INLAND REVENUE BOARD OF REVIEW DECISIONS

Case No. D84/03

Salaries tax – gain realised from exercise of share option – time for computation – whether matters personal to appellant relevant – section 9 of the Inland Revenue Ordinance ('IRO').

Panel: Kenneth Kwok Hing Wai SC (chairman), Chow Wai Shun and Vincent Kwan Po Chuen.

Dates of hearing: 24 and 25 October 2003.
Date of decision: 11 December 2003.

The appellant was a director of a subsidiary of a listed company (Listco). The appellant was granted an option to acquire 2,500,000 shares in Listco at the price of $0.63.

On 29 April 2000, Saturday, the appellant exercised the option. The closing prices of the shares in Listco on the proceeding trading day, i.e. 28 April 2000, and on the following trading date, i.e. 2 May 2000, were $2.80 and $2.95 respectively.

In his tax return, the appellant included a gain realised under the share option scheme of $5,425,000 [($2.80 - $0.63) x 2,500,000]. It was accepted by the assessor.

Later, the appellant wanted to correct the amount of the gain but was refused.

The appellant contends that he was not able to sell the option shares until 25 May 2000 because of the insider dealing provisions. Thus, the correct date for computation of the gain should be 25 May 2000.

Held:

1. Even if the Board assumed in favour of the appellant that he was governed by these provisions, there was no evidence that he possessed unpublished price sensitive information. If the appellant possessed such information, he would have to include it in the announcements published by Listco for 28 April 2000 to 25 May 2000. However, there was no such announcement.

2. Section 9 provides that the gain realised by the exercise of an option to acquire shares 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 acquired

and the amount of the consideration given. The Board held that matters personal to the appellant are not relevant in computing the gain.

Per incurium

The relevant time of computation of the gain should be actually that the time the share could be acquired from the open market, i.e. 2 May 2000, rather than the time the option was exercised, i.e. 29 April 2000. (D14/90 considered and disapproved; D43/99 followed). Therefore, the correct amount of the gain should have been $5,800,000 [($2.95 - $0.63) x 2,500,000] instead.

Appeal dismissed.

Cases referred to:

D14/90, IRBRD, vol 5, 131
D4/91, IRBRD, vol 5, 542
D6/91, IRBRD, vol 5, 556
D66/94, IRBRD, vol 9, 373
D43/99, IRBRD, vol 14, 448
D128/99, IRBRD, vol 15, 16
D76/88, IRBRD, vol 4, 136

Fung Ka Leung for the Commissioner of Inland Revenue.
Joseph Fu Chi Kwong of Messrs Deloitte Touche Tohmatsu for the taxpayer.

Decision:

1. This is an appeal against the determination of the Commissioner of Inland Revenue dated 25 June 2003 whereby the assessor' s notice of refusal, dated 15 May 2002, to correct the salaries tax assessment for the year of assessment 2000/01 pursuant to section 70A of the IRO, was upheld and the salaries tax assessment for the year of assessment 2000/01 under charge number 9-0584984-01-8, dated 27 August 2001, showing assessable income of $7,750,900 with tax payable thereon of $1,162,635 was confirmed.

The agreed facts

2. The facts in the 'Facts upon which the determination was arrived at' in the determination were agreed by the parties and we find them as facts. For the purpose of our decision, the following account suffices.

3. The Appellant objected to the assessor' s notice of refusal to correct the salaries tax assessment for the year of assessment 2000/01 raised on him, arguing that the amount assessed as the gain realised by the exercise of his right to acquire shares was excessive.

4. On 6 June 1991, a listed company ('Listco') adopted a share option scheme pursuant to which Listco could grant options to employees of the group to subscribe its shares.

5. At the relevant times, the Appellant was a director of a wholly owned subsidiary of Listco.

6. On 23 July 1997, Listco granted to the appellant the option to acquire 2,500,000 shares in Listco at the price of $0.63 per share during the option period from 23 January 1998 to 22 July 2000.

