

## INLAND REVENUE BOARD OF REVIEW DECISIONS

### Case No. D6/02

**Salaries tax** – computation of gain arising from the exercise of right to acquire shares – sections 9(4)(a) and 68(4) of the Inland Revenue Ordinance ('IRO').

Panel: Kenneth Kwok Hing Wai SC (chairman), Barry J Buttifant and Arthur Chan Ka Pui.

Date of hearing: 16 March 2002.

Date of decision: 30 April 2002.

The appellant's employer was the wholly owned subsidiary of a listed company ('Company A'). Shares in Company A were traded on the Hong Kong Stock Exchange. The appellant on 23 February 2000 exercised the subscription rights to subscribe for 500,000 shares in Company A at the subscription price of \$0.36 and the subscribed shares were allotted to the appellant on 1 March 2000. The market price of \$1.53 per share was adopted in computing the relevant gain which was reported in the employer's return.

The appellant objected to the salaries tax assessment raised on him and claimed that the amount of notional gain arising from the exercise by him of his right to acquire shares should be zero. It was the appellant's case that the shares were not sent to him until mid-March and that he was issued one share certificate for 500,000 shares. The appellant further argued that he was not allowed by the boss to sell his option shares.

#### **Held:**

1. The computation of the gain is governed by section 9(4)(a). Section 9(4)(a) dictates that the Board must ascertain 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.
2. The Board did not believe all the assertions of the appellant and found that the Commissioner was not incorrect in adopting the figure for the price of the shares. The appellant has not discharged the onus under section 68(4) of proving that the assessment appealed against is excessive or incorrect.

**Appeal dismissed.**

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Chow Cheong Po for the Commissioner of Inland Revenue.

Taxpayer in person.

### **Decision:**

1. This is an appeal against the determination of the Commissioner of Inland Revenue dated 5 November 2001 whereby the salaries tax assessment for the year of assessment 1999/2000 under charge number 9-1456472-00-7, dated 10 November 2000, showing net chargeable income of \$623,900 with tax payable thereon of \$95,563 was confirmed.

### **The admitted facts**

2. The following facts are admitted by the Appellant and we find them as facts.
3. The Appellant has objected to the salaries tax assessment for the year of assessment 1999/2000 raised on him. The Appellant claimed that the amount of notional gain arising from the exercise by him of his right to acquire shares should be zero.
4. At the relevant time, the Appellant's employer was the wholly owned subsidiary of a listed company ('Company A'). Shares in Company A ('the Shares') were traded on the Hong Kong Stock Exchange.
5. The employer's return of remuneration and pensions for the year ended 31 March 2000 in respect of the Appellant filed by the Appellant's employer disclosed the following particulars:

Period of employment:	1-4-1999 to 31-3-2000
Capacity in which employed:	Executive director- business development
Income –	\$
Salary	327,600
Bonus	27,300
Gain realized from share option scheme	<u>585,000</u>
	<u>939,900</u>

6. In his tax return for the year of assessment 1999/2000, the Appellant declared the following income accrued to him during the year ended 31 March 2000:

<b>Employer</b>	<b>Capacity employed</b>	<b>Amount</b>
The Appellant's	Executive director	\$
	Income	327,600

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employer	Bonus	27,300
	Share option gain (not yet sold)	<u>          </u> <u>          </u>
		<u>          </u> <u>354,900</u>

7. The assessor raised on the Appellant the following salaries tax assessment for the year of assessment 1999/2000:

	\$
Income [paragraph 5]	939,900
<u>Less: Home loan interest</u>	<u>100,000</u>
	839,900
<u>Less: Married person's allowance</u>	<u>216,000</u>
Net chargeable income	<u>623,900</u>
Tax payable thereon	<u>95,563</u>

8. The Appellant objected against the salaries tax assessment for the year of assessment 1999/2000 on the ground that there was no gain realized by the exercise of the relevant share options.

