Case No. D62/06

Salaries tax - notice of appeal filed without Determination – whether a valid notice of appeal – Determination filed out of time – whether extension of time applicable to filing of Determination – consideration for granting of extension of time – sections 66(1)(a) and 66(1A) of the Inland Revenue Ordinance ('IRO').

Notional gain from exercise of shares option on private unlisted shares – whether concept ludicrous – whether notional gain unsubstantiated by open market value wrong – sections 8, 9(1)(d), 9(1)(4) and 68(4) of the IRO.

Panel: Anna Chow Suk Han (chairman), Patrick James Harvey and Ho Kai Cheong.

Date of hearing: 13 June 2006.
Date of decision: 29 November 2006.

For the year of assessment 2000/01, the Taxpayer claimed that the amount assessed as gain realized by the exercise of his right to acquire shares in Company B, a private company, was excessive.

The taxpayer lodged his notice of appeal without the Determination by fax on 17 March 2006, the last day for his filing the same to the Board. The Board subsequently received the missed out Determination on 23 March 2006.

The Revenue contended that the assessment of the notional gain by the taxpayer from his exercise of share options was correct.

As a preliminary issue, the Revenue submitted that the notice of appeal was out of time and no extension of time could be granted to validate it.

Held:

Preliminary issue

1. The taxpayer's notice of appeal, filed without the Determination, was not a valid notice of appeal under section 66(1)(a).

2. Section 66(1A) provides only for extension of time to file a notice of appeal. The Board has no jurisdiction to grant extension of time to file the Commissioner's determination and other specified documents.

3. Even if the Board has jurisdiction, the taxpayer has failed to show that he was prevented from appealing in time due to illness, absence form Hong Kong or other reasonable causes under section 66(1A).

Substantive issue

4. Section 9(4)(a) of the IRO taxes notional gain and not actual gain.

5. The taxpayer, under the Stock Option Agreement, had all the rights as a stockholder once the shares were registered in his name.

6. The phrase 'an open market' in section 9(4)(a) of the IRO is not confined to 'stock market' or 'free market'.

7. In absence of evidence to the contrary, the determination of US$5 per share by the board of directors was the fair market value of the shares.

8. The 25% discount given by the Commissioner was fair and reasonable taking into account the various pre-emptive rights of Company B.

9. The taxpayer failed to prove that the notional gain as assessed is excessive or incorrect.

Appeal dismissed.

Cases referred to:

Chow Kwong Fai, Edward v CIR, IRBRD, vol 20, 484
D9/79, IRBRD, vol 1, 354
D11/89, IRBRD, vol 4, 230
D3/91, IRBRD, vol 5, 537
D32/99, IRBRD, vol 14, 345
D57/99, IRBRD, vol 14, 506
D48/05, IRBRD, vol 20, 638
D128/99, IRBRD, vol 15, 16
D14/90, IRBRD, vol 5, 131
D43/99, IRBRD, vol 14, 448

D120/02, IRBRD, vol 18, 125
D4/91, IRBRD, vol 5, 542
D84/03, IRBRD, vol 18, 832

Taxpayer in person.
Wong Kai Cheong and Lai Wing Man for the Commissioner of Inland Revenue.

Decision:

1. Mr A ('the Taxpayer') objected to the salaries tax assessment for the year of assessment 2000/01 raised on him. The Taxpayer claimed that (1) his employment income should be apportioned on a time basis such that only the income derived from services rendered in Hong Kong should be chargeable to salaries tax and (2) the amount assessed as gain realized by the exercise of his right to acquire shares was excessive.

2. By his determination dated 17 February 2006 ('the Determination'), the Deputy Commissioner of Inland Revenue ('the Commissioner') determined that (1) the Taxpayer should be assessed in full under section 8(1) of the Inland Revenue Ordinance ('IRO') in respect of his income from his employment with Company B and (2) the Taxpayer was correctly charged to salaries tax in respect of the notional gain derived by him from the exercise of share options by him.

3. By a letter to the Clerk to the Board of Review of 15 March 2006, the Taxpayer served his notice of appeal in respect of the Determination, in which he stated that he had abandoned his claim on apportionment of salaries tax on time-basis but he was still pursuing his objection against the assessment of notional gain realized by the exercise of his right to acquire shares. He further stated that in the interest of time, he would forward the supporting paper (including the IRA documentation) later.

4. By a letter of 17 March 2006, the Clerk to the Board informed the Taxpayer that since his notice of appeal was not accompanied by the Determination, his application could not be entertained and should he wish to appeal in accordance with section 66(1) of the IRO, he should forthwith comply with the requirements.

