorium period imposed on the Shares. Accordingly, the Assessor proposed to the Taxpayer that the Salaries Tax assessment for the year of assessment 2004/05 were to be revised as follows:

Income		\$579,946
<u>Less:</u> 10% discount on share		
\$(98,946 x 10%)		<u>9,895</u>
		570,051
<u>Less:</u> Income exempted under section 8(1)(c)		<u>125,474</u>
Net Assessable Income		444,577
<u>Less:</u> Charitable donations	\$ 1,000	
Home loan interest	12,929	
Contributions to recognized retirement schemes	<u>12,000</u>	<u>25,929</u>
Net Assessable Income		418,648
<u>Less:</u> Basic allowance		<u>100,000</u>
Revised Net Chargeable Income		<u><u>\$318,648</u></u>
Revised Tax Payable thereon		<u><u>\$52,929</u></u>

(15) The Taxpayer declined the proposal in Fact (14) and put forth the following arguments:

(a) “(1) Tax is based upon ‘ all income upon year of assessment’ . As these shares are not allowed to exercise until May 2006. It can not be classify as year 2004/05 income.

(2) Below is the update [16th June 2006] extract released from [Country D] stock exchange on [Company B] information:

(2008-09) VOLUME 23 INLAND REVENUE BOARD OF REVIEW DECISIONS

“... [Company G] has conducted a review of [Company B’s] transactions, operations and corporate governance practices. In its report, [Company G] raised certain concerns regarding possible breaches under the Securities and Futures Act ... and other laws in [Country D]. ...

It is the view of [Country D] stock exchange that the market will not be adequately informed about the financial status of [Company B] at this junction. The halt in the trading of [Company B’s] shares will be converted into a trading suspension until further notice.”

As [Company B’s] share is on halt (indefinitely) and likely to end up as scrap. Since I have not received any money nor finance gain from it [nor expected to received anything even after 15th July 2006]. It can not be classify as income.”

- (b) “... I still can not accepted your offer 10% discount due to following reason:-
- (1) Court case Abbott v Philbin [39 TC 82]. It is based upon assumption that a Third Party will provide money to exercise the share option. However as I have not make such arrangement. The assumption is not valid and thus no physical income received can be taxable for the year 2004/05.
 - (2) Review Decision D120/12 (sic): It is based upon assumption that the ‘ sale of the shares in the open market value will have 25% discount’ . However as no such action [sale of the shares option] had ever been consider. Also the shares trading is on suspension reflecting a drop of 100% [Not 25%], again the assumption is not valid. ...”

As your example based upon assumption that does not reflect the truth. I must re-iterate my objection to your tax calculation and can not accepted your offer.”

- (16) (a) The price, in [Country D] dollars, of one share in [Company B] on 16 July 2004 was as follows:

<u>Open</u>	<u>High</u>	<u>Low</u>	<u>Close</u>
-------------	-------------	------------	--------------

(2008-09) VOLUME 23 INLAND REVENUE BOARD OF REVIEW DECISIONS

0.19 0.19 0.16 0.16

(b) [Country D] stock exchange has suspended trading of the shares of [Company B] since 16 January 2006.

(17) The Assessor now agrees to exclude the consideration of Country D's currency \$1 or HK\$4.5695 in Fact (4) and suggests revising the 2004/05 Salaries Tax assessment as follows:

Income		
Salary and bonus [Fact (7)(a)]		\$481,000
The Shares	\$98,946	
<u>Less:</u> 10% discount for the Moratorium Requirement	9,895	
Consideration	<u>5</u>	<u>89,046</u>
		570,046
<u>Less:</u> Income exempted under section 8(1)(c)		<u>125,474</u>
Net Assessable Income		444,572
<u>Less:</u> Charitable donations	1,000	
Home loan interest	12,929	
Contributions to recognized retirement schemes	<u>12,000</u>	<u>25,929</u>
Net Assessable Income		418,643
<u>Less:</u> Basic allowance		<u>100,000</u>
Revised Net Chargeable Income		<u>\$318,643</u>
Revised Tax Payable thereon		<u>\$52,928</u> '

