Case No. D4/91

Salaries tax – share purchase option – termination of employment – compensation payment by employer – whether compensation taxable as income arising from employment.

Panel: William Turnbull (chairman), John C Broadley and Lincoln Yung Chu Kuen.

Date of hearing: 21 November 1990.
Date of decision: 19 April 1991.

The taxpayer was employed and was entitled to a stock option as part of the terms of his employment. The taxpayer resigned his employment. Prior to his resignation a dispute arose between the taxpayer and the employer with regard to the exercise of the stock option. The matter was settled by the employer paying to the taxpayer compensation to cover the loss which the taxpayer had suffered through his not being able to exercise the stock option at an earlier date. The taxpayer was able to exercise the stock option at a later date and made a substantial profit. The assessor assessed the taxpayer to salaries tax on the compensation payment made to him. He also assessed him to tax on a notional gain on the exercise of the option as opposed to the actual gain made by the taxpayer. The taxpayer appealed to the Board of Review.

Held:

The assessor was correct in assessing the compensation payment which arose from the employment of the taxpayer. It was a perquisite or emolument of the taxpayer for his services. With regard to the calculation of the quantum of the gain to be taxed when the taxpayer did in fact exercise the option, the assessor was correct in assessing a notional gain as required by the Inland Revenue Ordinance. However regard must be had to the actual circumstances and the taxpayer had actually realised the gain which the Ordinance was intended to calculate. The Ordinance calculated what a person could reasonably expect to receive and in this case the taxpayer had exercised the option and had actually received what a person could reasonably expect to obtain. The assessment was confirmed with regard to the compensation payment but was remitted back to the Commissioner to amend the quantum of the gain on the exercise of the option. Brokerage, stamp duty and other necessary charges should be deducted from the gross profits.

Appeal allowed in part.

[Editor's note: This decision can usefully be read in conjunction with D14/90 reported at page 131 of this volume where the same issue of section 9(4)(a) arises.]

Cases referred to:

Hochstrasser v Mayes 38 TC 673
Glynn v CIR 3 HKTC 245
Bird v Martland 56 TC 89
Burmah Steam Ship Co Ltd v CIR 16 TC 67
Commissioner of Taxation (NSW) v Meeks 19 CLR 568
Weight v Salmon 19 TC 174
Abbott v Philbin 39 TC 82

G P Bach for the Commissioner of Inland Revenue.
Taxpayer in person.

Decision:

This is an appeal by a taxpayer against a salaries tax assessment for the year of assessment 1988/89. The Taxpayer claims that an employee share purchase option has been incorrectly assessed to salaries tax. The facts are as follows:

1. The Taxpayer was employed by X Limited commencing on 15 February 1985. At the time when the Taxpayer commenced his employment, he was given a stock option for shares by X Limited.

2. During the year of assessment 1988/89, the employment of the Taxpayer was terminated when he resigned. Prior to his resignation, a dispute appears to have arisen between the Taxpayer and X Limited with regard to the stock option entitlement of the Taxpayer. He claimed that for a variety of reasons he had not been able to exercise the stock option in early 1988. Prior to his resignation, he had informed X Limited that he considered that he had incurred a commercial loss in the amount of US$175,000 based on a decline in the price of the stock option shares in early 1988. He claimed that he had not been able to exercise the option until 15 September 1988 and following his exercise of the option, he had immediately sold the shares at a profit. However, the profit which he made was in his opinion substantially below the profit which he would have been able to make if he had been able to exercise the option in early 1988 as he claimed he was entitled to have done.

3. The Taxpayer made a claim against his employer prior to his resignation for compensation in relation to his alleged inability to exercise the option. When he resigned his employment, X Limited in accepting his resignation, offered to

pay him a cash sum of $686,368.25 in settlement of the claim which he was making against X Limited in connection with the option. He accepted this offer made by X Limited.

4. When filing his tax return for the year of assessment 1988/89, the Taxpayer offered for assessment the profit he had made when he exercised the share option in September 1988 and had sold the shares which he acquired thereby. However, he did not offer for assessment the sum of $686,368.25 compensation which he had received from X Limited and he informed the assessor that this sum comprised damages awarded to him as the result of the failure of X Limited to meet their contractual obligations to him with respect to the stock option. He informed the assessor that the money paid to him by X Limited was compensatory damages for the commercial loss he had suffered by not being able to exercise his option in early 1988 as he had originally requested.

5. The assessor assessed the Taxpayer to salaries tax and included the sum of $686,368.25 and a notional gain of $561,000 on the exercise of the option.

6. The Taxpayer lodged objection against the inclusion of the $686,368.25 in the calculation of his assessable income on the grounds that this sum did not constitute gain from the exercise of a share option but was compensation paid to him because of his inability to exercise the share option. He also challenged the calculation of the gain on the exercise of the option which he said should be the actual profit he made and not a notional profit.