9. In amplification of his ground of objection, the Appellant contended the following in his letter dated 15 November 2000:

- (a) He exercised his share options for 500,000 of the Shares at a price of \$0.36 per share at the end of February 2000.
- (b) Market price of \$1.53 per share was adopted in computing the relevant gain which was reported in the employer's return.
- (c) '[Company A] has on many occasions argued that because of the low volume of shares traded in the market, it does not give a true reflection of the value of the shares. This argument has been accepted by the Stock Exchange in allowing [Company A] to transact in a much lower value than the then "market price" on several occasions.'
- (d) 'Recent volume of [the Shares] traded on the Stock Exchange prior to my taking up the share options:

<u>Month</u>	<u>No. of shares</u>
November 1999	104,000
December 1999	740,000

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January 2000	1,366,000
February 2000	4,900,000'

- (e) 'In addition to the above, [Company A] announced in the newspaper on 29 February 2000, that [the Offeror] was to subscribe for 310,000,000 new shares at a price of 20 cents per share ... This represents more shares transacted than in the whole of last year or even the last few years of [the Shares] trading on the Stock Exchange. In substance it reflects the "true" value of the shares in that it is the market price being paid by a third party at arms length negotiation for a substantial portion of [Company A], giving it majority voting control – representing approximately 54% of the shares of [Company A].'
- (f) 'On 15 March 2000 a circular was issued to all shareholders to this effect ... The "market price" of the shares was then \$1.67 per share – at 23 February 2000 as noted in the circular, yet the transaction was allowed to proceed at 20 cents per share.'
- (g) 'As a result of this and as a consequence to the effect of the Takeover Code (as more than 35% of [Company A's] share capital was acquired), a general offer was made to all minority shareholders by a circular dated 11 April 2000 for their shares at 20 cents per share ... All this indicate that the fair market price of the share is somewhere close to/or is 20 cents per share. If not, then there is a major problem as the minority shareholders would have been prejudiced with the offer of 20 cents per share.'
- (h) 'I believe [Company A] made an error in valuing the shares [at \$1.53 per share] and accordingly, I have used 20 cents per share as fair market value in concluding that there is no taxable income from this.'
- (i) '... with such a substantial share transaction that would trigger a Takeover Offer, this is the best support in valuing [the Shares] rather than the value in a very thinly traded market on the Stock Exchange.'
- (j) '[Company A], The Stock Exchange and Independent Financial Advisors have all accepted that the fair market value was 20 cents per share ... You have to accept the fair market value of 20 cents per share as this is what the majority of [the Shares] were valued at when it was traded (by a new issue) – by the major acquisition of shares that triggered the takeover offer.'

10. The Appellant provided, among others, copies of the following documents in support of his claim:

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- (a) Extract from Newspaper B dated 29 February 2000 containing a joint announcement dated 28 February 2000 made by Company A and the Offeror that they had entered into a subscription agreement on 23 February 2000 pursuant to which the Offeror had conditionally agreed to subscribe for and Company A had conditionally agreed to issue and allot 310,000,000 new shares at an issue price of \$0.2 per subscription share [see paragraph 9(e) above].
- (b) Front page of letter dated 15 March 2000 issued by Company A to the shareholders and the holders of the options regarding the subscription of new shares by the Offeror [see paragraph 9(f) above].
- (c) Unconditional cash offers dated 11 April 2000 made by the financial advisers to the Offeror on behalf of the Offeror for all the issued shares in and outstanding options of Company A [see paragraph 9(g) above]. This document contained, among others, the following:
  - (i) Letter dated 11 April 2000 from the board of directors of Company A to the independent shareholders and the holders of outstanding options regarding the above unconditional cash offers.
  - (ii) Letter dated 11 April 2000 from the independent financial advisers to the independent board committee of Company A regarding the above unconditional cash offers. This letter contained, among others, an analysis on the price performance and liquidity of the Shares during the relevant period (see pages 34 to 37 of the document).

11. The letter of the independent financial advisers [paragraph 10(c)(ii) above] contained the following passage:

‘ ... we believe that the significant surge in the Share prices since January 2000 and up to 23 February 2000 may be prompted by market speculations that [Company A] was subject to similar [takeover] activities at that time.

The closing prices further soared to the highest of HK\$2.8 per Share on 29 February 2000, being the first trading day immediately after the issue of the Announcement. We consider that the increase in the market prices of the Shares after the issue of the Announcement would have probably been stimulated by investors’ short-term expectations that the Offeror would bring new perspective to the Group...’