4. Since the above facts were agreed, we find them as facts.

5. The Taxpayer also gave evidence before us. He urged us to take into account the following points:

- (a) He drew to our attention the fact that Company B was suspended from trading and he had not received any money or financial gains from the shares that were allotted to him and indeed, he indicated to us that he did not expect to receive anything. He emphasized that the shares could not be classified as his income.
- (b) He also drew to our attention that the directors and chief financial officer of Company B were arrested by the Hong Kong Independent Commission against Corruption ('ICAC') in September 2007 and there were allegations of

(2008-09) VOLUME 23 INLAND REVENUE BOARD OF REVIEW DECISIONS

irregular financial practices. He also drew to our attention that the shares in the Company B dropped significantly from day one of the listing. He also stated that Company B changed its name to Company H. He provided us with an announcement dated the 13 March 2008 which indicated that Company H was in preliminary discussion for a potential acquisition of the new business, however, nothing so far has yet been agreed. He stated that this company is now a cash shell and as at February 2008, it had a holding of Country D's currency \$1,758,310.17 in cash. He also drew to our attention that in the event of an acquisition not taking place, it is quite likely that the [Country D] stock exchange would delist Company H.

- (c) However, the Taxpayer also confirmed to us that the par value of the shares in Company B allotted to him was HK\$0.15, the closing price of Company B on the first day of its listing on the 16 July 2004 was Country D's currency \$0.16 equated at the relevant exchange rate to HK\$0.73112.
- (d) He also accepted that the shares that were allotted to him were not cancelled as a result of his cessation of employment and there were no changes to the moratorium period of the shares which was up to the 15 July 2006.
- (e) The Taxpayer emphasized to us that there was a moratorium imposed upon him on the shares which prevented him from selling them during the two-year period from the 16 July 2004, hence, he was only able to sell or deal with the shares after the 15 July 2006.
- (f) He stated that the shares had dramatically dropped in price and the value of the shares should not be calculated according to the share price on the issue date and it should not be included in his Salaries Tax for the year of assessment 2004/05.

The law

6. The relevant sections of the Inland Revenue Ordinance ('IRO') are sections 8(1)(a), 9(1)(a) and 11B.

7. Section 8(1)(a) of the IRO provides as follows:

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

(a) any office or employment of profit;

(2008-09) VOLUME 23 INLAND REVENUE BOARD OF REVIEW DECISIONS

8. Section 9(1)(a) of the IRO provides as follows:

‘(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,’

9. Section 11B of the IRO provides as follows:

‘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.’

10. Section 68(4) of the IRO provides as follows:

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

11. Our attention was drawn to the following authorities:

- (a) David Hardy Glynn v Commissioner of Inland Revenue 3 HKTC 245 at 249 and 250 – In that judgment, the Privy Council held that a perquisite includes payment of money and money which can be obtained from property which is capable of being converted into money.
- (b) Abbott v Philbin 39 TC 82 – Again, the House of Lords held that the difference between market price and the option price is a perquisite at the date of grant. The clear test is whether the share option is something which is by nature capable of being turned into money. The House of Lords clearly was of the view that the non-transferability of the option may reduce the value of the option but it cannot alter its character so that it is no longer something which cannot be of its nature turned into pecuniary account.
- (c) Ede v Wilson 26 TC 381 – It was held by the King’s Bench that the share granted subject to an undertaking that it would not be sold without permission from directors is an advantage which is of such a nature that it can be turned into money.
- (d) We also refer to various decisions of the Board of Review:

(2008-09) VOLUME 23 INLAND REVENUE BOARD OF REVIEW DECISIONS

- (i) D120/02, IBRRD, vol 18, 125 - In that case, the Board concluded that a share is the interest of a shareholder in a 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. A share certificate is prima facie evidence of the title of the person named to the shares. There, the Board concluded that the date of allocation of shares, the taxpayer is a legal owner of the shares, the taxpayer's name is entered on the register of shareholders and as such, is entitled to dividends attributable to and the voting rights attached to the shares. Although her right to sell the shares is curtailed in the same manner, they may not be sold for five years from the date of acquisition. The bundle of rights and obligations was vested in the taxpayer at the time of allotment. They included that these are valid and subsisting rights. These rights do have value although they may not be as valuable as rights which are totally unfettered. The Board also concluded that the nature of the rights (which was a five-year restriction against dealings) would of course be relevant in determining the amount which a person might reasonably expect to obtain from a sale in the open market. The Board concluded that the valuation exercise which is to be undertaken is to be considered in the light of the facts of each relevant case.
- (ii) D65/06, IRBRD, vol 21, 1174 - The facts of that case are almost identical with the present appeal which is before us. In that case, the Board concluded as follows:

