



Inland Revenue Department
Hong Kong

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 38 (REVISED)

SALARIES TAX

EMPLOYEE SHARE-BASED BENEFITS

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued in March 2005.

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Commissioner of Inland Revenue

March 2008

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PART I – SHARE OPTION BENEFITS

INTRODUCTION

The purpose of this part of the Practice Note is to outline the assessing practice followed by the Inland Revenue Department (the Department) in relation to benefits obtained from share option schemes by employees and office holders. Typically, an employee receives a right to acquire shares at a nominated price some time in the future. Usually the shares are in the employer company itself or in a related company (e.g. the parent company of the employer or another company in the same group). The employee is not obliged to make any purchase until he “exercises” the option. Accordingly, there is an incentive for such an employee to work towards making the company concerned more profitable or valuable, which would increase his or her likelihood of being able to make a gain through exercising the right and acquiring the shares.

Taxation treatment prior to the introduction of specific provisions

2. The Inland Revenue Ordinance (the Ordinance) has since 1971 contained specific provisions relating to the taxation of benefits received from employee share option schemes. Prior to their introduction, a share option benefit would be charged to Salaries Tax if it could be regarded as a “perquisite” and hence, by virtue of section 9(1)(a) of the Ordinance, fall within the inclusive definition of income from an office or employment of profit. In the absence of any decision from the courts in Hong Kong concerning share option benefits, guidance on the issue of what constituted a chargeable perquisite was obtained from United Kingdom cases.

3. In 1961 the House of Lords handed down a decision in *Abbott v. Philbin* 39 TC 82, which had considerable impact on the taxation of benefits associated with share option schemes. The decision was important not only in that it provided guidance as to what should be regarded as a perquisite, but also in that it led to the introduction of specific share option provisions in the United Kingdom and Hong Kong.

4. The taxpayer concerned in *Abbott v. Philbin* was the secretary of a company that had decided to grant options over certain shares to executives of

the company and its subsidiaries. The taxpayer was offered the opportunity to acquire at a cost of £1 for every 100 shares a non-transferable option, valid for ten years, to purchase 2,000 shares at the market price ruling at the date of the offer. The taxpayer accepted the offer in October 1954. The following year the taxpayer exercised his right under the option and applied for and was allotted 250 shares at the specified option price.

5. In accordance with what was then the normal practice of the Revenue, a sum equal to the difference between the current market price and the amount paid for the shares (plus a proportionate part of the cost of the option) was included in the taxpayer's assessment for the year in which the option was exercised. However, the House of Lords held that the benefit of the option contract could be converted into money, even though it was non-assignable (the employee could have obtained money from a third party by agreeing to exercise the option when instructed and thereupon transfer the shares), and that as such it was a perquisite which was taxable on its value at the time of grant and not on the value when exercised.

6. The law relating to share options was subsequently amended in the United Kingdom to, in effect, over-rule the decision in *Abbott v. Philbin*. In essence, the legislation gave statutory support to what had been the Revenue's earlier practice in respect of binding option rights.

Amendments in Hong Kong

7. The UK amendments were considered locally in the course of the deliberations of the Second Inland Revenue Ordinance Review Committee, which delivered its final Report to the Government in 1968. The following excerpt from the Report is pertinent -

“169. The Commissioner asked us to consider the introduction of a provision for determining the value of income derived by an employee from the exercise of an option to take up shares in the corporation which employs him. We noted that it has been found necessary in the U.K. to lay down the basis for determining the value to be treated as income. The principle which the Commissioner wished to establish is that the value to be brought to charge as income should be calculated, and should be deemed to arise, at the

time the option is exercised. The income to be charged should be the difference between -

- (a) the open market value of the shares at the date of exercise of the option (or in the case of an assignment or release, the consideration received for the assignment or release); and
- (b) the cost of acquiring the shares including any consideration (apart from services in his office or employment) which the employee gave for the option.

170. WE RECOMMEND that there should be included, as an additional paragraph to Section 9(1), ‘any gain made by a director or employee of a corporation from the exercise of a right, obtained from the corporation, to acquire shares therein’ and that the principle which the Commissioner wished to establish should also be incorporated in the enabling provisions.”

8. The Ordinance was subsequently amended by Inland Revenue (Amendment) Ordinance 1971 to introduce, amongst other provisions, section 9(1)(d), 9(4) and 9(5). The Explanatory Memorandum of the Bill for the Amendment Ordinance contained the following -

“ The principal purpose of this Bill is to implement recommendations contained in Part II of the Report of the Inland Revenue Ordinance Review Committee.

....

6. Clause 6 (which follows section 25 of the U.K. Finance Act 1966) amends section 9 by adding new subsections (4) and (5) to provide for the charge to tax of any share options acquired by a person as a result of his employment. The manner of valuation of such options for tax purposes is also provided for.” [at C646]

9. The amendments were agreed as proposed by the Legislative Council without comment.

SCHEME OF THE LEGISLATION

10. Briefly, the legislation has the following three main elements -
- The first, **section 9(1)(d)**, in effect provides that income from an office or employment includes any gain realized by the exercise, assignment or release of a share option obtained by a person as an employee or office holder of a company.
 - The second, **section 9(4)**, specifies the basis of calculation of any realized gain that comes within the scope of section 9(1)(d).
 - The third, **section 9(5)**, provides that where a gain may be taxable by virtue of section 9(1)(d) in respect of the exercise of a right, the receipt of the right cannot be charged to tax under any other provision of the Ordinance.

The three elements are further discussed below, together with related matters.

Section 9(1)(d)

“any gain realized by the exercise of, or by the assignment or release of, a right to acquire shares or stock ...”

11. Section 9(1)(d) only has application where an employee (or office holder) has exercised, assigned or released a **“right”** to acquire shares. In this regard it is accepted that the term “right” refers to a legally enforceable right; not a “mere expectation”, such as where a person is invited to apply for shares in circumstances where the invitation may be withdrawn at any time. It should be noted, however, that in the latter situation a taxable perquisite would generally be received if an application were to be accepted and shares allotted. Such a perquisite, if meeting the other requirements for chargeability, would be taxable to the extent of the difference between the price for which the shares could be sold and the price paid for them: *Weight v. Salmon 19 TC 174*.

12. The taxpayer in that case was the managing director of a company. In addition to a fixed salary, he was given the privilege each year of applying for unissued shares at their par value, which was less than the market value.

The taxpayer accordingly applied for shares and they were issued to him. He was assessed to tax on the difference between the par and market values at the date the shares were allotted. The case eventually came before the House of Lords where the assessment was upheld. The decision was considered in *Abbott v. Philbin* where Lord Reid, at page 123, emphasised that that case could be distinguished as a binding option had not been involved -

“The case of *Weight v. Salmon* seems to me to be entirely different. There the servant had no enforceable right at all until he got his shares. He got his shares because the company chose to give him something then, to give him a perquisite when the shares were issued. But, in this case, the Appellant getting his shares did not flow from any voluntary act of the company when the shares were issued. It flowed from the company’s voluntary act in the previous year, when they gave him an option by which they were thereafter bound. It would, I think, require some peculiar circumstances to make a mere expectation capable of being turned to pecuniary account.”

13. The respective meanings of the terms “**exercise**”, “**assignment**” and “**release**”, within the context of these provisions, are discussed in paragraphs 16 to 32 below, in relation to section 9(4).

“... 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”

14. The words in section 9(1)(d) quoted above dictate that the following points should be kept in mind when considering the application of the share option provisions -

- The provisions can only apply where an option (i.e. a right to acquire shares or stock in a corporation) is obtained by an employee of a company or by the holder of an office in a company. Where such an option is obtained by a person who is employed other than by a company (e.g. by a partnership), chargeability generally depends on whether the option itself can be regarded as a perquisite, under section 9(1)(a), derived from Hong Kong (see paragraphs 2-5 above).

- For the provisions to apply, the shares (or stock) to which the option relates need not be in the company in which the person concerned is an employee or office holder. For example, the option could be granted in respect of shares in the overseas parent company of the local company employing the taxpayer.