12. In response to the assessor’s enquiry, the Appellant’s employer provided the following information and documents:

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- (a) Copy of subscription form signed by the Appellant on 23 February 2000 for exercising the subscription rights to subscribe for 500,000 shares in Company A at the subscription price of \$0.36 and payment of \$180,000 as the subscription price.
- (b) The 500,000 subscribed shares were allotted to the Appellant on 1 March 2000.
- (c) Copy of letter dated 29 February 2000 issued by Company A to its registrar regarding the issue of shares under share option scheme. It was stated that the allotment date for the shares was 1 March 2000.
- (d) The share option gain reported was computed by  $\$500,000 \times (\$1.53 - \$0.36) = \$585,000$ , where \$1.53 was the average closing price for March 2000.

13. The assessor ascertained from Hong Kong Exchanges and Clearing Limited that on 23 February 2000, 246,000 of the Shares were traded on the Hong Kong Stock Exchange. On that date, the price of the Shares traded rose from \$1.1 up to \$1.67 when trading was suspended as from 11:00 a.m. Full records of transactions on 23 February 2000, 29 February 2000 and 1 March 2000 were at appendix G to the determination.

### **The appeal**

14. The Appellant's grounds of appeal were set out in his notice of appeal dated 25 December 2001.

15. He appeared in person at the hearing of the appeal. At the end of his evidence and arguments, we told the parties that we were not calling on the Respondent and that we would be giving our decision in writing which we now do.

### **Our decision**

16. Section 9(1)(d) and (4)(a) of the IRO provides that:

‘ 9. (1) *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.*

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...

(4) *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’ .*

17. The computation of the gain is governed by section 9(4)(a). No useful purpose will be served by using words or phrases which are not in the provision itself in place of the statutory wording.

18. There is no dispute about the amount or value of the consideration given for the Appellant’s 500,000 option shares. He paid \$0.36 per share.

19. Section 9(4)(a) dictates that we must ascertain 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. To do so, we must decide the date when the Appellant acquired the 500,000 shares.

20. In our decision, he acquired the shares on or about 1 March 2000 when the 500,000 shares were allotted to him.

21. The Appellant has not produced any document in support of his assertions, which we do **not** believe, that the Shares were not sent to him until mid-March and that he was issued one share certificate for 500,000 shares.

22. 1,250,000 shares were traded on 1 March 2000 at prices between \$2.9 and \$2.125 and the closing price was \$2.325. 386,000 shares were traded on 2 March 2000 at prices between \$2.325 and \$1.98 and the closing price was \$1.98. 4,000 shares were traded on 3 March 2000 at \$1.98. 162,000 shares were traded on 6 March 2000 at prices between \$1.56 and \$1.41 and the closing price was \$1.56. These figures show that the Commissioner was not incorrect in adopting the figure of \$1.53 for 500,000 shares and that the net proceeds which a person might reasonably expect to obtain from a sale in the open market at that time of the shares or stock acquired would be not less than \$1.17 (\$1.53 - \$0.36) per share.

23. We **disbelieve** the Appellant’s assertion that he was not allowed by the boss to sell his option shares. What he declared in his tax return in respect of the share option gain was ‘not yet

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sold' (see paragraph 6 above). Not only was there no mention of any prohibition against sale or restriction on sale in his letter of objection dated 15 November 2000, he asserted in that letter that:

‘I, as I am sure with most of the other share option holders, decided to exercise the share options with a view that [the Shares’] price would be increased in the future with inclusion of a new majority shareholder who has substantial experience in the e-commerce business. In addition, there is new injection of working capital to [Company A] by the share issue.’

24. The Appellant claimed that he had returned the shares ‘back to the company’. What he did with his option shares after he had bought from the market another 230,000 shares in Company A in February 2001 is irrelevant to the computation of the gain under section 9(4)(a).

25. The Appellant has not discharged the onus under section 68(4) of proving that the assessment appealed against is excessive or incorrect. We dismiss the appeal and confirm the assessment as confirmed by the Commissioner.