

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D46/95

Salaries tax – share option – method of calculating the value of the share option for salaries tax purposes.

Panel: Ronny Wong Fook Hum QC (chairman), Peter R Griffiths and Peter White.

Date of hearing: 4 April 1995.

Date of decision: 10 August 1995.

The taxpayer and the Revenue had failed to agree upon the value of a share option. The matter was referred back to the Board of Review for adjudication.

Held:

After reviewing the evidence and submissions the Board reached a decision as to the way in which to calculate the value of the shares.

Appeal partly allowed.

Doris Lee for the Commissioner of Inland Revenue.

Kenneth K W Lo of Messrs Kenneth K W Lo & Co for the taxpayer.

Decision:

I. THE BACKGROUND

1. We refer to our earlier Decision dated 19 January 1995. The Taxpayer and the Revenue failed to agree on ‘the amount which [the Taxpayer] might reasonably expect to obtain from a sale in the open market’ on 27 May 1992 of the 6,000,000 shares in Company A which the Taxpayer obtained through the share option scheme operated by Company A. The 6,000,000 shares represented less than 1% of the paid up capital of Company A.

2. On 7 April 1992, there was a private placement of 10% of Company A’s issued share capital amounting to 64,000,000 shares at \$2 per share. \$2 represented a discount of 7% of the price at which Company A shares were traded that day.

3. On the day in question (that is, 27 May 1995):

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- (a) 3,656,000 Company A shares were traded. Of these, 734,000 shares were traded at \$2.575; 500,000 shares also at 2.575 and 420,000 shares at \$2.6. Full particulars of the trading on that day are set out in Schedule I annexed hereto.
 - (b) The market condition that day, as described in the Daily Quotations of the Stock Exchange of Hong Kong Limited ['the Daily Quotations'], was as follows:

‘The market regained its ground after initial fall today. As a result of continuous profit-takings early in the morning session, share prices adjusted lower. Upon strong buying support and pushed by individual shares in the afternoon session, share prices regained steadily. The market closed mix with hectic trading for the day’.
4. We have been supplied with statistics in relation to the daily trading volume and the daily unit price of Company A shares for the period between 27 May 1992 to 28 August 1992. They are set out in Schedules II and III annexed hereto.
5. On 20 July 1992, Company A announced its final audited financial statements for the year ended 31 March 1992. As compared with \$80,531,193 being profit for the year ended 31 March 1991, profit for the year ended 31 March 1992 jumped to \$138,693,917.
6. On 21 July 1992:
 - (a) The market condition as described in the Daily Quotations was as follows:

‘The market regained its ground after initial fall today. Share prices seesawed as buyers and sellers fought to take the lead. Individual shares performed well. Most of the share prices varied little. The market closed steady with moderate trading for the day’.
 - (b) 10,328,000 Company A shares were traded in the Stock Exchange that day.
7. On 26 November 1992, Company A announced its interim results for the 6 months ended 30 September 1992. Profit before extraordinary items rose from \$55,085,000 for 6 months ending 30 September 1991 to \$66,007,000 for 6 months ending 30 September 1992.
8. On 30 November 1992:
 - (a) The market condition as described by the Daily Quotations was as follows:

‘As a result of the Sino-British political arguments, selling pressure gradually increased today. Share price dropped sharply. The market closed low with moderately increased trading for the day’.

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(b) 14,596,000 Company A shares were traded in the Stock Exchange.

