

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D14/90

Salaries tax – share option scheme – method of calculating gain on realisation of share option – sub-sections 9(1)(d) and 9(4)(a) of the Inland Revenue Ordinance.

Panel: William Turnbull (chairman), John Haggarty and Benjamin Kwok Chi Bun.

Date of hearing: 14 February 1990.

Date of decision: 21 May 1990.

The taxpayer was entitled to the benefit of a share option scheme. In October 1987, the taxpayer exercised his option. It was agreed by the taxpayer and the Commissioner that the date of the exercise of the option was 5 October 1987. Unknown to the taxpayer the shares in question were allotted and issued to him on 5 October 1987. The shares certificate was posted to him on 3 November 1987 but was not received by him until 17 November 1987 in Hong Kong. The taxpayer was not able to sell the shares until he received the shares certificate and immediately upon receipt of the shares certificate he gave instructions to sell the shares but with a minimum price. The brokers were not able to sell the shares at that price and eventually on 8 January 1988 the taxpayer sold the shares at a substantially lower price. The taxpayer was assessed to tax on a notional benefit being the difference between the share option exercise price and the market price as at 5 October 1987. In fact the taxpayer did not realise a profit but made a net loss as a result of his exercise of the option. The taxpayer appealed to the Board of Review and submitted that he should not be taxed on a notional gain when he had in fact made a net loss.

Held:

Section 9(1)(d) and 9(4)(a) of the Inland Revenue Ordinance governed the situation and must be applied. The taxpayer had exercised the option on 5 October 1987 and that was the governing date. It was not possible to say that the date of the exercise of the option was when he had sold the shares.

Appeal dismissed.

E C D'Souza for the Commissioner of Inland Revenue.

Taxpayer in person.

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Decision:

This is an appeal by a taxpayer against an additional salaries tax assessment concerning a share option scheme. The facts are as follows:

1. The Taxpayer was employed by A Limited up to and including 8 January 1988. As part of the terms of his employment, the Taxpayer was granted an option on 3 May 1983 to purchase shares in X Limited, a public company registered in England, at a predetermined price.
2. On 5 October 1987, the Taxpayer exercised the option in respect of 15,000 shares at the predetermined price of 82.5 pence per share. The market price of the shares on 5 October 1987 was 140 pence per share.
3. The Taxpayer had physically delivered to his employer the application to exercise the option on 28 September 1987, but according to the terms of the share option scheme, the option was deemed to have been exercised on the date when X Limited received the notice of the exercise of the option and payment of the subscription moneys due. It was accepted by both the Taxpayer and the Commissioner that the date of exercise was 5 October 1987.
4. The share option scheme provided that forthwith upon the exercise of an option, X Limited should make application to the Council of the Stock Exchange in London for admission of the shares to be listed. It was stated that the shares should be allotted and issued not more than twenty-eight days after the exercise of the option.
5. Unknown to the Taxpayer, X Limited had applied in advance to the Stock Exchange in London for admission of the shares and the Stock Exchange in London had granted the necessary permission. Accordingly, no further application was required by X Limited to the Stock Exchange in London.
6. The share option scheme also provided that the Taxpayer must not deal in the shares to be allotted to him until he had applied to a committee for share dealings set up in X Limited and had received from that committee authorisation to deal. When the Taxpayer applied to exercise the option, he also applied to the committee for permission to deal in the shares and written permission was given to him for this purpose dated 5 October 1987 and stated to be valid for the period from 5 October 1987 until 5 November 1987. A subsequent permission to deal in the shares was granted to the Taxpayer to cover the period after 5 November 1987 and included the date when he actually sold the shares.

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7. Unknown to the Taxpayer the 15,000 shares were allotted and issued to him on 5 October 1987 and a share certificate to that effect was issued dated 5 October 1987. This share certificate was despatched by post from the registrar to the Taxpayer and was post marked 3 November 1987. It was not received by the Taxpayer until 17 November 1987 in Hong Kong.
8. The Taxpayer could have given instructions to brokers in London to sell the shares at any date on or after 5 October 1987 though for practical purposes this was impossible because neither his employer, A Limited, nor the public company, X Limited, had informed him of this and being a resident in Hong Kong, no broker or agent in Hong Kong would have accepted his instructions without his having available the share certificate certifying that he was the owner of the shares. To the best of the knowledge, information and belief of the Taxpayer, he could not sell the shares until he received the share certificate in Hong Kong.
9. Immediately upon receipt of the share certificate in Hong Kong, the Taxpayer instructed a bank in Hong Kong to sell the shares on his behalf which it proceeded to do. The Taxpayer stipulated a minimum price of 90 pence per share when he gave instructions on 18 November 1987 but his banker was unable to effect the sale at that price and the Taxpayer was obliged to sell the shares at a price of 82 pence per share on 8 January 1988.
10. When the Taxpayer exercised his option to acquire 15,000 shares, he obtained the subscription moneys by means of a loan from his banker on which he had to pay interest for the period from when he exercised the option up to the date when he sold the shares. The Taxpayer lost a total of \$5,549.65 interest and PDS281.75 being the loss on the sale price of the shares and brokers' commission.
11. Between 5 October 1987 being the date of the exercise of the option and 17 November 1987, being the date on which the Taxpayer received the share certificate, the market price of X Limited shares had plunged from 140 pence per share to between 78 and 81 pence per share.
12. On 6 June 1989, the Taxpayer was assessed to tax on a notional benefit of \$113,995 being the difference between the share option exercise price and the market value as at 5 October 1987 and tax of \$18,809 was assessed thereon.
13. The Taxpayer duly objected to this assessment and by his determination dated 5 August 1989, the Deputy Commissioner upheld the assessment. The Taxpayer then appealed to the Board of Review.