'18. We are in no doubt that the Shares allotted to the Taxpayer for the nominal consideration of Country E's currency \$1.00 was a perquisite derived by the Taxpayer from his office or employment with the Employer within the meaning of section 9(1)(a) of the IRO. Hence, the Sum, being the value of the Shares, is assessable income for the purpose of salaries tax.

19. We find on the established principles that the fact that the Taxpayer has been prevented from selling the Shares during the moratorium period, the subsequent drop in the trading price of the shares in Company B and the indefinite suspension of trading of those shares on Country E Stock Exchange is a totally irrelevant consideration.'

(2008-09) VOLUME 23 INLAND REVENUE BOARD OF REVIEW DECISIONS

The Board went on to consider the discount which the IRD gave to the value of the shares since they could not be traded for the relevant lock-in period and in paragraph 23, the Board stated that:

'23. We note that in the last-mentioned case the facts are not identical to those in the case before us. We also wonder whether it can be said that a rule of thumb has been established to the effect that a discount of 5% should be given for every year in which shares cannot be sold.'

The Board concluded that the taxpayer in that case had not adduced any evidence on the valuation of the shares and as such, the taxpayer had failed to discharge the burden of proof in that case and therefore, in turn, the Board had no alternative but to dismiss the taxpayer's appeal.

Our analysis

12. Having considered matters carefully, reviewed the evidence and the authorities, it is clear in our view that the shares were allotted to the Taxpayer were arising in or derived from his employment. It is clear that the Taxpayer was employed by Company C, it is in recognition of his efforts and contribution to Company C that the Taxpayer was rewarded 135,336 shares at a consideration of Country D's currency \$1.00. It is also clear that the shares were advantages that were convertible into money and indeed, the shares by their nature, money's worth and are capable of being converted into money. On acquisition of the shares, the Taxpayer became a legal owner, his name was registered on the register of shareholders and he was entitled to dividend and voting rights identical to all other shares of Company B. However, his right to sell the shares was curtailed in the same way that they could not be sold prior to the 16 July 2006. Hence, this bundle of rights was vested in the Taxpayer on the 16 July 2004. They were valid and subsisting rights. However, those rights are of value although they may not be as valuable as rights which are totally unfettered. We accept that the moratorium requirement may reduce the value of the shares although it cannot alter the character so that they are no longer something which can of their nature be turned into pecuniary account. Our conclusion is quite clear that the perquisite arising from the allotment of the shares should be assessed in the year of assessment 2004/05.

13. We now turn our attention to the valuation of those shares. The question for us to consider is what the valuation of the shares on the 16 July 2004 would be, taking into account the moratorium up to the 15 July 2006. In our view, it is quite clear that we accept the submissions by the Inland Revenue Department that no account should be taken of events that actually transpired after the 16 July 2004. Indeed, if the price of Company B increased to new heights or indeed had fallen dramatically, then the value of the bundle of rights (together with the two-year sale restriction) in the shares which were allotted on the 16 July 2004 would still have remained the same. We therefore accept that the suspension in trading is an irrelevant factor. We also accept that in the

(2008-09) VOLUME 23 INLAND REVENUE BOARD OF REVIEW DECISIONS

Determination, a discount of 10% was given for the share price on the 16 July 2006 taking into account the two-year sale restriction. Again, we accept that it is not rule of thumb that a 5% discount should be given for each year of a sale restriction, however, no compelling evidence was adduced by the Taxpayer on how the shares were to be valued. The Taxpayer asserted that the shares should only be valued at HK\$15,000, that is, asserting a 85% discount based on the closing price on the 16 July 2004 because of the two-year restriction, however, this assertion was not supported by any evidence.

14. Accordingly, we have no alternative but to dismiss the Taxpayer' s appeal.