7. The Deputy Commissioner by his determination dated 6 July 1990 accepted that the compensation payment of $686,368.25 was not a gain realised by the exercise of a right to acquire shares. However, he was of the opinion that the sum was liable to be assessed to salaries tax by virtue of sections 8(1) and 9(1)(a) of the Inland Revenue Ordinance. He decided that the payment was of an income nature because the payment by X Limited to the Taxpayer had its origin in the contractual employment terms of the Taxpayer. The Deputy Commissioner was of the opinion that the payment was either a gratuity or a perquisite within the meaning of the Inland Revenue Ordinance.

8. The Deputy Commissioner considered that in accordance with the wording of section 9(4)(a) of the Inland Revenue Ordinance the reference point for the calculation of the gain on the exercise of the option should be the time at which the right to acquire shares is exercised and not the time at which a taxpayer subsequently sells the shares. The Deputy Commissioner directed that the objection made by the Taxpayer failed and that the salaries tax assessment raised against the Taxpayer should be amended so that the total assessable income was $2,114,730 with tax payable thereon of $327,783.

9. The Taxpayer duly appealed against the Deputy Commissioner's determination to this Board of Review.

At the hearing of the appeal, the Taxpayer appeared in person. He reviewed the facts as set out in the Deputy Commissioner's determination and as contained in copies of various letters which were produced before the Board and related to the dispute which he had had with X Limited regarding the stock option. He submitted that the case of Hochstrasser v Mayes 38 TC 673 was the relevant authority for the decision of his case. He said that the Hochstrasser case established that payments made by an employer to an employee are not necessarily all subject to tax. He said that the Hochstrasser case established the principle that where an employee has received from his employer a benefit in money, that benefit is a profit of his employment and taxable unless it has been received for a consideration other than the giving of services. He said that this point was reinforced by section 8(1A)(a) of the Inland Revenue Ordinance which specifically refers to 'income derived from services rendered'.

He drew our attention to the final question in the Hochstrasser case which he says was whether the money received by the taxpayer in that case was a profit from his employment. He said that the decision of the court was that it was not for the simple reason that it was not a remuneration or reward or return for the individual's services in any sense of the word.

The Taxpayer went on to submit that in his own particular case, the mere fact of an amount coming from his employer to himself did not make the payment of an income nature. He said that the payment which he received did not in fact result in a gain to him but was rather to mitigate a loss which he had suffered by virtue of his being unable to exercise his stock option at the time at which he was entitled to exercise it. He said that had he been able to exercise it in March 1988 as he had requested and was entitled to do, the gain which he would have made would have been greatly in excess of the amount of compensation actually paid to him by X Limited and that amount would indeed have been taxable. He went on to point out that the money which he received was not a gratuity or perquisite and was not a reward for his services because the payment he received was not a contractual payment but was compensatory damages.

With regard to the second point under appeal, namely, the quantum of the gain which should be assessed to tax in respect of the profit on the exercise of the option he drew our attention to section 9(4)(a) of the Inland Revenue Ordinance which states that the gain to be taxed is 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. He pointed out when he had exercised his option, he had informed X Limited that he wished to liquidate the shares in their entirety upon receipt thereof and had authorised X Limited to sell all of the shares 'at best'. He said that the shares had actually been issued to him on Friday, 9 September 1988 and had been sold on the earliest possible date thereafter, namely Thursday, 15 September 1988, which was only three working days later and was in his opinion a reasonable time for processing

between the issue date and the sale date. He drew our attention to the fact that the gain was defined by the Inland Revenue Ordinance as the amount which a person might reasonably expect to obtain from a sale in the open market. He said that this meant the amount which a person might reasonably expect to obtain net of all brokerage, stamp duty and other similar charges.

The representative for the Commissioner submitted that the Taxpayer was wrong on both counts. He drew our attention to the Privy Council decision in Glynn v CIR 3 HKTC 245. He said that the payment received by the taxpayer from his employer was clearly a perquisite or emolument and that it arose directly from the taxpayer's contract of employment. He cited the decision of Bird v Martland 56 TC 89 where compensation paid to employees on the withdrawal of motor cars was held to be a perquisite of employment.

The Commissioner's representative then referred us to Burmah Steam Ship Co Ltd v CIR 16 TC 67. That case involved the taxability of damages for loss of profits claimed by a shipping company on the late delivery of a ship after repair. He then cited to us Commissioner of Taxation (NSW) v Meeks 19 CLR 568 where compensation paid in an ordinary commercial contract entered into in the normal course of the taxpayer's business operations had been considered. In referring to the Hochstrasser case, the representative for the Commissioner pointed out that the compensation payment in that case was a payment to compensate for a capital loss and not for a perquisite from employment.

With regard to the calculation of the gain in respect of the exercise of the option by the Taxpayer in September, the representative for the Commissioner drew our attention to the wording of section 9(1)(d) of the Inland Revenue Ordinance. He went on to cite to us section 9(4)(a). He said it was not disputed that the Taxpayer had made a gain but pointed out that section 9(4)(a) required the gain to be computed at the time of exercise of the right and not when the shares were sold. The representative for the Commissioner then referred us to the case of Weight v Salmon 19 TC 174 and Abbott v Philbin 39 TC 82. He pointed out to us that the legislation is seeking to tax notional profit at the moment in time when the taxpayer acquires the shares and that the Inland Revenue Ordinance does not anticipate any actual sale nor any expenses incurred by any actual sale. The Inland Revenue Ordinance specifically refers to a notional profit and not an actual profit.