Section 9(4)

15. As has been indicated above, section 9(4) must be applied to ascertain the quantum of any gain that comes within the scope of section 9(1)(d). In this regard -

- section 9(4)(a) details what is taken to be “the gain realized ” where a right of a kind referred to in section 9(1)(d) is exercised; and
- section 9(4)(b) similarly provides for cases where the gain is realized by assignment or release of such a right.

Section 9(4)(a)

“... by the exercise”

16. The Ordinance does not define what is meant by the word “exercise” in the context of section 9(1)(d). Nor is it possible, given the great variety of terms and conditions which can govern the operation of share option schemes, to state exhaustively how the word is construed in practice. Generally, however, a taxpayer is considered to have exercised an option when he has taken whatever steps are necessary to convert the offer contained in the option agreement into a contract to purchase the relevant shares. Depending on the terms of the option agreement, this may require no more than the employee providing the party concerned with written confirmation of acceptance of the offer. On the other hand, an agreement may contain provisions that deem an option to be validly exercised only when particular requirements are satisfied (e.g. that payment for the shares be made in a certain manner or that the “exercise” of the option be approved by the board of directors of the company). Provided that they are genuine and have not been inserted with a view to facilitating tax avoidance, such requirements will be recognised by the Department in ascertaining the time of exercise of an option.

The critical time

17. It is important to ascertain the point in time at which an option is exercised. This is because section 9(4)(a) provides, briefly put, that the gain realized by “the exercise at any time” of a share option is based on the amount which could be obtained for the shares acquired in the open market “at that time”. In other words, the gain is required to be calculated by reference to the open market value on the day of exercise and it will generally not be relevant to consider value at any later date. However, following the decision of the Board of Review in case *D43/99, IRBRD, vol. 14, 448*, if a taxpayer can establish that because of circumstances beyond his control he did not acquire the relevant shares (in the sense that the shares had been issued to him) until a date subsequent to the date of exercise, the Department will accept the adoption of that later date for the purposes of the provisions. It should be pointed out, however, that in case *D120/02, IRBRD, vol. 18, 125*, the Board drew a distinction between “a share certificate” and “a share”. The Board held that a share could be regarded as a bundle of rights, the non-availability of the share certificate did not prevent the vesting of the rights and thus the Appellant in that case acquired the shares when her name was entered in the Register of Shareholders and became entitled to dividends and voting rights.

A notional gain must be computed

18. The gain that has to be calculated is a notional one; the question of chargeability does not depend on whether or not the employee sells the shares acquired as a result of exercising the option. Even if no sale takes place, such as where the shares are held as an investment, the employee will nonetheless be chargeable (assuming that the income has a Hong Kong source) in respect of any notional profit arrived at as a result of the application of section 9(4)(a) to the circumstances at the time of the exercise of the option. Any subsequent gain derived from the actual sale of the shares would not be subject to Salaries Tax.

Computation method

19. Section 9(4)(a) provides, broadly put, that for the purposes of section 9(1)(d) the gain realized by the exercise at any time of an option shall be taken to be the difference between (a) the amount which a person might reasonably expect to obtain from a sale in the open market, at the time of exercise of the

option, of the shares acquired and (b) the amount or value of the consideration given for the shares and the grant of the option.

20. Section 9(4) also provides that the entire consideration shall be apportioned if it is for something beside the shares covered by the option. A proviso to the subsection makes it clear that the consideration cannot include any amount in respect of the performance of the duties of the office or employment, and that the amount or value of the consideration given for the grant of the option cannot be deducted more than once.

Open market value

Restrictions on sale

21. Share options are sometimes granted on the condition that restrictions will apply in relation to the disposal of any shares acquired under the scheme (e.g. as to when or to whom the shares can be sold). The restriction on disposal of the shares are relevant in determining the amount “which a person might reasonably expect to obtain from a sale in the open market”. This is a valuation exercise to be undertaken in the light of the facts of each particular case, see for example, *D120/02, IRBRD vol. 18, 125*, where a 25% discount was allowed to reflect the five year restriction period against alienation of the shares.

Quoted shares

22. Where the shares are listed on a stock exchange, the open market value of the shares acquired can be taken as the closing quotation value for shares of the same kind on the date the option is exercised. In practice, the Department will consider a request for downward adjustment of the quoted value if there is evidence to suggest that, because of the number involved, a sale of the shares obtained from exercising the option would only be possible at a reduced price, i.e. a “slump effect” would be induced if the shares in question were to be made available for sale. This practice reflects the decision of the Board of Review in case *D46/95, IRBRD, vol. 10, 308*. If the shares are listed in Hong Kong and overseas at the same time, it is normal practice for the Department to adopt the price quoted on the Hong Kong Stock Exchange. If

the shares are listed on two non-Hong Kong exchanges, the taxpayer may select the more favourable price.

23. Once the open market value of the shares is ascertained, the gain for the purposes of section 9(1) (i.e. the amount to be treated as income from an office or employment) is arrived at by deducting from this figure the consideration given for the grant of the option and the consideration given for the shares in question. It is accepted that the latter amount can include any brokerage, stamp duty or other charges that would have been levied if the notional sale had actually taken place.

Unquoted shares

24. Where the option exercised is in respect of shares in a private company (i.e. one which is not quoted on a recognised stock exchange at the date of exercise), it will generally not be possible to look to an actual sale of shares of the same kind to arrive at a valuation. And, because of the variations in circumstances that may be involved, it is not possible to say that for all such companies there is a single valuation method (e.g. reference to “dividend yield”, “earnings yield” or “asset backing”) which could appropriately be used to determine the open market value. It is also pertinent that the application of section 9(4)(a) in relation to such cases has not been considered by any court in Hong Kong.

25. Nevertheless, it is considered that guidance as to the correct approach to be used can be drawn from estate duty case-law concerning the open market value of private company shares. [See, for example: *Commissioners of Inland Revenue v. Crossman (1937) AC 26*; *In re Lynall (DECD.) (1971) 47 TC 375*; and *In re Harry Charrington (DECD.) (1975) HKLR 81.*] In this regard, the Department considers that the correct objective is to ascertain what price a hypothetical willing, but not anxious, purchaser would need to pay a hypothetical willing, but not anxious, seller in the open market to acquire the subject shares on the date of exercise of the option. Furthermore, in undertaking this exercise it should be assumed that -

- the shares are offered for sale to the world at large so that all potential purchasers have an equal opportunity to make an offer as a result of it being openly known what is offered for sale (*Lynall* p. 411);

- the hypothetical purchaser would not rely only on information published by the company, but would also consider its prospects having regard to matters of public knowledge, at the date of exercise, concerning the company, its directors and management and relevant business trends and developments (*Lynall* p. 411);
- the seller would give as much information as he was entitled to give. If not a director, he would provide the information he could get as a shareholder. If he was a director with confidential information, it should not be assumed that it would be disclosed to the public without the consent of the board of directors of the company (*Lynall* p. 406 & p. 413);
- the sale price paid would not be exceptional i.e. it should not be increased over what could be regarded as an ordinary market price to reflect a premium a particular buyer might pay because of special reasons unique to that party (*Crossman* p. 44);
- any conditions requiring satisfaction under the articles of association of the company to enable an open market sale to take place would be satisfied (e.g. the directors of the company would not exercise any discretion to refuse to register the transfer of the shares, and any existing shareholder's right of pre-emption would be waived); and
- following acquisition of the shares, the hypothetical purchaser would be subject to (and hence this would be reflected in the valuation) any restrictions imposed by the provisions of the articles of association relevant to the shares in question (e.g. relating to the alienation and transfer of shares in the company).

26. Where an option has been exercised over shares in a private company, it will sometimes be useful for officers of the Department to meet representatives of the company (subject to the appropriate authority being given by the employees concerned) with a view to agreeing the valuation on exercise. Negotiations can begin as soon as the exercise has taken place and there is no need to wait until the end of the tax year. In the first instance, a

request for a meeting should be sent to the Commissioner. The request should be accompanied by details of the basis of valuation proposed, together with relevant supporting documents.

Section 9(4)(b)

27. Section 9(4)(b) provides for cases where a right to acquire shares is assigned or released. The gain is 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 for the grant of the right (i.e. the amount paid for the option).