7. On 29 April 2000, Saturday, the Appellant exercised the option to acquire 2,500,000 shares in Listco at the price of $0.63 per share. The closing prices of the shares in Listco on the preceding trading date, that is, 28 April 2000, and on the following trading date, that is, 2 May 2000, were $2.80 and 2.95 respectively.

8. By a confirmation dated 4 May 2000, the Appellant acknowledged receipt of 2,500,000 shares in Listco which were issued to him on 29 April 2000.

9. By a notification dated 20 April 2001 and made under section 52(5) of the IRO, the subsidiary company reported the Appellant' s income which included a gain realised under share option scheme of $5,425,000.

10. In his Tax Return – Individuals for the year of assessment 2000/01 dated 30 May 2001, the Appellant declared income which included a gain realised under share option scheme of $5,425,000.

11. On 27 August 2001, the assessor raised on the Appellant a salaries tax assessment for the year of assessment 2000/01 based on the returned income, less charitable donations and contribution to retirement schemes. The Appellant did not object to the assessment under section 64 of the IRO.

12. On 28 December 2001, Messrs Deloitte Touche Tohmatsu lodged a claim on behalf of the Appellant under section 70A of the IRO to correct the salaries tax assessment for the year of

assessment 2000/01 on the ground that there was an error in relation to the calculation of the gain realised under share option scheme included in the Appellant's assessable income.

13. The assessor was not satisfied that there were errors or omissions within the meaning of section 70A of the IRO for the salaries tax assessment for the year of assessment 2000/01. Pursuant to section 70A(2) of the IRO, the assessor, by notice dated 15 May 2002, refused to correct the salaries tax assessment for the year of assessment 2000/01.

14. By letter dated 14 June 2002, Messrs Deloitte Touche Tohmatsu objected against the assessor's notice of refusal and put forward further contentions in support of their claims that the salaries tax assessment for the year of assessment 2000/01 was excessive as a result of errors in the employer's notification and the Appellant's tax return submitted for the year of assessment 2000/01.

15. Having regard to the daily quotation of closing price of shares in Listco, the assessor reckoned that the gain realised on exercise of options in the sum of $5,425,000 stated in the employer's notification was based on the closing price of Listco shares as at 28 April 2000, that is, ($2.80 - $0.63) x 2,500,000 = $5,425,000.

The appeal

16. By letter dated 25 July 2003, Messrs Deloitte Touche Tohmatsu gave notice of appeal on behalf of the Appellant contending that the employer's notification mistakenly took 28 April 2000 which was a wrong date in determining the amount of gain and that the correct date should be 25 May 2000.

17. Shortly before the hearing of the appeal, Messrs Deloitte Touche Tohmatsu submitted a bundle of the following authorities:

(a) sections 9(1)(d), 9(4)(a) and 70A of the IRO;

(b) D14/90, IRBRD, vol 5, 131;

(c) D4/91, IRBRD, vol 5, 542;

(d) D6/91, IRBRD, vol 5, 556;

(e) D66/94, IRBRD, vol 9, 373;

(f) D43/99, IRBRD, vol 14, 448;

(g) D128/99, IRBRD, vol 15, 16;

(h) Parts XIII and XIV of the Securities and Futures Ordinance, Ordinance No. 5 of 2002;

(i) Rules governing the listing of securities on the Stock Exchange of Hong Kong Limited ('Listing Rules'), chapters 3 and 14, Practice Note 11 and Appendix 10 (Model Code for securities transactions by directors of listed companies); and

(j) The Codes on Takeovers and Mergers and Share Repurchases issued by the Securities and Futures Commission, rules 21, 22, 24, 25 and 26.

18. Mr Fung Ka-leung's bundle of authorities comprised the following:

(a) section 68(4) of the IRO; and

(b) D76/88, IRBRD, vol 4, 136.