5. At the hearing of the Taxpayer's appeal on 13 June 2006, as a preliminary issue, the Revenue submitted that the Taxpayer's appeal was out of time and no extension of time could be granted to the Taxpayer to validate the appeal.

6. Thus, before we are to deal with the substantive issue on the Commissioner's Determination on the notional gain realized by the Taxpayer's exercise of his right to acquire shares, we first deal with the preliminary issue.

A. The relevant statutory provision

7. Section 66 of the IRO deals with a taxpayer's right of appeal to the Board. It provides as follows:

> *(1) Any person (hereinafter referred to as the appellant) who has validly objected to an assessment but with whom the Commissioner in considering the objection has failed to agree may within –*
>
> *(a) 1 month after the transmission to him under section 64(4) of the Commissioner's written determination together with the reasons therefor and the statement of facts; or*
>
> *(b) such further period as the Board may allow under subsection (1A),*
>
> *either himself or by his authorized representative give notice of appeal to the Board; but no such notice shall be entertained unless it is given in writing to the clerk to the Board and is accompanied by a copy of the Commissioner's written determination together with a copy of the reasons therefor and of the statement of facts and a statement of the grounds of appeal.*
>
> *(1A) If the Board is satisfied that an appellant was prevented by illness or absence from Hong Kong or other reasonable cause from giving notice of appeal in accordance with subsection (1)(a), the Board may extend for such period as it thinks fit the time within which notice of appeal may be given under subsection (1). This subsection shall apply to an appeal relating to any assessment in respect of which notice of assessment is given on or after 1st April 1971.*
>
> *(2) The appellant shall at the same time as he gives notice of appeal to the Board serve on the Commissioner a copy of such notice and of the statement of the grounds of appeal.*
>
> *(3) Save with the consent of the Board and on such terms as the Board may determine, an appellant may not at the hearing of his appeal rely on any grounds of appeal other than the grounds contained in his statement of grounds of appeal given in accordance with subsection (1).*

B. Case law

7. The Revenue produced the following legal authorities in support of the submission that the Taxpayer's appeal was out of time and no extension of time could be granted to the Taxpayer to validate the appeal.

1. Court of Appeal

Chow Kwong Fai, Edward v CIR, IRBRD, vol 20, 484

2. Board of Review decisions

(a) D9/79, IRBRD, vol 1, 354
(b) D11/89, IRBRD, vol 4, 230
(c) D3/91, IRBRD, vol 5, 537
(d) D32/99, IRBRD, vol 14, 345
(e) D57/99, IRBRD, vol 14, 506
(f) D48/05, IRBRD, vol 20, 638

C. The Taxpayer's case

8. At the hearing, the Taxpayer explained that he only lodged his notice of appeal to the Board by fax on 17 Mach 2006 because during the period between 17 February 2006 and 24 March 2006 he had to make frequent travels and furthermore, he was then focusing on his new job where he needed to prove his abilities. Upon receiving the letter of 17 March 2006 from the Clerk to the Board, he immediately sent a copy of the Determination to the Board by post on or before 21 March 2006. During the hearing, he did not claim that he sent a set of appendices of the Determination to the Board.

9. At the end of the hearing, the Taxpayer asked for time to make his submission in writing. The Board acceded to his request. Accordingly, the Board received the Taxpayer's written submission on 26 June 2006, which included a submission on the preliminary issue. In his written submission, the Taxpayer claimed that his travelling commitments during the working hours of 17 March 2006 had prevented him from delivering to the Board the Determination together with the reasons therefor and the statement of facts; contrary to the Revenue's allegation, he did not receive the letter of 17 March 2006 of the Clerk of the Board by fax but he received it by post only in the evening on or about 20 or 21 March 2006; the Determination together with a full set of appendices was sent to the Board and was received by the Board on 23 March 2006; and upon receiving the letter of the Clerk of the Board of 24 March 2006 which requested for a full set of appendices of the Determination, he immediately telephoned the office of the Board when a Miss Liu of the office of the Board confirmed that the Board had already received the Determination together with a full set of appendices and she confirmed that it was not necessary for him to send another set of the Determination and appendices. It should be noted at this juncture that the aforesaid allegations were never made by the Taxpayer before or at the hearing. Neither did he

give evidence to this effect or in this regard and thus, he was not cross-examined on the aforesaid assertions. Furthermore, he submitted that due to his ignorance of the law, he failed to appreciate that 'a notice of appeal' meant 'a notice of appeal accompanied by a copy of the Commissioner's written determination together with the reasons therefor and the statement of facts' and inadvertently construed that he could deliver the Commissioner's written determination and other documents to the Board subsequent to the giving of the notice of appeal.