Assignment

28. In the context of section 9(4)(b), it is considered that the term “assignment” refers to the situation where an employee (or office holder) transfers the whole of his interest in rights acquired under an option agreement to a third party. In order to ascertain whether a purported assignment was for tax avoidance purposes, the Department will generally require copies of all agreements and other documentation relating to the grant of the option and the assignment to be submitted for consideration. If it is not otherwise apparent, the employee (assignor) will also be required to advise -

- whether the option agreement prohibited any assignment and if so whether the prohibition was subsequently waived;
- whether the employer was notified of the assignment;
- whether the assignor retained any interest in the option right and if so the nature of that interest;
- whether the party to whom the right was assigned (i.e. the assignee) could, as a result of the assignment, formally exercise the option;
- whether any vesting period under the option agreement had been completed prior to the assignment;

- the nature of the relationship, if any, of the assignor to the assignee;
- the amount of and terms of payment of the consideration for the assignment; and
- the basis used to decide upon the consideration in respect of the assignment.

Release

29. Within the context of section 9(4)(b), the term “release” refers to the situation where an employee, without exercising his right to acquire shares under a share option scheme, agrees to the discharge of that right either for valuable consideration or under seal (i.e. release by deed).

30. To simply allow an option right to lapse by not exercising it within the option period would not amount to a “release” within the context of section 9(4)(b). Likewise, if an employer were empowered under a share option agreement to unilaterally cancel an option right in certain circumstances and did so, this would not constitute a release.

31. It should be noted, however, that if an employee were to receive compensation because he had suffered a loss as a result of having to delay the exercise of an option, the compensation would be regarded as a perquisite chargeable to Salaries Tax (if derived from Hong Kong) by virtue of sections 8(1) and 9(1)(a) of the Ordinance: see the decision of the Board of Review in case *D4/91, IRBRD, vol. 5, 542*. By parity of reasoning, the same would apply in respect of any compensation received by an employee for agreeing to let an option expire without exercising it (as distinct from agreeing to the legal discharge of the option).

Exchange of rights

32. Cases sometimes arise where a right to acquire shares of a particular type is exchanged for a right to acquire shares of another type, e.g. as a result of a take-over or restructuring of a company. In such a case (i.e. where a straight exchange is involved, without the employee also receiving monetary

consideration), the Department will generally accept that the exchange does not constitute an assignment or release for the purposes of section 9(1)(d). Accordingly, no Salaries Tax liability arises as a result of the exchange itself. Instead, the relevant provisions are applied in relation to the right received in exchange, when it is subsequently exercised, assigned or released (taking into account any consideration given for the grant of the original right). The Department should be consulted regarding the appropriate basis of assessment, by writing to the Commissioner, in any case where the consideration received in exchange includes both a new right and a monetary payment.

Section 9(5)

33. As has been indicated in paragraph 5 above, prior to the introduction of the specific provisions in the Ordinance dealing with share options, if an employee or office holder acquired an enforceable right to obtain shares in a company, the person concerned was assessable on the value of the right at the time of its grant, less any sum paid for it. The specific provisions, on the other hand, impose liability in respect of the subsequent exercise, assignment or release of the right. The role of section 9(5) is to ensure that a person who acquires a right is not subject to double taxation i.e. in respect of the receipt of the right (as a perquisite) and under the specific share option provisions. In essence, the subsection looks ahead and provides that where a person may become chargeable by virtue of section 9(1)(d) in respect of any gain which may be realized by the exercise of a right, the person cannot be charged to Salaries Tax under any other provision in respect of the receipt of the right (i.e. on the basis that a perquisite falling within section 9(1)(a) has been received).

34. Section 9(5) would not prevent the receipt of a right being charged to Salaries Tax as a perquisite if it were to become apparent in a particular case that no amount would be chargeable by virtue of section 9(1)(d). In practice, however, if at the time a right is obtained there is a possibility that an amount may eventually be chargeable by virtue of section 9(1)(d), the Department will not in any event (i.e. irrespective of the ultimate outcome) seek to charge an amount under any other provision.

APPLYING THE PROVISIONS

General principles

35. Apart from valuation issues, questions concerning the application of the share option provisions most frequently arise in relation to situations where employment circumstances change between the time of grant of the right to acquire the shares and the time of exercise of the right, and cases involving employees who have non-Hong Kong employments. In considering the various circumstances, it may be useful to keep the following points in mind -

- (i) When a person is granted a right to acquire shares by virtue of his employment, he derives income in the form of a perquisite. Normally, if derived from Hong Kong, the perquisite would be chargeable to Salaries Tax in the year of assessment in which the person obtains it. However, by virtue of the specific provisions under section 9(1)(d) and 9(5), the person is not necessarily charged to tax in the year in which the perquisite is derived, but on a notional basis in the year of assessment in which the right is subsequently exercised, assigned or released.
- (ii) Section 9(1)(d) provides that any gain realized by the exercise, assignment or release of the rights constitutes “income from employment”.
- (iii) The gain in respect of the exercise etc. of the right is calculated on a notional basis in accordance with section 9(4), and is assessable to the extent that it is derived from Hong Kong. The gain is taken to accrue to the taxpayer in the year of assessment in which the right is exercised etc. and, by virtue of section 11B, falls for assessment in that year of assessment (rather than the year in which the benefit of the right was derived).
- (iv) Section 9(1)(d) and associated provisions provide for the calculation and timing of any charge to Salaries Tax in respect of a share right benefit. They do not, however, have any

bearing on the question of when the benefit is actually derived, which is determined by the time of grant of the relevant right.

- (v) While some options are allowed to be exercised without any conditions, some may require certain conditions to be fulfilled before the option can be exercised. The concept of “vesting” is common in share options. An option will generally be considered to have vested when all conditions for its exercise have been satisfied and the employee is free to exercise without restriction. Among the typical conditions, it is frequently required that the employee continues to work for the employer for a certain period of time. For the present purposes, an option will be regarded as vested when such period has expired. Therefore, “vesting period” here normally means the period from the date of grant of option, or such date as mentioned in the terms of the grant, to the first available date that an employee is entitled to exercise the option.

Hong Kong employment

36. Although section 9(1)(d) provides that any gain realized (calculated in accordance with section 9(4)), by the exercise, assignment or release of the rights constitutes “income from employment”, the gain is only chargeable to Salaries Tax if it comes within the scope of section 8(1)(a), i.e. if it can correctly be described as “income arising in or derived from Hong Kong”. In other words, one has to consider whether the income had a source in Hong Kong.

37. The source of the income mentioned in paragraph 36 above is the right to acquire shares obtained by the person as an employee. As such, if the person had a Hong Kong employment at the time of the grant of the right, the income is also regarded as having been derived from Hong Kong. Any gain realized by the subsequent exercise etc. of the right will be chargeable to Salaries Tax unless the gain is excluded by virtue of section 8(1A)(b), i.e. where the person renders outside Hong Kong all the services in connection with his employment. In the latter regard, if a right is granted to an employee

on an unconditional basis during a year of assessment in which the person renders all services in respect of his employment outside Hong Kong, any gain subsequently realized, even if realized whilst the person is working in Hong Kong will not be charged to Salaries Tax. Although the gain is considered to accrue to the person in the year of assessment in which the right is exercised, it is recognised as having been derived from the services rendered outside Hong Kong.

Example 1

The taxpayer had a Hong Kong employment. He was granted an unconditional right to subscribe for shares. He ceased employment and exercised his option after cessation of employment.

38. Cessation of employment does not prevent the application of the share option provisions. As the taxpayer concerned had a Hong Kong employment at the time of grant of the right, the relevant income was derived from Hong Kong and accordingly is chargeable to Salaries Tax in the year of assessment in which the right is exercised. It should be noted that as the application of section 9(1)(d) is concerned with notional income, rather than any payment made to an employee, section 11D cannot apply in relation to the income - i.e. it cannot act to deem the amount to have been received by the employee on the last day of his employment. Instead, the income simply falls to be assessed in respect of the year of assessment in which it accrued to the employee i.e. the year of assessment in which the right was exercised. This approach has been endorsed in *CIR v. Sawhney, Subhash Chander, HCIA 1/2006*.

Example 2

The taxpayer had a Hong Kong employment. All services were rendered in Hong Kong prior to and during the year the unconditional grant of the right was granted to him. During the year of assessment in which the right was exercised, the taxpayer rendered all services outside Hong Kong in connection with the same employment.