19. On the first day of hearing, we asked Mr Joseph Fu Chi-kwong:

(a) whether he wished to contend that there was an error in the Appellant's return;

(b) the relevance of the Securities and Futures Ordinance, an ordinance enacted in 2002; and

(c) the relevance of the February 2002 version of the Takeover Code.

20. On the second day of hearing, Mr Joseph Fu Chi-kwong sought our permission to contend that there was an error in the Appellant's return. Mr Fung Ka-leung had no objection and we allowed the Appellant to rely on this additional ground of appeal under section 66(3) of the IRO. Mr Joseph Fu Chi-kwong submitted a copy of the following authorities:

(k) November 1993 version of chapter 3 of the Listing Rules;

(l) 1993 version of Appendix 10 on the Model Code for Securities Transactions by Directors of Listed Companies ('Model Code');

(m) April 2000 version of rule 21 of Hong Kong Codes on Takeovers and Mergers and Share Repurchases ('Takeover Code'); and

(n) Securities (Insider Dealing) Ordinance, Cap. 395 ('the repealed Ordinance').

21. Mr Joseph Fu Chi-kwong called 2 witnesses, that is, the Appellant and a former executive director of Listco who was a solicitor by profession. No witness was called by Mr Fung Ka-leung.

22. In his final submission, Mr Joseph Fu Chi-kwong:

(a) abandoned reliance on the Takeover Code;

(b) argued that as from 28 April 2000, the insider dealing provisions under the repealed Ordinance, the Listing Rules and the Model Code prohibited any sale by the Appellant of the shares in Listco until 25 May 2000; and

(c) submitted that the correct date for computation should be 25 May 2000.

23. Mr Fung Ka-leung argued that the correct date for computation should be the trading day after 29 April 2002, that is, 2 May 2000, and applied to us to increase the assessment, based on a gain of ($2.95 - $0.63) x 2,500,000 = $5,800,000. In answer to our question, Mr Fung Ka-leung said he did not dispute that an employer' s notification was a return or statement within the meaning of section 70A of the IRO.

Our decision

Decision on facts

24. Based on what the parties have placed before us, and in chronological order, the events which are in our decision material are:

6 June 1991	Share option scheme adopted
23 July 1997	Listco granted share option to the Appellant

12 April 2000	Listco issued a circular to all its shareholders informing them, inter alia, that: • Listco had entered into agreements with certain parties to subscribe new shares and warrants; • upon completion, those parties and their concert parties would acquire an 82% interest in Listco; • those parties had undertaken to the Stock Exchange to take appropriate steps to ensure that sufficient public float would exist within one month after completion; • an application had been made for the Whitewash Waiver which the Executive had agreed, subject to the approval of the independent shareholders; and • Listco had been granted a put option to require a named company to acquire all (but not part only) of certain operations.
28 April 2000	Closing price: $2.800
28 April 2000	Listco issued an announcement stating, inter alia, that at the special general meeting of Listco held on 28 April 2000 all resolutions (including those on the Whitewash Waiver) were passed
29 April 2000 (Saturday)	The Appellant exercised his share option
1 May 2000	Public holiday
2 May 2000	28 April 2000 announcement published
2 May 2000	Closing price: $2.950
4 May 2000	The appellant' s confirmation dated 4 May 2000, acknowledging receipt of the shares in Listco issued to him on 29 April 2000
4 May 2000	The Appellant resigned as a director of Listco with effect from this date
4 May 2000	Listco issued an announcement stating, inter alia, that the subscription was completed on 4 May 2000 and that certain persons (including the Appellant) had resigned as directors of Listco with effect from 4 May 2000
4 May 2000	Closing price: $3.125
5 May 2000	4 May 2000 announcement published
5 May 2000	Closing price: $2.975
17 May 2000	Listco published an announcement dated 16 May 2000 announcing the change of name
19 May 2000	Listco published an announcement dated 18 May 2000 announcing the extension of the deadline for placing of shares to 29 May 2000

25 May 2000	Listco issued an announcement stating, inter alia, that a named corporate shareholder had entered into a placing agreement to place shares, with information on the number of shares to be placed and the placement price
25 May 2000	Closing price: $1.470
26 May 2000	25 May 2000 announcement published

25. The Appellant's case is that as he was privy to information on the price at which the named corporate shareholder was to place its shares, he was not at liberty to sell the option shares because of the insider dealing provisions, the Listing Rules and the Model Code until 25 May 2000 when the placement price was announced.