9. The performance of Company A shares on 27 May 1992, 21 July 1992 and 30 November 1992 can be summarised as follows:

Date	Hang Seng Index [Open/Close]	Volume of Company A Shares Traded	Open \$	High \$	Low \$	Close \$	Slump Effects As contended by the Revenue
27-5-1992	6052/6082	3,565,000	2.575	2.6	2.55	2.6	$(2.6 - 2.55)/2.6 = 1.92\%$
21-7-1992	5986/6010	10,328,000	2.013	2.025	2	2	$(2.025 - 2)/2.025 = 1.23\%$
30-11-1992	5986/5810	14,596,000	1.65	1.69	1.61	1.62	$(1.69 - 1.61)/1.69 = 4.73\%$

II. THE RIVAL CONTENTIONS

1. The Taxpayer placed reliance on various letters written by Mr D, Executive Director of Company B. According to Mr D:

(a) The 'daily transaction volume' of Company A shares between the end of May 1992 to the end of June 1992 was around 2,000,000 shares. 'So in our opinion, in order to sell 6,000,000 shares of Company A in the open market on 27 May 1992, the market price would be adversely affected by 10% to 15%'.

(b) This conclusion was based 'on reviewing of market trend of Company A and according to our experience'.

2. Despite strong suggestions by the Revenue, the Taxpayer did not tender Mr D for cross examination.

3. The Revenue maintained that for the following reasons there is no justification for the 10% to 15% discount as contended by the Taxpayer:

(a) In the last hearing before us the Taxpayer relied on the following instances of private placements in support of his claim of 'slump effects':

Name of shares	% of paid up capital	Discount given
Company C	20%	3.8%
Company D	19.5%	9.5%

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Company E	6.16%	4.43%
Company A	10%	7%

The Revenue argued that in none of these instances was there a discount of more than 9.5%. The Taxpayer responded by pointing out that these instances were mere examples to demonstrate the presence as opposed to the extent of the so-called 'slump effects'. It would be wrong to compare Company A with the other 3 companies as their lines of business are different.

- (b) The Revenue accepted that discount given to buyers through a private placement in a favourable market situation would usually be smaller than discount given in unfavourable market condition. The Revenue further accepted that price fluctuation in selling in the open market is more significant than selling through a private placement. The Revenue however pointed out that the Taxpayer had not adduced any evidence to indicate that market condition on 27 May 1992 was not as favourable as 7 April 1992. There is therefore no reason why the discount applicable for the sale of the 6,000,000 shares on 27 May 1992 should be more than the 7% allowed in favour of institutional investors for the private placement of 10% of Company A's issued share capital on 7 April 1992. In reply the Taxpayer laid emphasis on the preparation required for a successful private placement. No such preparation could be made for sale in the open market.
- (c) The Revenue placed reliance on the 'slump effects' calculated on the basis of the figures that obtained for 21 July 1992 and 30 November 1992 summarised above. 10,328,000 Company A shares were traded on 21 July 1992 with a discount of 1.23%. 14,596,000 Company A shares were traded on 30 November 1992 with a discount of 4.73%. Adding the 6,000,000 Company A shares to the 3,656,000 shares actually traded on 27 May 1992 would only produce 9,656,000 shares – a figure much less than those applicable for 21 July 1992 and 30 November 1992. The Taxpayer did not challenge the manner whereby the Revenue arrived at the 'slump effects' but replied that the figures of 21 July 1992 and 30 November 1992 are not true comparables given the optimistic announcements of Company A shortly before those 2 trade days.

III. OUR DECISION

1. We agree with the Taxpayer that given the favourable announcements of Company A shortly before 21 July 1992 and 30 November 1992, the results of those 2 days do not provide suitable comparables for assessing the market situation on 27 May 1992.
2. We also agree with the Taxpayer that very little assistance can be obtained from results of private placements by other companies in wholly different lines of business.

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3. We disagree with the Taxpayer on the relevance of the private placement of Company A shares on 7 April 1992. Giving every allowance for advance preparation in relation to private placement, one must not lose sight of the fact that 10% of Company A's issued capital was placed on 7 April 1992 whilst the 6,000,000 shares in question amounted to less than 1% of such capital. There is also force in the Revenue's criticisms that the Taxpayer had not seen fit to call Mr D to compare the market conditions between 7 April 1992 and 27 May 1992. The onus of proof is on the Taxpayer. We are not impressed by his attempt to shift that onus on the basis of the bland assertion by Mr D that 10% to 15% discount is appropriate.