39. As the taxpayer had a Hong Kong employment, the gain would be treated as having been derived from Hong Kong. The gain would only be

excluded from the charge to Salaries Tax by virtue of section 8(1A)(b)(ii), taking into account section 8(1B), if all services were rendered outside Hong Kong in the year of grant of the right. The gain, calculated in accordance with section 9(4), would fall for assessment in the year of assessment in which the right was exercised. The fact that the taxpayer did not render any services in Hong Kong during the year of exercise would not in itself have any bearing on whether the gain would be chargeable to Salaries Tax, see *D4/02, IRBRD, vol. 17, 400*.

Example 3

The taxpayer had a Hong Kong employment. All services were rendered outside Hong Kong in the year of assessment in which the right was unconditionally granted, but rendered inside Hong Kong during the year of assessment in which the right was exercised.

40. As the taxpayer rendered all services outside Hong Kong during the year of assessment in which the right was granted, and as it was granted on an unconditional basis which did not involve services being rendered in Hong Kong, it would be accepted that the gain on realization should qualify for exemption by virtue of section 8(1A)(b)(ii), taking into account section 8(1B), notwithstanding the fact that the taxpayer was rendering services in Hong Kong during the year in which the right was actually exercised.

Example 4

The taxpayer had a Hong Kong employment. The right was conditionally granted, subject to the completion of a vesting period of 2 years from 1 April 2000. The position during the vesting period was as follows:

Year ended

31.3.2001 *More than 60 days in Hong Kong rendering services*

31.3.2002 *No services rendered in Hong Kong*

He exercised the option on 1 July 2002. During the year ended 31 March 2003, he did not render service in Hong Kong.

41. 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. 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)).

42. 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).

Non-Hong Kong employment

43. Where a person has a non-Hong Kong employment at the time of grant, the gain will have a non-Hong Kong source and will not be chargeable to Salaries Tax unless it comes within the scope of section 8(1A)(a) i.e. if it is derived from services rendered in Hong Kong. In this regard, the Department will generally accept that no liability to Salaries Tax arises where a right is granted on an unconditional basis (or on completion of a vesting period of a conditional grant) prior to a person rendering any services in Hong Kong, notwithstanding that the right may be exercised after the person commences to render such services.

44. The more complex situation is the one where a person with a non-Hong Kong employment is granted the right subject to a vesting period during which services are rendered both in and outside Hong Kong. In such a situation, it is considered that the gain on the subsequent exercise etc. of the right should not be fully assessable in Hong Kong as it can partly be attributed to services rendered outside Hong Kong. On the other hand, because the gain can be partly attributed to services in Hong Kong, the benefit should to some extent be chargeable to Salaries Tax.

45. In considering the appropriate proportion, if any, of the gain to be treated as derived from services rendered in Hong Kong, regard must, of course, be had to the terms of the contract governing the grant of the right and to any other relevant facts. In the case of a non-Hong Kong employment, however, the Department will generally accept that it is equitable to have regard to the number of days in Hong Kong plus leave days attributable to services in Hong Kong during the period from the date of conditional grant to the date the employee became unconditionally entitled to exercise the right (i.e. the vesting period) to the total number of days in the period, notwithstanding that it may only be exercised after a further period. In other words, the assessable amount of the gain can generally be arrived at by applying the following formula -

$$\frac{\text{Days in Hong Kong plus attributable leave during vesting period}}{\text{Total number of days in the vesting period}} \times \frac{\text{Gain calculated in accordance with sections 9(1)(d) and 9(4)}}{1}$$

46. For example, if the vesting period was two years (i.e. 730 days) and the person's days in Hong Kong plus leave days attributable to service in Hong Kong were 292 days during the period, 40% of the gain would be assessable in the year of exercise of the right (i.e. $292/730 = 40\%$). For the purpose of counting the number of days in Hong Kong, only one day is generally counted in respect of the days of arrival and departure (the so-called "midnight rule"). This is consistent with the assessing practice usually applied in relation to time apportionment claims under section 8(1A)(a) and (c).

47. The provisions of section 8(1A)(b)(ii), as read with section 8(1B), may be relevant in relation to the calculation of the proportion referred to above. By virtue of section 8(1A)(b)(ii), chargeable income does not include income derived from services rendered by a person who renders outside Hong Kong all the services in connection with his employment. In this regard, section 8(1B) provides that in determining whether or not all services are rendered outside Hong Kong, services rendered during visits not exceeding a total of 60 days in the basis period for the year of assessment are not to be taken into account. Accordingly, if services are rendered by the taxpayer in Hong Kong during visits of less than 60 days during any year of assessment

that falls within the vesting period, the days concerned are not taken into account in computing the proportion of the gain attributable to services rendered in Hong Kong. To illustrate, if in the example used in paragraph 46 the vesting period had covered the period 1 January 2001 to 31 December 2002, and the taxpayer had only rendered services in Hong Kong for a total of 40 days during the 2000/01 year of assessment (with the remaining 252 of the total 292 “Hong Kong days” falling in 2001/02), the chargeable portion of the gain would be taken to be 34.52%, i.e. $252/730$, when the option is exercised.

48. It should be noted that for the purpose of determining whether section 8(1B) is applicable (i.e. in ascertaining whether or not services were rendered in Hong Kong during visits exceeding a total of 60 days), the basis of counting days differs slightly from the “midnight rule” referred to above. More particularly, the decision of the Board of Review in case *D29/89, IRBRD, vol. 4, 340*, is applied, where it was held that “any part of a day counts as a ‘day’ for the purpose of section 8(1B)”. This decision was also followed in case *D12/94, IRBRD, vol. 9, 131*.

49. The chargeable portion of a gain of the kind referred to under the previous point is calculated separately from other chargeable income. Although the chargeable portion will fall for assessment in the year of assessment in which the gain is realized, it is calculated by reference to the “days in” and “days out” during the vesting period, which may have taken place in earlier years of assessment. The person’s other assessable income, if any, is calculated separately (and may involve a different time apportionment calculation in respect of remuneration for services rendered during that year).

50. The Ordinance does not require that the person be currently employed at the time of exercise etc. for section 9(1)(d) to be applied. Liability, if any, to assessment to Salaries Tax arises at the time the right is granted and cannot be extinguished by deferring exercise etc. until after cessation of employment. Where a right is exercised after cessation, the gain is treated as assessable income for the year of assessment in which the exercise takes place (section 11D cannot apply to treat the gain as having accrued to the person on the last date of his employment as the exercise of a right does not involve any payment by the employer to the person).

Example 5

The taxpayer had a non-Hong Kong employment. All services were rendered outside Hong Kong in the year of assessment in which the right was unconditionally granted, but rendered inside Hong Kong during the year of assessment in which the right was exercised.

51. As the taxpayer rendered all services outside Hong Kong during the year of assessment in which the right was granted, and as it was granted on an unconditional basis that did not involve services being rendered in Hong Kong, the right would accordingly be recognised as having been derived from services rendered outside Hong Kong. As such, the gain on exercise of the right would not be chargeable to Salaries Tax.

Example 6

The taxpayer had a non-Hong Kong employment. All services were rendered in Hong Kong during the year of assessment in which the right was unconditionally granted, but during the year of assessment in which the right was exercised, the taxpayer rendered all services in connection with the employment outside Hong Kong.

52. As the taxpayer rendered all services in connection with the employment in Hong Kong during the year of assessment in which the right was granted, and as it was granted on an unconditional basis which did not involve services being rendered outside Hong Kong, the gain on exercise would be fully chargeable to Salaries Tax by virtue of section 8(1A)(a) (i.e. the gain would fall within the words “income derived from services rendered in Hong Kong”). The timing of the exercise of the right would determine the year of assessment in respect of which the gain is chargeable, but would not otherwise be relevant. The chargeability of the gain depends on where the person rendered the services from which the benefit, i.e. the right, was derived; not on where the taxpayer was rendering services at the time of the subsequent exercise of the right. Likewise, if the taxpayer had ceased the employment prior to exercising the right, it would not have any bearing on the issue of chargeability.

