HONG KONG SOCIETY OF ACCOUNTANTS
(Incorporated by the Professional Accountants Ordinance, Cap. 50)

香港會計師公會

BY FAX AND BY POST
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Mrs. Alice Lau Mak Yee-ming,
Commissioner of Inland Revenue,
Inland Revenue Department,
36/F, Revenue Tower,
5 Gloucester Road,
Wanchai, Hong Kong.

Dear Mrs. Lau,

DIPN 38 – Employee share option benefits

At the Annual Meeting held between the Society and the Inland Revenue Department ("the Department") on 14 January 2004, you indicated that the Department was in the process of updating Departmental Interpretation & Practice Notes No.38 (Employee share option benefits)("DIPN 38") and you invited views from the Society as to possible amendments to the practice note.

We thank you for the invitation to express our views on DIPN 38 and our comments and suggestions for changes are set out below.

Paragraph 17 - The critical time

Paragraph 17 of DIPN 38 seems to require revision in the light of the Board of Review decision in D120/02.

In D120/02 (paragraph 13 of the decision), the Board identified two conflicting lines of authorities regarding the date for calculating the gain on the exercise of share option, as follows:

(i) The line of authorities D40/90, D4/91, D66/94 and D128/99 supported the view that the time of exercising the share option was the relevant time for determining the amount which a person might reasonably expect to obtain from a sale in the open market. The notional sale envisaged by section 9(4)(a) of the Inland Revenue Ordinance (IRO) would take place on that date. As the provision made no reference to the taxpayer being able to deal in the shares, the absence of any share certificate did not prevent the operation of the notional sale.

(ii) The other line of the authority, represented by D43/99, held that the relevant time was "when the shares were acquired". It presupposed that no share was acquired at the time the option was exercised. This authority suggested that the non-availability of any certificate was to be taken into account in determining whether there could be a notional sale.

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Whilst paragraph 17 identifies the conflict between these two lines of authorities, DIPN 38 does not address the situation where no share certificate was issued. Paragraph 17 simply states:

> *"However, following the decision of the Board of Review in case D43/99, IRBRD, vol.14, 448, if a taxpayer establishes that because of circumstances beyond his control the relevant share certificates were not issued and available for collection until a date subsequent to the date of exercise, the Department will accept the adoption of that later date for the purpose of the provisions."*

In D120/02 the taxpayer sought to argue that, as she had not received a share certificate, she should not be subject to salaries tax. However, the Board of Review was of the view that non-availability of a share certificate would not prevent the vesting of the rights relating to the shares in the taxpayer, and should not be relevant in considering the viability of the notional sale.

As paragraph 17 does not address the situation where no share certificate was issued, it would seem to be appropriate to revise DIPN 38 in the light of the Board of Review decision in D120/02.

Paragraph 21 – Open market value - restrictions on sale

According to paragraph 21 of DIPN 38, section 9(4)(a) of the IRO does not allow restrictions in relation to the disposal of any shares acquired under the option scheme to be taken into account in ascertaining the gain realised. In other words, when applying the provision, one should consider only the amount that a person might reasonably expect to obtain, at the time of exercising the option, from a sale in the open market of the shares acquired, but not the amount which might be obtained if the shares acquired were sold subject to the restrictions of the same kind.

However, in the Board of Review case D120/02, the Department agreed that the market price of the shares on the trade date should be discounted by 20% to reflect the restrictions on the right of disposal of the shares. Nevertheless, the Board of Review noted that the United Kingdom ("UK") Capital Taxes Office was prepared to allow a 25% discount to "reflect the five year restriction period with early release clauses", and that the Department had not furnished any reason to differentiate the Hong Kong and the UK positions. The Board of Review felt that a 20% discount was too low in the circumstances and, therefore, instructed that a 25% discount rather than a 20% discount should be allowed.

It would appear, therefore, that the decision in D120/02 and the position adopted by the Department in that case are at odds with paragraph 21 of DIPN 38.

In keeping with the Board of Review decision in D120/02, we would suggest that DIPN 38 be revised to make it clear that, in ascertaining the gain realised, consideration should be given to any restrictions in relation to the disposal of any shares acquired under the option scheme.

