

INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D66/94

Salaries tax – share option scheme – date of exercise of option – value of option.

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

Date of hearing: 21 November 1994.

Date of decision: 19 January 1995.

The taxpayer was entitled to the benefit of a share option scheme operated by his employer. The shareholder gave notice of his exercise of the option on 26 May 1992. On 27 May 1992 payment was made of the subscription price and the share registrar was instructed to issue the shares. The shares were not sold by the taxpayer until August and November in the same year by which time the price of the shares had fallen substantially. The taxpayer submitted that the option had been exercised when the shares were traded by him and that in the alternative the share price should be discounted because of the number of shares involved and thin trading. The assessor was of the opinion that the option had been exercised for salaries tax purposes on 27 May 1992 and that the relevant price should be \$2.55 being the lowest price that the share traded on that day.

Held:

Board of Review decision D14/90 should be followed. The relevant date was 27 May 1992. However the sale of a significant number of shares on one day would have had an adverse but not dramatic effect on the share price. Accordingly the price should be discounted down from \$2.55.

Appeal remitted to the Board for determination.

Case referred to:

D14/90, IRBRD, vol 5, 131

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 FACTS

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1. On 20 March 1991, Company A adopted a share option scheme. The rules of the scheme provide:

- (a) By clause 2 that the directors of Company A may 'offer to an eligible person an option to subscribe for such number of shares as they may determine at the option price during the option period'. 'Eligible person' is defined to mean 'any executive director or employee of the company or a subsidiary'.
- (b) By clause 4.1 that Company A shall on the date of grant of the option issue option certificates.
- (c) By clause 7.1 that:

'In order for exercise of an option to be effective, the secretary of the company must, prior to the expiry of the option period, have received:

- (i) a written notice (which may be endorsed on the option certificates) exercising the option ...
- (ii) option certificates sufficient to cover the number of shares in respect of which the option is being exercised; and
- (iii) payment in full of the subscription price.

Unless otherwise agreed between the company and the option holder, shares in respect of an option shall be issued to the option holder or his nominees within 30 days of the date upon which exercise of an option becomes effective (being the date of such receipt).'

2. Pursuant to these provisions, the directors of Company A on 14 October 1991 granted to the Taxpayer an option in respect of 6,000,000 shares at \$1.28. The option period spanned between 14 October 1991 and 31 March 1994. The option certificate stipulated that 'if the option holder intends to exercise the option before 31 March 1994, such exercise of the option shall be subject to the approval of the board of director of the company ...'

3. The Taxpayer became a director of Company A on 28 February 1992. As at 31 March 1992, he held 400,000 shares of Company A in his own name and 26,636,880 shares of Company A through a company.

4. On 26 May 1992, the Taxpayer gave notice to Company A of his intention to exercise his option in respect of the full 6,000,000 shares. This was approved by the directors of Company A on the same day.

5. On 27 May 1992:

- (a) The Taxpayer paid the full subscription price of \$7,680,000.

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- (b) Company A gave instructions to its share registrar to issue share certificate to the Taxpayer.
 - (c) At the Stock Exchange, shares of Company A opened at \$2.575; with high at \$2.6 and low at \$2.55 closing at \$2.6.
 - (d) 3,656,000 shares of Company A were traded. Of these, 734,000 shares were traded at \$2.575; 500,000 shares also at \$2.575 and 462,000 shares at \$2.6.
6. The Taxpayer did not receive his certificate until July 1992.
7. The Taxpayer effected the following sales of Company A shares:

Date	No. of shares	Unit Price (\$)	Consideration (\$)
6-8-1992	1,000,000	2.025	2,025,000
6-8-1992	500,000	2.05	1,025,000
7-8-1992	500,000	2	1,000,000
7-8-1992	500,000	2.025	1,012,500
28-8-1992	2,000,000	1.75	3,500,000
30-11-1992	1,500,000	1.62	2,430,000

8. After deducting his expenses of \$70,513.12 and his subscription price of \$7,680,000, the Taxpayer made an actual profit of \$3,241,986.88. The Taxpayer maintains that it is this figure that attracts salaries tax.

9. The Revenue contends otherwise. The Revenue maintains that the relevant date is 27 May 1992 and that the relevant price is \$2.55 being the lowest price that shares of Company A traded on that date.

II. THE STATUTORY PROVISIONS

1. Section 8(1) of the Inland Revenue Ordinance (the IRO) provides that:

'Salaries tax shall, ... , 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) *...'*

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2. Section 9(1) provides that:

'Income from any office or employment includes:

(a) ...

(b) ...

(c) ...

(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.'*

3. Section 9(4) provides that:

'For the purposes of subsection (1):

(a) *the gain realised by the exercise at any time of such a right as is referred to in paragraph (d) of the 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.'*

III. THE ISSUES

1. This appeal raises 2 questions:

(a) What is the relevant point of time for the purpose of section 9(4)? The Revenue contends for 27 May 1992 whilst the Taxpayer argues in favour of the dates of actual sales.

(b) What is the amount which the Taxpayer might reasonably expect to obtain from a sale in the open market at the relevant point of time? If 27 May 1992 is the relevant date, the Revenue says the unit rate should be \$2.55. The Taxpayer disagrees on the basis that sale of 6,000,000 shares of Company A must have further dampening effect on the price.

2. In relation to the second question, the Taxpayer tenders before us a letter from a securities company (Company B) dated 18 August 1994. Company B expressed the opinion that 'when a large volume of shares is traded in the stock market and such volume is unusual (sic) large as compare with the daily transaction volume, it may result in a significant fluctuation in the share price'. Company B observed that between the end of May 1992 to the end of June 1992, the daily transaction volume of shares of Company A was around \$2,000,000. Company B therefore took the view that \$2.55 'may not be the price that might be reasonably expect to obtain in the stock market at that date'. Company B was not called as a witness before us.

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IV. OUR DECISION

1. On the first question, it is regrettable that neither side has drawn our attention to the decision of this Board D14/90, IRBRD, vol 5, 131. That decision is directly in point and the learned chairman there said:

'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 the circumstances beyond his control. However, that is not an answer to the submission made by the representative for the Commissioner. What we must look at is whether the taxpayer made a gain as defined in section 9(4)(a).

The IRO 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 IRO 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 IRO 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.'

2. We respectfully agree with the reasoning of the learned chairman in D14/90. On the facts in our case, the relevant date can only be 27 May 1992. On that date, Company A had received the notice exercising the option; the option certificates and the subscription price. Clause 7.1 of the scheme expressly provides that to be the 'date upon which exercise of an option becomes effective'.

3. What then is the 'amount which a person might reasonably expect to obtain from a sale in the open market' on 27 May 1992? We agree with the Taxpayer that the sum

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of \$2.55 adopted by the Revenue is not one that the Taxpayer might reasonably expect to obtain from a sale in the open market that day. Whilst we appreciate that the statements of Company B have not been tested by cross examination, we take the view that those statements are not inept when one takes into account the volume of shares traded on 27 May 1992; the volumes traded between 27 May 1992 to 28 August 1992 and the fact that the price for Company A shares was on a general decline.

4. The Taxpayer has not ventured to put forward any figure. We would give the parties an opportunity to reach agreement on this issue with an indication that on the evidence currently before us we are of the view that whilst sale of the portfolio would certainly have its impact on the market price, such impact is unlikely to be dramatic. In the absence of agreement between the parties within 1 month from delivery of this decision, the matter should be restored before us for our determination.