Example 7

The taxpayer had a non-Hong Kong employment. Services were rendered inside and outside Hong Kong during the year of assessment in which the right was unconditionally granted and during the year in which it was exercised.

53. If the right was unconditionally granted to the taxpayer before he commenced to render any services for the employer concerned in Hong Kong, it would be accepted that the right was not derived from services rendered in Hong Kong, and accordingly no part of the gain calculated under section 9(4) in respect of the exercise of the right would be chargeable to Salaries Tax.

54. If, however, the right was unconditionally granted to the taxpayer after he had commenced to render services in Hong Kong, part of the gain would be regarded as having been derived from services rendered in Hong Kong. In practice, in such a case, the right would be treated as having been derived from the services rendered during the course of the year of assessment in which it was granted. Accordingly, the assessable portion would be calculated using the same “time basis” ratio applied in relation to the other income derived by the person in the year of assessment of the grant. The actual assessable amount would, of course, also depend on the amount of the gain calculated in accordance with section 9(4), and would be assessable in the year of assessment in which the right was exercised. The fact that the taxpayer rendered some services in Hong Kong during the year of assessment in which the right was exercised would not in itself have any bearing on whether the gain on exercise would be chargeable to Salaries Tax.

Example 8

The taxpayer had a non-Hong Kong employment. The right was conditionally granted subject to the completion of a vesting period during which services were rendered partly inside and partly outside Hong Kong.

55. In a case involving a non-Hong Kong employment, because of the terms of section 8(1A)(a), it is necessary to ascertain the extent to which the income (i.e. the gain on exercise) was derived from services rendered in Hong Kong. The approach to use in such a case is explained in paragraphs 44 to 48

above. The assessable portion, if any, would be chargeable to Salaries Tax in respect of the year of assessment in which the right was exercised.

Changes from Hong Kong to non-Hong Kong employment or vice versa during vesting period

56. The option may be granted at the time when the taxpayer holds a Hong Kong employment or non-Hong Kong employment, subject to the completion of a vesting period. During the vesting period, the taxpayer's source of employment changes from a Hong Kong to a non-Hong Kong employment, or vice versa. Given that the taxpayer holds both a Hong Kong and non-Hong Kong employment during the vesting period, the assessable gain of the option is apportioned between the periods covered by the two employments.

Example 9

The taxpayer had a non-Hong Kong employment at the time when the option was conditionally granted subject to the completion of a vesting period during which the taxpayer's employment was changed to a Hong Kong employment within the same group of companies.

57. As the option was derived by the taxpayer from both the non-Hong Kong employment and the Hong Kong employment, it is necessary to apportion the share option gain, which can be done by simple time apportionment, to ascertain the amount of the gain attributable to each employment. The portion attributable to the Hong Kong employment would be fully assessed or fully exempt in accordance with the principles and examples set out in paragraphs 36 to 42 above. On the other hand, the portion of the gain attributable to the non-Hong Kong employment would be fully exempt or further apportioned to arrive at the amount attributable to services rendered in Hong Kong pursuant to the principles and examples set out in paragraphs 43 to 55 above.

PART II – SHARE AWARD BENEFITS

THE ASSESSMENT APPROACH

58. For purposes of this part of the Practice Note, the terms “stock” and “share” are used interchangeably and reference to “share” includes “stock” and vice versa. Share-based remuneration schemes are becoming more common. There is no dispute that shares obtained through such schemes are taxable perquisites forming part of a taxpayer’s employment income. While share or stock award plans vary in details, the points which need to be addressed are -

- When does the perquisite accrue to the employee?
- What value should be attached to the perquisite when it has accrued to the employee?

The first question can be considered in the light of section 11D(b) of the Ordinance, which provides that income accrues to a person when he becomes entitled to claim payment. While this section uses the term “entitled to claim payment”, in the situation of share award, this phrase is taken to mean “entitled to ownership of the shares”. Section 11D(a) provides that income which has accrued to a person but which has not been received by him shall not be included in his assessable income until such time as he shall have received such income. Further, income which has been made available to an employee to whom it has accrued or has been dealt with on his behalf or according to his directions, will be regarded as received by him. In regard to the second question, the fair value of the perquisite at the time of accrual should be ascertained.

59. For salaries tax purposes, the time at which the shares accrue to the employee can be determined by reference to the terms of the award plan. Generally, there are two approaches in assessing such awards. These are (1) “Upfront”, i.e. at the time when the employer makes an award of shares to the employee, and (2) “Back End”, i.e. when the shares are actually vested in the employee free of any conditions. Which of these two approaches to be adopted will depend on when the employee is regarded as fully entitled to ownership of the shares. In determining whether ownership of the shares has passed to the

employee, consideration will be given to whether the employee is entitled to the full economic benefit of the shares.

60. Experience shows that the terms of award plans in most cases are complex and varied. For purposes of this DIPN, it is not practicable to set out and comment on every kind of share award plans. What is important is to follow the guidelines consistently in determining when the perquisite has accrued to the employee. The following are general guidelines -

(1) “Upfront” approach

Under this approach, the award is assessed to tax at the time of grant by the employer. The award granted may or may not be subject to certain restrictions. The most common restriction is a restriction to sell, e.g., the employee is not allowed to sell the shares awarded within a certain period of time. Only at the expiry of the restriction period would the employee be allowed to sell. Other than this restriction, the employee’s name would be entered in the shareholders’ register, he would be entitled to vote in general meetings, receive dividends, pledge the shares to banks for loans, etc. In short, he has all the rights of a normal shareholder, except the freedom to sell during the restriction period. Most importantly, at the end of the restriction period, normally little needs to be done to “vest” the shares in the employee. In such situation, the Department takes the view that the employee has received a perquisite in the form of shares at the time of grant and he would be chargeable to tax at this point of time (i.e. upfront).

(2) “Back End” approach

Under this approach, certain conditions have to be satisfied before the shares are vested in the employees. The most common conditions include completing a period of employment with the same employer/group, the company attaining certain level of financial or operational results, etc. Before fulfilment of these conditions, the shares are simply not vested in the employee. The shares might be allotted and held by a trustee but they are liable to be forfeited if the conditions are not fulfilled, or in the event that the employee resigns or is dismissed due to misconduct, etc. Normally, the employee does

not have rights of a shareholder, he is not registered as a shareholder, he is not allowed to vote or to receive dividend, etc. It is only at the expiry of the vesting period that the employee would receive all shares together with dividend or dividend shares, or bonus shares distributed during the vesting period. In this situation, the Department takes the view that at the time of grant, the employee only receives a promise with respect to the shares. It is only when the shares are vested in the employee (or when the employee is entitled to ownership of the shares) free of any restriction that the employee is taken as having received the perquisite. It is then that the share award will be chargeable to tax (i.e. back end).

61. For the present purpose, “vesting” refers to the time when the employee is entitled to ownership of the shares free of all conditions and “vesting period” is taken to mean the period from the date that the share award is granted to an employee to the date immediately before the date that the employee is entitled to ownership of the shares free of all conditions. Generally speaking, if shares granted are subject to forfeiture by reason of termination of employment or some future events, the “Back End” approach is more appropriate in assessing the shares. There is more certainty under this approach as the employee is entitled to the shares free of any condition. No doubt, there must be many factual scenarios more complicated than those highlighted above. It is more appropriate to examine the terms of the award to ascertain the point of time that the shares accrue to the employee for salaries tax purposes. The following table summarizes the two broad approaches -

	“Upfront” approach	“Back End” approach
Vesting period applies?	No.	Yes.
Time of assessment	Upfront, i.e. at the time of the grant.	Back end, i.e. upon fulfilment of conditions.
Valuation	Market value at time of grant.	Market value at time of fulfilment of conditions.
Discount in valuation?	Yes. The discount is to be determined in the light of the facts of each particular case. Generally, a 5% discount will be given for each year of sale restriction [see <i>D120/02, IRBRD Vol. 18, 125</i> where a 25% discount was allowed for a 5 year restriction period]. This is in line with the treatment of share options under paragraph 21.	No.
Distributions (e.g. dividends, bonus shares)	Received during the restriction period: Not taxable; regarded as investment income since employee is entitled to the shares at the time of award.	Received during the vesting period: Taxable, since employee is entitled to the shares only at the end of the vesting period.