4. We would use the 7% discount as our yardstick. Giving every allowance for the distinction between a private placement as opposed to an open market sale and bearing in mind the substantial margin between a 10% as opposed to a less than 1% sale in the context of the market conditions on 27 May 1992, we conclude that the discount of about 4% as conceded by the Revenue is not inappropriate. We would order that the Taxpayer be assessed on the basis of \$2.45 per share.

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SCHEDULE I

Trading of Company A Shares on 27 May 1992

Quantity	Price [\$]
40,000	2.55
224,000	2.575
40,000	2.60
176,000	2.575
20,000	2.60
210,000	2.575
32,000	2.60
10,000	2.575
12,000	2.60
734,000	2.575
40,000	2.60
6,000	2.575
150,000	2.575
2,000	2.60
102,000	2.575
10,000	2.55
500,000	2.575
218,000	2.60
50,000	2.575
80,000	2.60
100,000	2.575
462,000	2.60
20,000	2.575
238,000	2.60
10,000	2.575
120,000	2.60
x50,000	2.575

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SCHEDULE II

Daily Trading Volume Statistics for Company A

Date	Volume
27-5-92	3,656,000
28-5-92	1,140,000
29-5-92	1,242,000
1-6-92	658,000
2-6-92	1,034,000
3-6-92	1,372,000
4-6-92	456,000
8-6-92	3,636,000
9-6-92	1,414,000
10-6-92	438,000
11-6-92	1,942,000
12-6-92	2,266,000
16-6-92	828,000
17-6-92	312,000
18-6-92	1,692,000
19-6-92	558,000
22-6-92	734,000
23-6-92	518,000
24-6-92	1,728,000
25-6-92	714,000
26-6-92	551,000
29-6-92	564,000
30-6-92	476,000
1-7-92	1,416,000
2-7-92	286,000
3-7-92	760,000
6-7-92	1,308,000
7-7-92	3,440,000
8-7-92	1,748,000
9-7-92	1,654,000
10-7-92	2,350,000
13-7-92	3,850,000
14-7-92	4,156,000

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Date	Volume
15-7-92	2,540,000
16-7-92	2,172,000
17-7-92	2,418,000
20-7-92	2,546,000
21-7-92	10,328,000 (Amended according to IRD fax on 16-11-94)
23-7-92	2,824,000
24-7-92	4,275,000
27-7-92	422,000
28-7-92	382,000
29-7-92	1,160,000
30-7-92	2,762,000
31-7-92	1,512,000
3-8-92	1,134,000
4-8-92	934,000
5-8-92	3,190,000
6-8-92	3,876,000
7-8-92	1,288,000
10-8-92	3,568,000
11-8-92	1,628,000
12-8-92	1,646,000
13-8-92	734,000
14-8-92	1,700,000
17-8-92	1,682,000
18-8-92	1,264,000
19-8-92	2,650,000
20-8-92	920,000
21-8-92	320,000
24-8-92	130,000
25-8-92	284,000
26-8-92	568,000
27-8-92	938,000
28-8-92	2,620,000

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SCHEDULE III

Daily Share Price Statistics for Company A

Date	Open	High	Low	Close
27-5-9	2.5750	2.6000	2.5500	2.6000
2				
28-5-9	2.5500	2.5750	2.5250	2.5500
2				
29-5-9	2.5380	2.5750	2.5000	2.5500
2				
1-6-92	2.5250	2.5500	2.5000	2.5000
2-6-92	2.4750	2.5000	2.4500	2.4750
3-6-92	2.4880	2.5000	2.4750	2.4750
4-6-92	2.4630	2.4750	2.4500	2.4750
8-6-92	2.4130	2.4500	2.3750	2.4000
9-6-92	2.3750	2.4000	2.3500	2.3750
10-6-9	2.3500	2.3750	2.3250	2.3500
2				
11-6-9	2.3130	2.3250	2.3000	2.3250
2				
12-6-9	2.4000	2.4500	2.3500	2.4250
2				
16-6-9	2.4250	2.4500	2.4000	2.4000
2				
17-6-9	2.1430	2.4250	2.4000	2.4000
2				
18-6-9	2.3380	2.4000	2.2750	2.2750
2				
19-6-9	2.3000	2.3250	2.2750	2.3000
2				
22-6-9	2.3130	2.3500	2.2750	2.3000
2				
23-6-9	2.3000	2.3250	2.2750	2.3000
2				
24-6-9	2.3130	2.3500	2.2750	2.3000