26. Neither party cited paragraph 2 of the Listing Agreement or basic principle 5 of the Model Code.

27. For the purpose of our decision, we assume in favour of the Appellant that the Appellant was governed by all these provisions. However, the prohibitions only apply if a person possesses **unpublished** price sensitive information. There is simply no evidence before us that the Appellant possessed **unpublished** price sensitive information **throughout** the period from 29 April 2000 to 25 May 2000 (we interpose here to note that the 25 May 2000 announcement was not published until 26 May 2000, but we have not been told about the share price on 26 May 2000). If the Appellant possessed any price sensitive information on 28 April 2000, the Appellant was bound to include it in the 28 April 2000 announcement. Mr Joseph Fu Chi-kwong did not dispute the duty to publish price sensitive information. His response in the course of his final submission was that the price sensitive event had not yet occurred! The short answer is that the Appellant was perfectly at liberty to sell on 2 May 2000 and the appeal must fail. Mr Joseph Fu Chi-kwong then applied to recall his witnesses. No basis had been made out for this exceptional course and we refused his application. As the above chronology shows, Listco published four announcements (dated 28 April 2000, 4 May 2000, 16 May 2000 and 18 May 2000) between 29 April 2000 and 25 May 2000. There were four occasions when any and all hitherto unpublished price sensitive information should have been included in the announcements. These four announcements militate against possession by the Appellant on a continuing basis of unpublished price sensitive information.

28. Section 68(4) of the IRO provides that the onus of proving that the assessment appealed against is excessive or incorrect is on the Appellant. As the Appellant has failed to make good the factual premise of his case, his appeal must and does fail.

Taxation of option gains

29. In any event, his appeal also fails in law.

30. In 1971, the law on taxation of share option gains was changed.

31. Section 9(1)(d) includes as income any gain realised by the exercise of a right to acquire shares. Section 9(4) governs the computation of the gain. Section 9(5) excludes the receipt of the right from any charging provision.

32. Section 9 provides that:

> *'(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; and*
>
> *(b) the gain realized by the assignment or release of such a right as is referred to in paragraph (d) of that subsection shall be taken to be the difference between the amount or value of the consideration for the assignment or release and the amount or value of the consideration given for the grant of the right,*
>
> *(a just apportionment being made of any entire consideration given for the grant of the right to acquire the said shares or stock and other shares or stock or otherwise for the grant of the right to acquire those shares or stock and for something beside):*
>
> *Provided that neither the consideration given for the grant of the right nor any such entire consideration shall be taken to include the performance of any duties in or in connection with the office or employment by reason of which the right was granted, and no part*

of the amount or value of the consideration given for the grant shall be deducted more than once under this subsection.

(5) Where salaries tax may by virtue of subsection (1)(d) become chargeable in respect of any gain which may be realized by the exercise of a right, salaries tax shall not be chargeable under any other provision of this Ordinance in respect of the receipt of the right.'

33. Section 9(4)(a) provides that the difference between two amounts 'shall be taken to be' the gain. Whether that was in fact the gain or whether there was in fact any gain is irrelevant. The first amount is '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 second amount is 'the amount or value of the consideration given whether for them or for the grant of the right or for both'.

34. Our task is to construe and apply the statutory provisions, not to re-write them.

35. In this case, there is no dispute about 'the amount or value of the consideration given whether for them or for the grant of the right or for both'.

36. What is at issue is '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'. In our decision, that amount is one which 'a person' might reasonably expect to obtain. Significantly, it is not the amount which 'the person' or 'such a person' or 'such person' might reasonably expect to obtain. This suggests that matters personal to the taxpayer are not relevant in computing the gain under section 9(4)(a). This is another reason why the appeal must and does fail.