D. Finding of facts

10. Having carefully perused and considered all the documentary and oral evidence before us and the oral and written submissions of both parties, we have found the following facts in relation to the preliminary issue.

11. By a letter of 17 February 2006, the Commissioner informed the Taxpayer that he was unable to agree to the Taxpayer's objection to the assessment and at the same time he sent to the Taxpayer the Determination, the reasons for his decision and a statement of the facts upon which the Determination was arrived at. In the letter the Commissioner also set out in detail the Taxpayer's rights, the procedures and time limit in lodging an appeal to the Board.

12. By a letter of 15 March 2006 sent by the Taxpayer to the Clerk to the Board by facsimile on 17 March 2006, the Taxpayer gave to the Clerk to the Board his notice of appeal. He did not however sent together with this letter a copy of the Determination. A copy of this letter was produced to us on which was stamped the word 'FAXED' and the number 'xxxxxxxx'. The number 'xxxxxxxx' was the Taxpayer's facsimile number.

13. By a letter of 17 March 2006, the Clerk to the Board informed the Taxpayer that his letter of 15 March 2006 was received by his office on 17 March 2006 through facsimile but his application could not be entertained because his letter was not accompanied by a copy of the Determination and should he wish to appeal in accordance with section 66(1) of the IRO, he should forthwith ensure due compliance of the necessary requirements.

14. On 23 March 2006, the Board received the Determination from the Taxpayer.

15. By a letter of 24 March 2006, the Clerk to the Board informed the Taxpayer, inter alia, that he had not sent to the Board a full set of appendices of the Determination and that the Determination was not received by the Board until 23 March 2006.

16. By another letter of 8 May 2006, the Clerk to the Board informed the Taxpayer that the Board still had not received a full set of appendices of the Determination and requested the Taxpayer to send the same on or before 29 May 2006 for the Board's perusal.

17. Up to the date of the hearing, the Board had not received a full set of the appendices of the Determination.

18. The record provided by the Immigration Department shows that the Taxpayer was only absent from Hong Kong on the whole day of 10 March 2006 during the period between 18 February 2006 and 18 March 2006.

19. By a memorandum of 13 April 2006, the postmaster general replied to the Commissioner's enquiry on the registered mail item No.RR xxx xxx xxx HK which was sent by the Commissioner on 17 February 2006 to the Taxpayer at the address of Address C, and he also sent a copy of the receipt of the registered item to the Commissioner showing the date of delivery of the said registered mail item as 18 February 2006. The aforesaid letter of the Commissioner to the Taxpayer of 17 February 2006 was duly delivered to the Taxpayer at his address at Address C on 18 February 2006.

E. Analysis

20. Under Section 66(1)(a) of the IRO, an appellant may, within one month after the transmission to him the Commissioner's written determination together with the reasons therefor and the statement of facts, give notice of appeal to the Board. In the present case, we have found that the Commissioner's Determination dated 17 February 2006, together with the other necessary documents was delivered to the Taxpayer at his address in Address C on 18 February 2006. Thus, the last day for the Taxpayer to file his notice of appeal fell on 17 March 2006. It is not in dispute that the Taxpayer's letter to the Board dated 15 March 2006, purportedly giving notice of his appeal was sent by the Taxpayer to the Board by facsimile on 17 March 2006. It is also not in dispute that the purported notice of appeal was sent without the Determination and the Determination was subsequently received by the Clerk to the Board on 23 March 2006.

21. In the circumstances, the first question for the Board to decide is whether or not the purported notice of appeal served on 17 March 2006, without the Determination, was a valid notice of appeal under section 66(1)(a), and if not, whether or not the Board may grant the Taxpayer an extension of time to file the Determination, and other relevant documents and, it not, whether or not the Board should extend the time for the Taxpayer to file a notice of appeal against the Determination.