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2				
25-6-9	2.3130	2.3250	2.3000	2.3250
2				
26-6-9	2.3250	2.3500	2.3000	2.3250
2				
29-6-9	2.3250	2.3500	2.3000	2.3250
2				
30-6-9	2.3250	2.3500	2.3000	2.3250
2				
1-7-92	2.2500	2.3000	2.2000	2.2250
2-7-92	2.2250	2.2500	2.2000	2.2250
3-7-92	2.1750	2.2250	2.1250	2.1500

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6-7-92	2.0630	2.1250	2.0000	2.0250
7-7-92	2.0200	2.0500	1.9900	2.0250
8-7-92	2.0750	2.1000	2.0500	2.1000
9-7-92	2.0500	2.1000	2.0000	2.0250
10-7-9	2.0500	2.1000	2.0000	2.1000
2				
13-7-9	2.1880	2.2750	2.1000	2.2250
2				
14-7-9	2.1880	2.2500	2.1250	2.1500
2				
15-7-9	2.1750	2.2000	2.1500	2.1750
2				
16-7-9	1.1750	2.2000	2.1500	2.1500
2				
17-7-9	2.1000	2.1250	2.0750	2.1000
2				
20-7-9	2.0500	2.1000	2.0000	2.0250
2				
21-7-9	2.0130	2.0250	2.0000	2.0000
2				
23-7-9	1.9500	2.0000	1.9000	1.9300
2				
24-7-9	1.8600	1.9200	1.8000	1.8000
2				
27-7-9	1.8350	1.8700	1.8000	1.8500
2				
28-7-9	1.9150	1.9600	1.8700	1.9400
2				
29-7-9	1.9450	1.9700	1.9200	1.9400
2				
30-7-9	1.8600	1.9400	1.7800	1.7800
2				
31-7-9	1.8700	1.9200	1.8200	1.9100
2				
3-8-92	1.9650	1.9800	1.9500	1.9700
4-8-92	1.9700	1.9800	1.9600	1.9700

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5-8-92	1.9830	2.0250	1.9400	2.0000
6-8-92	2.0630	2.1000	2.0250	2.0500
7-8-92	2.0130	2.0250	2.0000	2.0250
10-8-9	2.0130	2.0250	2.0000	2.0250
2				
11-8-9	2.0130	2.0250	2.0000	2.0250
2				
12-8-9	2.0080	2.0250	1.9900	1.9900
2				
13-8-9	1.9750	1.9900	1.9600	1.9700
2				
14-8-9	1.9600	1.9700	1.9500	1.9600
2				
17-8-9	1.9600	1.9700	1.9500	1.9500
2				

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18-8-9	1.9250	1.9500	1.9000	1.9000
2				
19-8-9	1.8650	1.8900	1.8400	1.8500
2				
20-8-9	1.8100	1.8500	1.7700	1.8000
2				
21-8-9	1.7900	1.8000	1.7800	1.8000
2				
24-8-9	1.8100	1.8400	1.7800	1.7800
2				
25-8-9	1.7750	1.8000	1.7500	1.7700
2				
26-8-9	1.7850	1.8000	1.7700	1.7800
2				
27-8-9	1.7500	1.7600	1.7400	1.7400
2				
28-8-9	1.7400	1.7500	1.7300	1.7500
2				