Hong Kong employment

62. The value of shares accruing in a year of assessment will be added to the taxpayer’s other income for this year and be assessed to tax according to the general charging provisions. If the taxpayer does not render any services in Hong Kong or if he renders some services, his visit in Hong Kong does not exceed 60 days for that year, the shares, along with the taxpayer’s employment income, will be exempt from tax by applying sections 8(1A)(b)(ii) and 8(1B).

Shares vested after cessation of employment are deemed to accrue on the last day of employment.

Example 10

On 1 May 2005, while the taxpayer was an employee of a group company in Hong Kong, he was granted 5,000 shares by his employer subject to a vesting period. On 1 July 2006, he resigned from the company. On 1 May 2007, the 5,000 shares vested in him. The value of the vested shares was \$A on 1 May 2007.

In this example, the value of the vested shares, \$A, is to be included in the taxpayer's assessment for 2006/07 according to section 11D(b) proviso (ii).

Non-Hong Kong employment

63. If shares are subject to a vesting period, they are perquisite accruing to an employee in the year of assessment in which vesting takes place. For an employee who is entitled to time basis apportionment, the value of the shares should be added to the employee's other taxable income for that year and the time apportionment factor relevant to that year be applied to ascertain income chargeable to tax in Hong Kong. Except in commencement and cessation cases mentioned in paragraphs 66 and 67, the factor is to be determined as follows -

$$\frac{\text{Days in Hong Kong in the year of assessment that vesting takes place}}{\text{Days in the year of assessment that vesting takes place}}$$

64. The factual situation between share award and share option is not the same. Share options involving vesting periods may be exercised by an employee a few years after the options are vested. In paragraph 45, a time apportionment factor by reference to the days-in-days-out in the vesting period is adopted for ascertaining the chargeable portion of the gain when the options are exercised. This approach is not suitable for share award cases. If it is accepted that the perquisite accrues at the moment of time of vesting, it is only necessary to apply the time apportionment factor in the year of vesting, i.e. the year that the perquisite accrues to the employee. Section 8(1) provides that salaries tax shall be chargeable for each year of assessment in respect of income arising in or derived from Hong Kong from an office or employment.

In section 11B, the assessable income of a person in any year of assessment shall be the aggregate amount of income accruing to him in that year of assessment. Section 8(1A) which is an extension of section 8(1), provides that income arising or derived from Hong Kong includes income derived from services rendered in Hong Kong. The approach to assess shares accruing in a year of assessment by reference to the time apportionment factor for that year is consistent with the aforementioned provisions.

Continuous employment cases

65. In a continuous employment situation, it is generally true that the amount of time that an employee spends in Hong Kong and outside Hong Kong would be fairly constant comparing one year with the next. It is not anticipated that the use of the formula in paragraph 63 should create undue unfairness. Exemptions under sections 8(1A)(ii)(b) and 8(1B) are also available to non- Hong Kong employment cases.

Example 11

The taxpayer had a non-Hong Kong employment. On 1 May 2005, he was granted 10,000 shares by his employer subject to a vesting period. Shares would only be vested on condition that he remained an employee of his company on the vesting dates. 5,000 shares vested in him on 1 May 2007 and the remaining 5,000 on 1 May 2008. The number of days in Hong Kong and outside Hong Kong was ascertained as follows -

	(A)	(B)	(C)	%
	<u>Days In</u>	<u>Days outside</u>	<u>Total days</u>	<u>(A)/(C)</u>
<u>Year ended</u>	<u>Hong Kong</u>	<u>Hong Kong</u>		
31.3.2006	275	90	365	75
31.3.2007	260	105	365	71
31.3.2008	250	116	366	68
31.3.2009	255	110	365	70

In the above example, the assessor and taxpayer agreed that the “back end” approach is applicable to assess the vested shares. The value of the first 5,000 vested shares is to be included along with the taxpayer’s other remuneration in the year of assessment 2007/08 and 250/366 of the value is to be subject to tax

while the remaining 5,000 vested shares is to be included in 2008/09 and 255/365 of their value is subject to tax.

Inbound employee cases

66. An employee holding a non-Hong Kong employment may have been granted shares before he takes up his employment or assignment in Hong Kong and such shares are subject to a vesting period. If shares are vested in him after he takes up such employment or assignment and the terms of the share award clearly state that the vesting of the shares will depend on a period of employment, the Department can agree to exclude a portion of the gain on time apportionment referable to the vesting period before the taxpayer's transfer to Hong Kong under the "Back End" approach. If it is not so clearly stated, the whole of the benefit should be included in the year of vesting.

Example 12

On 1 September 2006, while the taxpayer was an employee of a group company outside Hong Kong, he was granted 10,000 shares by his employer subject to a vesting period. Shares would only be vested on condition that he remained an employee of the group on the vesting dates. On 1 August 2007, he was transferred to another company in Hong Kong within the group. The Department accepts that the taxpayer had a non-Hong Kong employment.

On 31 August 2007, 5,000 of the shares vested in him. The vesting period for these shares totalled 365 days, i.e. 1.9.06 to 31.8.07. The number of days in the vesting period after the taxpayer's transfer to Hong Kong was 31 days, i.e. 1.8.07 to 31.8.07 for the first 5,000 shares.

On 31 August 2008, the remaining 5,000 shares vested. The vesting period for these shares totalled 731 days, i.e. 1.9.06 to 31.8.08. The number of days in the vesting period after the taxpayer's transfer to Hong Kong was 397 days, i.e. 1.8.07 to 31.8.08, for these remaining 5,000 shares.

The number of days in Hong Kong and outside Hong Kong was ascertained as follows -

<u>Period/ Year ended</u>	(A) <u>Days In Hong Kong</u>	(B) <u>Days outside Hong Kong</u>	(C) <u>Total days</u>	% <u>(A)/(C)</u>
1.8.2007 to 31.3.2008	166	78	244	68
31.3.2009	255	110	365	70

In this example, the assessor and taxpayer agreed that the “back end” approach is applicable to assess the vested shares. Assuming the value of the vested shares on 31 August 2007 was \$A and those on 31 August 2008 was \$B, the amounts to be included in the assessments would be calculated as -

Year of assessment 2007/08: \$A x (31/365) x (166/244)

Year of assessment 2008/09: \$B x (397/731) x (255/365)

Outbound employee cases

67. Similarly, shares may have been granted to the employee holding a non-Hong Kong employment during the time of his employment or assignment in Hong Kong but such shares, which are subject to a vesting period, are vested in him after his transfer outside Hong Kong to another group company. If the “Back End” approach is applicable and if the terms of the award clearly state that the vesting of the shares will depend on a period of employment, the value of the shares attributable to the vesting period before his transfer outside Hong Kong should be chargeable to tax. However, there may be situations in which a taxpayer’s entitlement to receive the vested shares is not affected by his resignation. In other words, if the taxpayer will still receive shares under the award after his resignation, the value of the shares should be included in the year of resignation, see Example 10 above.

Example 13

The taxpayer had a non-Hong Kong employment. On 1 October 2005, while the taxpayer was an employee of a group company in Hong Kong, he was granted 5,000 shares by his employer subject to a vesting period. Shares would only be vested on condition that he remained an employee of the group on the vesting date. On 1 July 2007, he was transferred to another company outside Hong Kong within the group.

On 1 October 2007, the 5,000 shares vested in him. The vesting period for these shares totalled 730 days, i.e. 1.10.05 to 30.9.07. The number of days in the vesting period before the taxpayer's transfer outside Hong Kong was 638 days, i.e. 1.10.05 to 30.6.07 for the 5,000 shares.

<i>Period</i>	(A) <u>Days In</u> <u>Hong Kong</u>	(B) <u>Days outside</u> <u>Hong Kong</u>	(C) <u>Total days</u>	% <u>(A)/(C)</u>
1.4.2007 to 30.6.2007	65	26	91	71

The assessor and taxpayer agreed that the “Back End” approach is applicable to assess the vested shares. Assuming the value of the vested shares on 1 October 2007 was \$A, the amount to be included in the assessment for the year 2007/08 is to be calculated as -

$$\text{Year of assessment 2007/08: } \$A \times (638/730) \times (65/91)$$

“Phantom share plans”

68. Some employers may set up incentive schemes involving “phantom or hypothetical shares”. Under such schemes, the employee is “allocated” a number of shares in the employer company or group company. The employee receives a future cash bonus linked to the value of such shares. No tax is chargeable at the time when the phantom shares are allocated if no actual value passes to the employee. When bonus is paid by the employer, it will be taxed together with his other income in the year of payment.