At the hearing of the appeal, the Taxpayer appeared on his own behalf and gave evidence. The Taxpayer submitted that he should not be assessed to tax on a notional

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benefit which he had not in fact received. He pointed out that as a matter of fact, he could not have sold the shares which he received under the share option scheme until after he had received the share certificate in Hong Kong. He submitted that it was wrong and unfair that he should be charged tax when he had received no benefit.

The representative for the Commissioner submitted that though the Commissioner may be sympathetic, he has no power to waive collection of tax no matter how unfair it might be. He drew the attention of the Board to the relevant provisions of the Inland Revenue Ordinance and submitted that the assessment to tax of the notional benefit was correct.

Unfortunately for the Taxpayer, we find ourselves in the same position as the Commissioner and have no alternative but to confirm the assessment against which the Taxpayer is appealing. We consider that it is wrong that the Taxpayer should be taxed upon a notional benefit which he did not and could not receive, but, unfortunately for the Taxpayer, it appears clear to us that this is the meaning of the Inland Revenue Ordinance.

The case is governed by section 9(1)(d) and section 9(4)(a) of the Inland Revenue Ordinance which respectively read as follows:

- ‘9(1)(d) any gain realised by the exercise of ... a right to acquire shares or stock in a corporation obtained by a person as the holder of an office in or an employee of that or any other corporation;’
- ‘9(4)(a) the gain realised by the exercise at any time of such a right as is referred to in paragraph (d) of that sub-section 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;’

These provisions apply specifically to an employee who receives and exercises a share option. Sub-section 9(1)(d) includes in the income of a person any gain realised by the exercise of an option. Section 9(4)(a) then states that the amount to be taxed is a notional amount which is calculated by reference to the difference in the price at the time when the shares are acquired and the subscription price which is paid for the shares.

In the present appeal there is no dispute that the Taxpayer was entitled to exercise a right to acquire shares as part of the terms of his employment, and that he exercised this right. There can be no doubt that as a matter of law the Taxpayer is liable to pay salaries tax on ‘any gain realised by the exercise’ of this right. There is also no doubt that the Taxpayer did not in fact realise any gain because of circumstances beyond his control. However, that is not an answer to the submission made by the representative for the

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Commissioner. What we must look at is whether the Taxpayer made a gain as defined in section 9(4)(a).

The Ordinance uses the word 'time' in section 9(4)(a) and not the word 'date' and we wondered whether it would be possible for us to decide that the word 'time' has a different meaning to the word 'date' in this context. Unfortunately, we cannot see that this is possible. The word 'time' must refer to a specific moment in time and in relation to the exercise of a share option or the acquisition of shares, this must relate to a specific date. We have then considered whether the date (or time) could refer, as suggested by the Taxpayer, to the date on which the Taxpayer received the shares certificate. On the facts before us, we cannot accept any date other than 5 October 1987 as being the relevant date. That was the date on which the Taxpayer was deemed to have exercised the option, the date on which and with effect from which he had permission to deal in the shares, and the date on which the shares were actually issued and allotted to him. The date of receipt of the share certificate cannot be said to be the time when the Taxpayer exercised the right to acquire the shares.

The Inland Revenue Ordinance makes no reference to the Taxpayer being able to deal in shares. Instead section 9(4)(a) specifically refers to 'the exercise at any time of such a right' and then relates the notional sale back to that time. Accordingly the wording of the Ordinance is quite clear and the notional gain must be calculated as at the date when the Taxpayer exercised the share option to which he was entitled. That was clearly 5 October 1987 and no other date.

At the hearing of the appeal, we informed the Taxpayer that in the event of our being obliged to find against him and in favour of the Commissioner, we would place on record that the provisions of the Inland Revenue Ordinance are clearly unfair in circumstances such as the present and express the view that consideration should be given as to whether or not the law should be changed. This we now do. However, this cannot have any retrospective effect and for the reasons given we dismiss this appeal and confirm the assessment against which the Taxpayer is appealing.