22. Having carefully perused section 66 of the IRO and the authorities produced, in particular, the Board of Review Case No 48/05, we are of the view that the purported notice of appeal served by the Taxpayer on 17 March 2006, without the Determination, was not a valid notice of appeal under section 66(1)(a). Section 66(1)(a) provides that 'no such notice [of appeal] shall be entertained unless it is given in writing to the Clerk to the Board and is accompanied by a copy of the Commissioner's written determination together with' the other requisite documents. Similar to section 82B(1) of the IRO, which deals with notice of appeal against assessment for

additional tax, this section also draws a distinction between a notice of appeal and the documents which must accompany it. It also provides that no notice of appeal shall be entertained unless it is in writing and be accompanied by the Commissioner's determination and other requisite documents. Thus, on the construction of the section, a failure to comply with the section is not a mere irregularity but would render a notice of appeal ineffective. We concur that the Taxpayer's purported notice of appeal without the Determination as required by law is not a valid notice of appeal and secondly the Board has no jurisdiction to extend the time for filing the required documents, because section 66(1) of the IRO clearly states that a notice of appeal shall not be entertained unless it is given in writing and is accompanied by a copy of the Commissioner's determination and other specified documents and section 66(1A) of the IRO provides only extension of time to file a notice of appeal and not the Commissioner's determination and other specified documents.

23. After concluding that firstly the Taxpayer's notice of appeal of 17 March 2006 without the Determination was not a valid notice of appeal under section 66(1)(a) of the IRO and secondly the Board has no jurisdiction to grant an extension of time to file the requisite documents, there remains the last question as to whether the Board should grant an extension of time for the Taxpayer to appeal.

24. As submitted by the Revenue, the Board is constituted under the IRO, it only has such powers as are conferred by the IRO. The Board's authority to grant an extension of time to file an appeal is limited to the conditions specified in sub-section (1A) of section 66, namely that *'the Board is satisfied that an appellant was prevented by illness or absence from Hong Kong or other reasonable cause from giving notice of appeal in accordance with subsection (1)(a)'*. In order to succeed in an application for an extension of time to file the appeal, it is not sufficient for the taxpayer merely to prove that his failure to appeal in time was due to illness, absence from Hong Kong or other reasonable cause. He must also satisfy the Board that he was prevented by such illness, absence or reasonable cause to lodge an appeal within the stipulated time.

25. On the evidence submitted, we have found that the Taxpayer has failed to discharge the burden on him to show that he was prevented by illness, absence from Hong Kong or other reasonable cause to lodge an appeal within the one month period stipulated by law.

26. From the information provided by the Immigration Department to the Revenue on the Taxpayer's movement during the period between 18 February 2006 and 18 March 2006, the Taxpayer was only absent from Hong Kong on the whole day of 10 March 2006, and he only travelled out of Hong Kong on 7, 9, 11 and 17 March 2006 respectively. The Taxpayer was in Hong Kong most of the time during the relevant period. Thus, we are not satisfied that he was prevented to file the notice of appeal within time due to his absence from Hong Kong.

27. The Taxpayer asserted that during the relevant time, he was under pressure of work and had little personal time to compile his notice of appeal and his failure to send the Determination with his notice of appeal was due to his lack of experience and ignorance of the law. It has been

established in previous Board of Review cases that pressure of work, lack of experience or ignorance of the law, does not constitute a reasonable cause upon which an extension of time should be granted. We prescribe to this established view.

28. Consequently, the Taxpayer's application for extension of time to file a notice of appeal must be dismissed.

29. Not having an appeal before us, we need not deal with the merits of the appeal. However, if we need to deal with them, we would have found that the Taxpayer has also failed to satisfy us on the substantive issue.

30. The reasons are briefly stated below.

31. The substantive issue is whether the Taxpayer was correctly charged to salaries tax in respect of the notional gain derived by him from the exercise of share options by him.

32. The facts relevant to the substantive issue are as follows:

(a) The Taxpayer commenced his employment with Company B on 31 July 2000. Company B was a company incorporated in Country D in June 1999. Pursuant to a share option plan established in 1999 ('the Plan'), Company B could grant share options to employees of the group to subscribe for shares in Company B.

(b) On 13 October 2000, the Taxpayer exercised his option under two grants at the exercised price of US$1.2 and US$4 per share respectively. A total of 45,000 shares in Company B were registered under his name upon the exercise of his right of share options. Company B was operated as a privately-held company until November 2003. Under the Plan, the board of directors of Company B had the full and final power and authority to determine the fair market value of the Plan shares. The board of directors of Company B determined that the fair market price of the share was US$5 per share at the material time. Following the merger between Company B and another company in November 2003, the shares in Company B were traded in the Exchange E of Country D.

(c) Before Company B had gone public, it did not issue any share certificates to employees under the Plan since its shares were not openly traded in the market. Instead, the shares were held in escrow by attorneys of Company B.

(d) The Taxpayer did not have rights as a stockholder with respect to the shares covered by the option until the date of the issuance of a certificate for the shares for which the option has been exercised (as evidenced by the appropriate entry on the books of the company or of a duly authorized transfer agent of the

company). Pursuant to the Plan, the Taxpayer was entitled to deal with the shares granted under the Plan but subject to Company B' s right of exercising of 'Unvested Share Repurchase Option' and 'Right of First Refusal' before Company B went public.