37. We would add that the relevant time is 'that time of the shares or stock acquired'. The relevant act in determining the relevant time is the acquisition of the shares or stock.

38. The amount is determined by reference to 'a sale in the open market'.

D14/90

39. Mr Fung Ka-leung quoted and relied on the following passage from D14/90 (at page 135):

' The Inland Revenue Ordinance 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 Ordinance is quite clear and the notional gain must be calculated at the date when the Taxpayer exercised the share option to which he was entitled.'

40. For reasons given in paragraphs 33 to 38 above, we respectfully disagree.

41. We agree that section 9(4)(a) 'specifically refers' to 'the exercise at the time of such a right'. That was in the context of identifying 'the gain' and connecting it with subsections (1) and (5). We disagree that section 9(4)(a) 'relates the notional sale back to that time'. What section 9(4)(a) specifically relates to is 'a sale in the open market at that time of the shares or stock acquired' and the amount is 'the amount which a person might reasonably expect to obtain from a sale in the open market' at that time. In our decision the statements in D14/90 that the IRO 'makes no reference to the Taxpayer being able to deal in shares' and that 'the notional gain must be calculated at the date when the Taxpayer exercised the share option' do not take sufficient cognisance of the express statutory reference to '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'. The result may be the same in some cases. But the time of the exercise of the right and the time of the acquisition of the shares is not necessarily the same in all cases.

42. In D43/99, the Board arrived at conclusions similar to ours and declined to follow D14/90, see paragraphs 27 to 32 in D43/99.

Jurisdiction to increase assessment in a section 70A case

43. We turn now to the application by Mr Fung Ka-leung to increase the assessment.

44. The employer's notification computed the gain by reference to the closing price on 28 April 2000. That was on any reckoning wrong. As at 28 April 2000, the Appellant had not yet exercised his option. The Appellant exercised his option on 29 April 2000. It was an agreed fact that the shares were issued to him on 29 April 2000 (see paragraph 8 above). No sale in the open market could have taken place until the first trading day after 29 April 2000, that is, 2 May 2000.

45. We have mentioned the question of sale expenses, but Mr Joseph Fu Chi-kwong did not take up this matter.

46. The correct amount of the gain is ($2.95 - $0.63) x 2,500,000 = $5,800,000. There is an error in the employer's notification and in the Appellant's return each of which reported a gain of $5,425,000.

47. The powers of an assessor to correct errors under section 70A are restricted to cases where the assessor is satisfied that the tax charged is 'excessive'. An assessor has no power under section 70A to increase the tax charged.

48. Section 70A(2) provides that:

> *'Where an assessor refuses to correct an assessment in accordance with an application under this section he shall give notice thereof in writing to the person who made such application and such person shall thereupon have the same rights of objection and appeal under this Part as if such notice of refusal were a notice of assessment.'*

49. In assessment cases, the Board of Review has power under section 68(8)(a) to increase the assessment.

50. Neither the appellant nor the respondent has made any submission to us on the jurisdiction of the Board of Review to increase the assessment in a section 70A appeal.

51. We do not think we should decide this question and we decline to increase the assessment. Whether the respondent wishes to take the matter any further, under section 60(1) or otherwise, is a matter for her upon which we express no view.

Conclusion

52. The appeal fails and must be dismissed. We decline to increase the assessment, not being satisfied that we have jurisdiction to do so.

Disposal

53. We dismiss the appeal and confirm the Commissioner's determination to uphold the assessor's notice of refusal, dated 15 May 2002, to correct the salaries tax assessment for the year of assessment 2000/01 pursuant to section 70A of the IRO and to confirm the salaries tax assessment for the year of assessment 2000/01 under charge number 9-0584984-01-8, dated 27 August 2001, showing assessable income of $7,750,900 with tax payable thereon of $1,162,635.