Paragraph 35(viii) – Applying the provisions

Paragraph 35(viii) of DIPN 38 contains a formula to calculate the amount of the assessable gain under a non-Hong Kong employment. In this regard, the practice note does not specify whether the words "days spent rendering services in Hong Kong during the vesting period" in the formula should be interpreted literally or should be taken as including leave days. Therefore, we suggest that a note should be added to the formula to clarify this issue, as follows:

$$\frac{\text{Days spent rendering services in Hong Kong during vesting period*}}{\text{Total number of days in vesting period}} \times \frac{\text{Gain calculated in accordance with section 9(1)(d) and 9(4)}}{1}$$

* *This refers to the actual number of days in which the taxpayer is rendering services in Hong Kong during the vesting period including leave days spent in Hong Kong.*

In respect of conditional awards, DIPN 38 does not address the situation where the source of income, i.e., the location of employment, changes during the vesting period. For example, an employee could be granted conditional rights whilst he is regarded as holding a Hong Kong employment but the right could partially vest whilst he is regarded as holding a non-Hong Kong employment (e.g., if the employee is transferred to another group company overseas). Therefore, we suggest that a further example should be added in the practice note to cover this situation:

> **"*Scenario: Right was conditionally granted at the time when the taxpayer was rendering services in Hong Kong under Hong Kong employment, subject to the completion of a vesting period. During the vesting period, the taxpayer was reassigned and the location of employment changed. Following the change to a non-Hong Kong employment, and throughout the remainder of the vesting period, all services were rendered outside Hong Kong.***

Given that the taxpayer was engaged in both Hong Kong and non-Hong Kong employment during the vesting period, it would be reasonable and equitable to adopt an apportionment basis in computing the assessable gain of the option. Therefore, wording along the following lines is proposed to cover this:

> *"In these circumstances, the Department is prepared to accept that an apportionment of the gain between the Hong Kong employment and the non-Hong Kong employment could be used to compute the amount of the gain attributable to the Hong Kong employment and the non-Hong Kong employment. The apportionment would be computed by reference to the number of days in which the taxpayer was in a Hong Kong employment and non-Hong Kong employment during the vesting period."*

Paragraphs 39 and 40 – Hong Kong employment when the right was granted

Paragraphs 39 and 40 of DIPN 38 seek to address the following scenario:

> *"Right conditionally granted whilst taxpayer rendering services in Hong Kong, subject to the completion of the vesting period during which services were rendered both in and outside Hong Kong. Right exercised during a year in which taxpayer rendered all services outside Hong Kong."*

According to paragraph 39, the chargeability of any gain on exercise will be determined by having regard to where the services were rendered during the vesting period, rather than where or if the taxpayer was rendering services in the year of assessment in which the right was exercised. Paragraph 39 also states that:

> *"It has to also be kept in mind that, unlike the situation with a non-Hong Kong employment where the primary purpose is to ascertain the income derived from services rendered in Hong Kong, for a Hong Kong employment case income can only be excluded from the charge to Salaries Tax if the taxpayer renders outside Hong Kong all the services in connection with his employment (taking into account the 60 days allowance provided under section 8(1B)."*

Paragraph 40 provides that:

> *"Accordingly, having regard to the latter point in the previous paragraph, if during any year of assessment included in the vesting period the taxpayer rendered services in Hong Kong during visits exceeding 60 days, all of the gain from the exercise of the option would be chargeable to Salaries Tax. On the other hand if during each such year the taxpayer's visits did not exceed a total of 60 days, no part of the gain would be treated as chargeable (section 8 (1A)(b)(ii) and (1B) would apply)."*

Our concern is that paragraph 40 seems to indicate that this is an all-or-nothing scenario. Consider the following example of a person who has a share option with a three-year vesting period: in Year 1 he visits Hong Kong for 120 days and is subject to salaries tax; in Year 2 he visits Hong Kong for 53 days and so is not subject to salaries tax; and in Year 3 he visits Hong Kong for 63 days and will be chargeable to salaries tax if he has a Hong Kong sourced employment.