33. The Taxpayer objects to the assessment of notional gain realized by the exercise of his right to acquire shares in pursuance of the Plan. He contends that the concept of notional gain as it related to his circumstances is, in and of itself, impossible to substantiate and any attempt to tax an individual on a 'nonexistent' gain in any transaction is simply ludicrous. He further contends that since Company B was not a public company at the material time and its shares were not listed and traded in any stock exchange, there could not be any open market for the shares. He also objects to the Commissioner using the fair market value determined by the board of directors of Company B on the date he exercised the option as the amount which he might reasonably expect to obtain from the exercise of his option. He contends that the Commissioner has failed to take into account a condition in the Stock Option Agreement that an optionee has no right as a stockholder with respect to any shares covered by the option until the date of the issuance of a certificate for the shares for which the option has been exercised and that he was not issued with any share certificates in respect of his shares and he had no voting rights and/or entitlement to any dividends declared, if any, in respect the shares as a stockholder.

34. The relevant statutory provisions of the IRO are:

Section 8 of the IRO

'(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; and
(b) any pension.'

Section 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.

…..…

(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;…'

Section 68(4)

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

35. Section 9(4)(a) of the IRO seeks to tax a notional gain and not an actual gain. Former Board of Review cases have established the following principles: as the assessment is based on a notional gain, the fact that the taxpayer could not realize such gain because of circumstances beyond his control are not relevant considerations (D128/99, IRBRD, vol 15, 16 and D14/90, IRBRD, vol 5, 131); there is a difference of opinion as to whether the material time for the purpose of assessing the notional gain is the date of exercise of the right to acquire the shares (D14/90, IRBRD, vol 5, 131) or the date of acquisition of the shares (D43/99, IRBRD, vol 14, 448); in any case, both views do not suggest that the collection of a share certificate by the taxpayer is the material time referred to in section 9(4)(a) of the IRO (D120/02, IRBRD, vol 18, 125); in assessing the notional gain one has to look at the position in reality and in substance, not theoretically; 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 (D4/91, IRBRD, vol 5, 542); any matters personal to the taxpayer are not relevant in computing the gain under section 9(4)(a) of the IRO (D84/03, IRBRD, vol 18, 832).

36. We accept that section 9(4)(a) of the IRO is to tax notional gain and not an actual gain and the material time for the purpose of assessing the notional gain is either the date of exercise of the right to acquire shares or the date of acquisition of the shares. In the present case, the Taxpayer exercised his right to acquire the shares on 13 October 2000 and was registered as a shareholder of 45,000 shares upon the exercise of his right. When the Taxpayer received the share certificate of those shares is the material time for the purpose of assessing the notional gain. The notional gain of the Taxpayer should be assessed in the year of assessment 2000/01 since the exercise of right and the acquisition of shares occurred at the same time. The Taxpayer' s contention that he had no rights as a stockholder until the issuance of a certificate for those shares is unsustainable. Pursuant to Clause 10 of the Stock Option Agreement, the Taxpayer had all the rights as a

stockholder once the shares were registered in his name or the shares were transferred to Company B's agents. The Taxpayer had all the rights of a stockholder although some of those rights were restricted by certain provisions of the Stock Option Agreement. As to the Taxpayer's contention that there was no open market for his shares because at the material time Company B was not a public company, it is clear from the wordings of section 9(1)(d) of the IRO that any gain realized does not apply only to gains from shares of public companies. We also accept the submission on behalf of the Commissioner that 'an open market' in section 9(4)(a) does not confine to a 'stock market' or 'free market'. As to the fair market value of the shares, we note that it is a term under the Plan that the board of directors of Company B shall have the full and final power and authority to determine the fair market value of the shares. Apart from mere assertions of the Taxpayer that the market price of the shares determined by the board of Company B was entirely arbitrary, there is no evidence before us that the price determined by the board of Company B was not the market price of the shares under the circumstances of the company. Thus, the market value of US$5 per share as determined by Company B should be the basis upon which the fair market value of the shares can be reached. We accept the discount of 25% given by the Commissioner as fair and reasonable under the circumstances, taking into account of the facts that the shares were subject to a vesting schedule and that the transfer of the shares were restricted by pre-emptive right employed by Company B.

37. Consequently, if we need to decide on the merits of the substantive issue, we would have concluded that the Taxpayer has failed to discharge the onus upon him under section 68(4) of the IRO to prove that the notional gain as assessed is excessive or incorrect.