Having heard the detailed submissions by both the Taxpayer and the representative for the Commissioner, and having carefully reviewed the facts as set out by the Commissioner and which were not disputed before us and also as contained in the documents tabled before us, we are of the opinion that the money which was paid by X Limited to the Taxpayer as compensation for the inability of the Taxpayer to exercise his stock option has a direct relationship to his contract of employment, is of an income nature and is subject to assessment to salaries tax. We appreciate and understand the submission made by the Taxpayer but we cannot agree with him that the payment made by the employer does not arise directly from the contract of employment. The Taxpayer agreed with his employer that he would be remunerated in a particular fashion. This fashion included his right to a stock option. Apparently, the Taxpayer and the employer both agreed that because

of something done or omitted to be done by the employer, the Taxpayer had not received the full financial rewards and benefits of his employment contract. The employer agreed to pay the employee a lump sum to compensate the employee. This lump sum relates directly to the services which the employee performed under his employment contract and as such is clearly taxable. The Taxpayer in his submission both to us and previously to the assessor and Deputy Commissioner had placed great reliance upon the Hochstrasser case. In our opinion that case has little relevance to the facts before us. It is clear that the Hochstrasser case related to a capital loss incurred by the respondent outside of his employment. The case before us is a payment by an employer to an employee as compensation because the employee has not received the full benefits to which he is entitled under his employment contract for the services which he has rendered. It is clearly a perquisite or emolument of the employee for his services.

We now turn to the second question to be decided by us. This relates to the quantum of the gain to be taxed when the Taxpayer did in fact exercise the option. We agree with the Commissioner's representative when he says that the Inland Revenue Ordinance seeks to tax a notional gain and not an actual gain. However, the notional gain is not an academic gain but is stated by the Inland Revenue Ordinance to be the amount which a person might reasonably expect to obtain from a sale in the open market at the time when he exercises the option. The section of the Ordinance does not relate to the date on which the option is exercised. It relates to the 'time' when the option is exercised. In our opinion, the use of the word 'time' as opposed to the word 'date' and the inclusion of the words 'which a person might reasonably expect to obtain' mean that one is to take a realistic attitude and not a theoretical attitude. One is to look at the question in reality and in substance. One must decide what a person could reasonably expect to have received if he had exercised the option and sold the shares as quickly as possible in the open market. In the present case, we are of the opinion that the Taxpayer actually realised what the Ordinance lays down as the notional amount. There can be no better test of what a person might reasonably expect to receive by the sale of shares received by him when he exercises an option than if he in fact does sell the shares immediately when he exercises the option. It is clearly impossible to sell the shares on the same day that the option is exercised because the recipient of the shares has not actually received them. However, there is nothing to stop the Taxpayer, as he did in fact in this case, from giving instructions to the person providing shares, the employer in this case, to sell the shares immediately in the open market. This he did and we agree with him that three working days is not an unreasonable period of time for the said shares to be sold. Apparently the price which he received for the shares when he sold them in the open market was less than the quoted price on the day when the option was exercised. We do not know the reason for this and it is not necessary for us to speculate. However, we would draw attention to the fact that if a substantial number of shares are placed in the market when such shares are thinly traded or where there is only a nominal price being quoted, the actual price which may be received can be significantly less than the price previously appearing on the board at the stock exchange. We only mention this point as being one of many possible reasons why a person is unable to realise a quoted price for the shares which he has received even if he sells them as quickly as possible in the open market. Clearly the Inland Revenue Ordinance intends to try to tax a taxpayer on a profit on the value of the benefit which he

receives and which approximates the profit which he would make if he sold the shares as quickly as possible. In this case, the Taxpayer did sell the shares as quickly as possible and there were no unusual circumstances which would lead us to decide that the price actually received by the Taxpayer was anything other than the amount which under section 9(4)(a) of the Inland Revenue Ordinance a person might reasonably expect to have received if he had sold the shares at the time that he exercised the option.

For the reasons given we find against the Taxpayer on the first limb of his appeal and in favour of the Taxpayer on the second limb of his appeal. We accordingly direct that the assessment appealed against be referred back to the Commissioner to be amended accordingly, namely, to include therein the amount of $686,368.25 being the compensation paid by the employer to the Taxpayer and which we have held to be assessable to salaries tax, and to re-assess the taxable gain of the Taxpayer on the exercise of the option from the assessed sum of $561,000 to the sum of $452,612 being the net amount of the gain realised by the Taxpayer. It should be noted that we have confirmed that the amount is the net amount after payment of stamp duty, brokerage and other charges. Section 9(4)(a) of the Inland Revenue Ordinance clearly refers to the difference between the amount which a person might reasonably expect to obtain from a sale in the open market of the shares and the cost thereof. A person who sells quoted shares can only expect to obtain the net proceeds of sale and cannot reasonably expect to obtain the gross proceeds of sale. To sell shares which are publicly quoted on the stock exchange in Hong Kong means accepting the payment of stamp duty, brokerage and any other necessary charges.