Method of valuation

69. The Department assesses the shares according to their market value if they are listed shares. There should not be great difficulty getting their quotation from the stock exchange. If the shares are unlisted, the Department needs to employ other methods, e.g. net assets value. Generally, the same methods of valuation as advocated in paragraphs 22 to 26 would apply.

PART III – ADMINISTRATIVE MATTERS

PERSONS DEPARTING PERMANENTLY FROM HONG KONG

Share option benefits

70. It will be appreciated from what is said in Part I that a gain realized from the exercise, assignment or release of a share option after permanent departure from Hong Kong might nonetheless be chargeable to salaries tax. However, with a view to finalising the salaries tax liabilities of such persons prior to departure, the Department will, as a concession, allow a person to elect to have the liability ascertained on the basis of a notional exercise of the option. More particularly, the Department will accept that the liability, if any, can be finalized on the basis of the gain (calculated in accordance with section 9(4)(a)) that would have been realized if the option had been exercised on a day within 7 days before the date of submission of the person's tax return for the final assessment applicable to the year of assessment in which he or she permanently departs from Hong Kong. It should be noted that if the person concerned has a non-Hong Kong employment and the option in question is a conditional one in respect of which the vesting period has not expired on the date of the notional exercise, the gain should nonetheless be calculated on the basis that the vesting period would be deemed to end on that date.

71. If a person wishes to make such an election, an election form cum computation of gain statement per the **Appendix 1** should be attached to the return to the effect that the gain is offered for assessment on the understanding that no further liability will arise when the option is actually exercised, assigned or released (i.e. after departure from Hong Kong). The election should be made in respect of all grants received but not exercised prior to cessation of employment for Hong Kong salaries tax purposes and/or departure from Hong Kong. Election relating to some of the grants or only part of a grant is not accepted.

72. As a further concession, the Department is prepared to accept an election made within 3 months from the date of permanent departure from Hong Kong if it has not been made before departure. In this kind of situation, the date of departure will be taken as the date of the notional exercise for purposes of calculating the gain.

73. An election once made cannot be withdrawn before the actual exercise, assignment or release, except (i) within the objection period of the assessment in which the gain of the notional exercise is included, or (ii) total forfeiture of the options with no replacement or compensation before the actual exercise. On the other hand, if it transpires that the gain in respect of the actual exercise, assignment or release is less than the amount assessed in respect of the notional exercise, the Department will favourably consider any application for appropriate amendment and re-assessment.

Share award benefits

74. With regard to share awards granted but not yet vested in the employee, and where the “Back End” approach is applicable, the Department agrees to adopt the same practice as set out under paragraphs 70 and 72 above to facilitate early finalization of the taxpayer’s tax liability before his permanent departure. A person may elect to be assessed on either (a) the deemed value on a day within 7 days before the submission of his return for the final assessment applicable to the year of assessment in which he permanently departs Hong Kong if election is made before his departure from Hong Kong, or (b) the deemed value on the date of his departure if his election is made within 3 months from the date of permanent departure from Hong Kong. Election can be made by completing **Appendix 2**. An election once made cannot be withdrawn. Such election is only accepted if it applies to all unvested shares chargeable to tax according to this Practice Note. Once an election is accepted by the Department and an assessment is made according to this paragraph, a subsequent request to revise the assessment will not be entertained unless the assessment is objected to within the statutory time allowed for objection. On the other hand, the Department will not seek to increase the assessment for the sole reason that the value upon vesting has increased if the assessment is raised according to this paragraph.

REPORTING REQUIREMENTS

Employees

75. Where, by virtue of section 9(1)(d) and the related provisions referred to above, a person is chargeable to salaries tax in respect of a gain realized by the exercise, assignment or release of a right to acquire shares or

stock in a corporation or in respect of shares awarded to him by reason of his office or employment, the person is obliged to inform the Department of the fact under section 51(2). Just as chargeability does not depend on the person being employed at the time of exercise, assignment or release of share options or at the time when shares are vested in him, the person has an obligation to inform the Department should such events take place. The only exception is where a person has elected for a notional exercise of the options as set out in paragraphs 70 to 73 above. If all tax liability has been settled through a notional exercise, the person is not required to inform the Department at the time of actual exercise. Or if all tax liability has been settled through “deemed vesting” of otherwise unvested shares before permanent departure mentioned in paragraph 74 above, the person is not required to inform the Department when the shares are vested.

76. The requirement to inform the Department can generally be satisfied when the person submits his or her “Tax Return - Individuals” (B.I.R.60) for the year of assessment in which the right is exercised, etc. or share awarded or vested. Details of the necessary particulars are listed in Guide Book issued with each such return. After taxpayers have departed from Hong Kong, they may still have chargeable income through exercising options granted to them during their employment in Hong Kong or through shares vested in them which are granted to them because of their office or employment in Hong Kong. For these taxpayers, “Tax Return - Individuals” may no longer be sent to them in the annual bulk issue of returns. Nevertheless, these taxpayers are still required to advise the Department by way of a letter when there is chargeable income.

77. The obligation to inform the Department does not, however, depend on a tax return being issued to the person. Section 51(2) of the Ordinance provides that where a person chargeable to salaries tax has not been required by an assessor to furnish a return, he is nonetheless required to inform the Commissioner that he is so chargeable not later than 4 months after the end of the basis period for the year of assessment concerned. In the case of share option, the time is not later than 4 months after the end of the year of assessment in which the option is exercised. In the case of share award, the basis period should be that for the year of assessment in which he is entitled to ownership of the shares. If vesting of the shares takes place after his employment has ceased, the taxpayer should advise the Department as soon as he is entitled to ownership of the shares unconditionally.

78. As with any other income that is chargeable to tax, serious consequences may follow if a person fails to meet his obligations under the Ordinance in respect of any chargeable gain arising from the exercise, assignment or release of a right to acquire shares or stock or arising from share awarded. In this regard it is worth noting that the penalty provisions of the Ordinance may apply where a person fails to notify the Commissioner that he is chargeable to tax, fails to comply with a notice to submit a return, or makes an incorrect return by omitting or understating anything. In such cases, depending on the nature of the shortcoming, prosecution action may be taken or additional tax imposed (see sections 80, 82 and 82A of the Ordinance). The Ordinance also provides for various recovery measures to be adopted, depending on the circumstances, where a person has failed to pay tax which is due and payable or if it appears likely that this will happen -

- section 75 provides for recovery action in the District Court where a person defaults in the payment of tax;
- section 76 for recovery from debtors of the taxpayer and certain other parties where tax payable is in default, or the person concerned has left Hong Kong or in the opinion of the Commissioner is likely to leave Hong Kong without paying the tax; and
- section 77 for the Commissioner to seek a Departure Prevention Order from a District Court Judge where a person has not paid all the tax assessed and there are reasonable grounds for believing that the person intends to depart, or has departed, from Hong Kong to reside elsewhere.

Employers

79. Employers are required to provide information in respect of share option benefits received by employees. Section 52(4) provides that where an employer commences to employ in Hong Kong an individual who is or is likely to be chargeable to salaries tax, the employer must within three months of the date of commencement of such employment notify the Commissioner in writing of, amongst other things, the individual's terms of employment. Accordingly, if the terms of employment provide for participation in a share

option scheme, full details of how the scheme operates should be supplied to the Commissioner. Details should also be provided if an employee has been granted a share option prior to commencing to be employed in Hong Kong but not yet exercised by him. The option may be not fully vested and may only become vested and exercisable after rendering services in Hong Kong, or the option may be fully vested but granted as an inducement to take up employment in Hong Kong. In both of these situations, the subsequent gains realized by the exercise, assignment or release of the options are income from office or employment under section 9(1)(d). Details thus need to be provided. Particulars should include the number and type of shares covered by the option, the consideration (if any) paid for the grant of the option, the consideration required to exercise the option and the period within which the option must be exercised. The information may, if the employer wishes, be provided in either case as an attachment to a form I.R.56E (the standard form available from the Department which an employer may use to comply with notification requirements under section 52(4)).