In this example, the employee would only be subject to salaries tax for two out of the three years. Nevertheless, paragraph 40 seems to indicate that, as the taxpayer was subject to salaries tax during one of the three years of assessment included in the vesting period, he would be subject to tax on all of the gain from the exercise of the option. On the other hand, if the taxpayer was not liable for salaries tax in the three-year period, he would not be subject to tax on any gain realised by the exercise of the share option.

The Society believes that this section of DIPN 38 needs to be made clearer if the intention is to apportion the gain based on the number of years for which the employee is subject to salaries tax on his employment income (so that e.g., in the case illustrated above, only two-thirds of the gain would be taxable). The Society believes that, if the taxpayer was not subject to salaries tax on a given year of assessment during the vesting period, this should be recognised in calculating the taxable amount of the gain by apportioning the gain over the total vesting

period, and exempting the gain relating to the year of assessment during which the taxpayer was not subject to salaries tax.

This would be appear to be consistent with the statement in paragraphs 39, that "the chargeability of any gain on exercise would not hinge on where (or if) the taxpayer was rendering services in the year of assessment in which the right was exercised. Rather the matter would be determined by having regard to where the services were rendered during the vesting period."

Paragraph 51 – Persons departing permanently from Hong Kong

Paragraph 51 of DIPN 38 states that the Department will allow a person departing from Hong Kong to elect to have his salaries tax liability associated with a share option to be ascertained on the basis of a notional exercise of the option. However, the practice note does not specify whether an election can still be made after the taxpayer has departed from Hong Kong. In practice, due to factor(s) beyond the taxpayer's control, it is possible that the taxpayer would not be able to submit his final tax return until he has departed from Hong Kong. In this regard, we would suggest the inclusion of wording along the following lines to cover the late submission of final tax return in relation to an election to ascertain liability on the basis of a notional exercise of the option:

> *"An employer of any person who is chargeable to salaries tax and is about to permanently depart from Hong Kong should give notice to the Department in writing no later than one month before the expected date of departure. The Department's normal practice is to immediately issue a final tax return to the taxpayer for completion upon receipt of such notice. Under normal circumstances, the taxpayer would be required to submit his final tax return prior to his departure and his election to have his liability ascertained on the basis of the notional exercise of the option would be considered and processed by the Department at that time.*
>
> *However, if the final tax return is submitted after the person has permanently departed Hong Kong, the Department will, as a concession, consider accepting the election as valid, having regard to the reason(s) for such delay. Such elections will be considered by the Department on a case-by-case basis."*

Currently, DIPN 38 specifies that the salaries tax liability under the election is to be calculated on the basis of the gain that would have been realised if the option had been exercised on "*the day before the date of submission of the person's Salaries Tax return for the year of assessment in which he or she permanently departs from Hong Kong*". However, if the Department is prepared to accept late elections (i.e., after the taxpayer has departed from Hong Kong), it is necessary to specify a date on which the notional gain is to be computed under this circumstance. In this regard, it seems that the day before the taxpayer's permanent departure from Hong Kong could be used as a reasonable basis to compute the notional gain and, on this basis, the following wording is proposed for consideration:

> *"Where the final tax return is submitted after the person has permanently departed Hong Kong, the amount of assessable gain would be computed based on the gain that would have been realised if the option had been exercised on the day before the person permanently departed Hong Kong."*

When an election has been made and accepted by the Department, DIPN 38 does not seem to have clearly specified whether the taxpayer and his employer are still required to report the actual exercise of the stock option, even though the taxpayer's final salaries tax liability would have been determined at that time. Given that the taxpayer's final salaries tax liability has already been determined, it would seem that the requirement to report the actual exercise of the option is unnecessary and we therefore propose that the following be inserted in paragraph 52 to address this issue:

> *"Where an election has been made and accepted, the Department will not require the taxpayer and his employer to report the actual exercise of the option."*

I hope that you find the above comments and suggestions to be constructive. If you have any questions on them, please feel free to contact me on 22877084.

Yours sincerely,

PETER TISMAN
TECHNICAL DIRECTOR
(BUSINESS MEMBERS & SPECIALIST PRACTICES)

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