80. It is also relevant that employers are generally issued with a notice each year, under section 52(2) of the Ordinance, which requires the submission of returns detailing the remuneration of employees (i.e. forms B.I.R.56A and I.R.56B). The notes accompanying the forms set out the nature of the information required in respect of rights to acquire shares that have been granted, exercised, assigned or released. Employers should be aware when completing these forms that, in effect, the information is called for where a gain calculated in accordance with section 9(4) of the Ordinance has been realized during the year of assessment covered by the return in respect of a right granted “at any time”. In other words, the information should be supplied if such a gain was realized during the year, irrespective of whether the person concerned was a current or former employee at the time of exercise. However, in the case of a former employee, no information need be provided to the Commissioner where the gain realized was less than the basic allowance for the relevant year and it is known that during the relevant year the person concerned did not derive any other income chargeable to salaries tax (e.g. where the person was employed by another company in the same group and worked wholly outside Hong Kong throughout the year).

81. Particulars of gains realized under share option schemes are also requested on forms I.R.56F and I.R.56G which, respectively, may be completed by an employer to comply with requirements under section 52(5), to notify the Commissioner where an employee is about to cease to be employed, and section 52(6), to notify the Commissioner when an employee is about to depart from Hong Kong.

82. Where an employer is required to report details in respect of a gain realized by the exercise etc. of a share option, the gain should be calculated in accordance with section 9(4) of the Ordinance and reported accordingly. The employer should not make an apportionment of the gain for reporting in the employer's return even if the employee (or former employee) might be entitled to time-basis apportionment of his/her income by virtue of section 8(1A)(a). Details of the calculation of any such apportionment should only be included in the tax return of the individual concerned.

83. With regard to share awards, the employer's obligations are similar. Employers are required to report share award benefits in I.R.56E in commencement cases, I.R.56Bs in continuous employment cases, I.R.56Fs and I.R.56Gs in cessation and departure from Hong Kong cases. If share awards are vested in the employee after cessation of employment, an amendment to the I.R.56 forms previously filed should be made by either filing a "Replacement" or a written notification of amendment. For details, see -

www.ird.gov.hk/eng/tax/ere_amd.htm.

LIQUIDITY AND TAX LIABILITY

84. The Department does not consider that there is unfairness in demanding a taxpayer to pay tax on share awards before he can sell the shares for cash. That said, the Collector is always prepared to assist if any taxpayer has a liquidity problem. Instalment payments could be granted in appropriate cases.

APPLICATION OF SECTIONS 61, 61A, 70 AND 70A

85. The Department will generally act in accordance with the Practice Note in relation to assessments raised after its issue and to objections concerning relevant gains that are subsequently finalized. Exceptionally, a different basis of assessment may be used in any particular case if it is considered that section 61 or section 61A of the Ordinance should be applied. In such circumstances, the assessment may be made either on the basis that the relevant scheme or any part of it had not been entered into, or in such other manner as is considered appropriate to counteract the tax benefit that would otherwise be obtained. It should also be noted that where an assessment made prior to the issue of this Practice Note was regarded as final and conclusive in terms of section 70 of the Ordinance, it will not be reopened for the purpose of making an adjustment to reflect any change of practice detailed in the Practice Note.

File No. : _____

To : Commissioner of Inland Revenue

Salaries Tax
Departing Permanently from Hong Kong
Election for Notional Exercise of Share Option

Year of Assessment : _____

I hereby elect to ascertain the salaries tax liability relating to the share option granted to me by my employer(s) but not yet exercised, assigned or released (as listed below) on the basis of a notional exercise of the option. The notional gain of \$_____ as shown in the attached computation is offered for assessment to salaries tax on the understanding that no further tax liability will arise when the same shares are actually exercised, assigned or released after my departure from Hong Kong.

Name of corporation, the shares of which are subject of the grant	Total number of shares covered by the grant	Date of Grant	Date of Vesting, if applicable	Final Date for exercise of the option granted

(Please attach additional sheets if the space above is insufficient)

Signature : _____

Name : _____

Hong Kong Identity Card / Passport No. : _____

Date : _____

Computation of Gain on Notional Exercise of Share Option¹**Year of assessment** : _____**Deemed Vesting Date²** : _____**Date of departure from Hong Kong** _____

	[A]	[B]	[C]	[D]	[E]
Date of grant ³	Total no. of shares covered by the grant	Market Price ⁴ per share at Notional Exercise Date \$	Consideration paid for the grant, if any \$	Consideration required for exercising the option granted ⁵ \$	Gain on Notional Exercise ⁶ $E = [(A \times B) - C - D]$ \$
Total Gain on Notional Exercise of all Options Granted					

(Please attach additional sheets if the space above is insufficient.)

¹ Election should be made in respect of all shares in all of the grants received prior to cessation of employment for Hong Kong salaries tax purposes (Paragraphs 71, DIPN No. 38).

² Notional Exercise Date can be either (i) any one day within seven days before the date of submission of the return for the final assessment of the year of assessment the person permanently departs from Hong Kong if election is made before departure, or (ii) the date of permanent departure from Hong Kong if election is made after departure (Paragraphs 70 and 72, DIPN No. 38).

³ Please attach documents / correspondence from employer in support of the grant.

⁴ Market Price refers to the closing quotation value on Notional Exercise Date (Paragraphs 70 and 72 of DIPN No. 38).

⁵ Consideration may include sums payable at the time of vesting, brokerage, stamp duty, and other costs associated with vesting of the shares.

⁶ Gross amount of gain should be reported. If you are entitled to time-basis apportionment of income, please provide details of the calculation in accordance paragraphs 44-48 of DIPN No. 38 in a separate computation.

File No. : _____

To : Commissioner of Inland Revenue

Salaries Tax
Departing Permanently from Hong Kong
Election for Deemed Vesting of Shares

Year of Assessment : _____

I hereby elect to ascertain the salaries tax liability relating to the shares granted to me by my employer(s) but not yet vested (as listed below) on the basis of a deemed vesting of the shares. The gain of \$_____ as shown in the attached computation is offered for assessment to salaries tax on the understanding that no further tax liability will arise when the same shares are actually vested after my departure from Hong Kong.

Name of corporation, the shares of which are subject of the grant	Total number of shares covered by the grant	Date of Grant	Date of Vesting

(Please attach additional sheets if the space above is insufficient)

Signature : _____

Name : _____

Hong Kong Identity Card / Passport No. : _____

Date : _____

Computation of Gain on Deemed Vesting of Shares¹**Year of assessment** : _____**Deemed Vesting Date²** : _____**Date of departure from Hong Kong** _____

	[A]	[B]	[C]	[D]	[E]
Date of grant ³	Total no. of shares covered by the grant	Market Price ⁴ per share at Deemed Vesting Date \$	Consideration paid for the grant, if any \$	Consideration spent for vesting of shares ⁵ \$	Gain on Deemed Vesting ⁶ $E = [(A \times B) - C - D]$ \$
Total Gain on Deemed Vesting of all Shares Granted					

(Please attach additional sheets if the space above is insufficient.)

¹ Election should be made in respect of all shares in all of the grants received prior to cessation of employment for Hong Kong salaries tax purposes (Paragraph 74, DIPN No. 38).

² Deemed Vesting Date can be either (i) any one day within seven days before the date of submission of the return for the final assessment of the year of assessment the person permanently departs from Hong Kong if election is made before departure, or (ii) the date of permanent departure from Hong Kong if election is made after departure (Paragraph 74, DIPN No. 38).

³ Please attach documents / correspondence from employer in support of the grant.

⁴ Price refers to the closing quotation value on Deemed Vesting Date (Paragraph 74 of DIPN No. 38).

⁵ Consideration may include sums payable at the time of vesting, brokerage, stamp duty, and other costs associated with vesting of the shares.

⁶ Gross amount of gain should be reported. If you are entitled to time-basis apportionment of income, please provide details of the calculation in accordance with the applicable paragraphs under Part II of DIPN No. 38 in a separate computation.