Salaries Tax –

Taxation of Share Award Benefits

(Relevant to ATE Paper 5 – Hong Kong Taxation)

Dr. Dora L Y Lee

Introduction

In March 2008, the Inland Revenue Department (IRD) issued DIPN 38 (Revised) Salaries Tax – Employees Share-based Benefits to replace the previous DIPN 38 Salaries Tax – Employee Option Benefits (first issued in February 2001 and then revised in March 2005). In the latest revised DIPN, the IRD retained the section on the Taxation of Share Option Benefits in Part I and added Taxation of Share Awards Benefits in Part II. This article describes the taxation of share award benefits as stated in the revised DIPN. All section numbers in this article refer to those of the Inland Revenue Ordinance (IRO).

Taxation Of Share Award Benefits

The assessment approach

Shares obtained through share-based remuneration are taxable perquisites forming part of a taxpayer's employment income. For salaries tax purposes, it is necessary to ascertain:

- when the perquisite accrued to the employee, and
- the value which should be attached to the perquisite when it has accrued to the employee (DIPN 38 (revised), para 58)

When does the perquisite accrue to the employee?

Income accrues to a person when he becomes entitled to claim payment. In the situation of share awards, the phrase "entitled to claim payment" is taken to mean "entitled to ownership of the shares" (section 11D(b)). Income which has accrued to a person but which has not been received by him shall not be included in his assessable income until he receives the income (section 11D(a)). 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 (DIPN 38 (revised), para 58).

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:

- Upfront, i.e. when the employer makes an award of shares to the employee, and
- Back end, i.e. when the shares are actually vested in the employee free of any conditions.

The approach to be adopted will depend on:

- when the employee is regarded as fully entitled to ownership of the shares, i.e., whether the employee is entitled to the full economic benefit of the shares, and
- when the employee has all the rights of a normal shareholder (DIPN 38 (revised), paras 59 and 60)).

What value should be attached to the perquisite when it has accrued to the employee?

The fair value of the perquisite at the time of accrual should be ascertained (DIPN 38 (revised), para 58).

Quoted shares

The fair value of quoted shares generally refers to the closing quotation value on the stock market. If the shares are listed on two non-Hong Kong exchanges, the taxpayer may select the more favourable price (DIPN 38 (revised), para 22).

Unquoted shares

The IRD has to adopt other methods, such as the net asset value, for unquoted shares. The 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 (DIPN 38 (revised), para 25). It will sometimes be useful for officers of the IRD 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 (DIPN 38 (revised), para 26).

Guidelines for determining when the perquisite has accrued to the employee

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. Other than this restriction, the employee's name is entered in the shareholders' register and he is 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 the above situation, the IRD considers that the employee has received a perquisite in the form of shares at the time of grant and he is chargeable to tax at this point of time (i.e. upfront) (DIPN 38 (revised), para 60).

Back end approach

Under this approach, certain conditions (e.g., completing a period of employment with the same employer/group, the company attaining a certain level of financial or operational results) have to be satisfied before the shares are vested in the employees. 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 dividends, etc. It is only at the expiry of the vesting period that the employee receives all shares together with dividends or dividend shares, or bonus shares distributed during the vesting period. In this situation, the IRD 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) (DIPN 38 (revised), para 60).

Vesting and vesting period
"Vesting" refers to the time when the employee is entitled to ownership of the shares free of all conditions. "Vesting period" refers to 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.

When should the back end approach be used?
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. As there are many complicated scenarios, 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 (DIPN 38 (revised), para 61).

Comparison between the upfront and back end approaches

The following table summarizes the two broad approaches (DIPN 38 (revised), para 61):

	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 D120/02, IRBRD Vol. 18, 125 where a 25% discount was allowed for a five-year restriction period]. This is in line with the treatment of share options.	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.

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The value of shares accruing in a year of assessment will be:

- added to the taxpayer's other income for this year of assessment, and
- assessed to tax according to the general charging provisions of the IRO.

If the taxpayer:

- does not render any services in Hong Kong, or
- has rendered some services during visits to Hong Kong not exceeding 60 days for that year of assessment,

the shares, along with the taxpayer's employment income, will be exempt from tax (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 1
On 1 May 2005, while T 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, T resigned from the company. On 1 May 2007, the 5,000 shares were vested in him. The value of the vested shares was \$A on 1 May 2007.

The value of the vested shares, \$A, is to be included in T's assessment for the year of assessment 2006/07 according to section 11D(b) proviso (ii).

Non-Hong Kong employment – Taxation of share award benefits

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. If an employee is entitled to time basis apportionment, the value of the shares should be added to the employee's other taxable income for that year of assessment and the time apportionment factor relevant to that year of assessment shall applied to ascertain income chargeable to tax in Hong Kong. Except in commencement and cessation cases, the factor is to be determined as follows -

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

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. 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 (sections 8(1) and 11B) (DIPN 38 (revised), para 64).

Example 2

T had a non-Hong Kong employment. On 1 May 2005, T was granted 10,000 shares by his employer, subject to a vesting period. The shares will only be vested if T is still an employee of his company on the vesting dates. A total of 5,000 shares were vested in T on 1 May 2007 and the remaining 5,000 on 1 May 2008. The respective numbers of days that T spent in Hong Kong and outside Hong Kong were as follows:

Year ended	(A) Days in Hong Kong	(B) Days outside Hong Kong	(C) Total days	% (A)/(C)
31 Mar 2006	275	90	365	75
31 Mar 2007	260	105	365	71
31 Mar 2008	250	116	366	68
31 Mar 2009	255	110	365	70

The assessor and T agreed that the back end approach should be applied to assess the vested shares.

The share-award benefits are assessed as follows:

- the value of the first 5,000 vested shares is to be included along with T'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 the year of assessment 2008/09 and 255/365 of their value is subject to tax.

Inbound employee cases

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 IRD 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 (DIPN 38 (revised), para 66).

Example 3

On 1 September 2006, while T 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 T remained an employee of the group on the vesting dates. On 1 August 2007, T was transferred to another company in Hong Kong within the group. The IRD accepts that T had a non-Hong Kong employment. On 31 August 2007, 5,000 of the shares were vested in T. The vesting period for these shares totalled 365 days, i.e. 1 September 2006 to 31 August 2007. The number of days in the vesting period after T's transfer to Hong Kong was 31 days, i.e. 1 August 2007 to 31 August 2007 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 September 2006 to 31 August 2008. The number of days in the vesting period after T's transfer to Hong Kong was 397 days, i.e. 1 August 2007 to 31 August 2008, for these remaining 5,000 shares.

The respective numbers of days in Hong Kong and outside Hong Kong were as follows:

Period	(A) Days in Hong Kong	(B) Days outside Hong Kong	(C) Total days	% (A)/(C)
1 Aug 2007 to 31 Mar 2008	166	78	244	68
Year ended 31 Mar 2009	255	110	365	70

The assessor and T 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

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 applies 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.

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 (DIPN 38 (revised), para 67).

Example 4

T had a non-Hong Kong employment. On 1 October 2005, while T 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, T was transferred to another company outside Hong Kong within the group. On 1 October 2007, the 5,000 shares vested in T. The vesting period for these shares totalled 730 days, i.e. 1 October 2005 to 30 September 2007. The number of days in the vesting period before T's transfer outside Hong Kong was 638 days, i.e. 1 October 2005 to 30 June 2007 for the 5,000 shares.

Period	(A) Days in Hong Kong	(B) Days outside Hong Kong	(C) Total days	% (A)/(C)
1 April 2007 to 30 June 2007	65	26	91	71

The assessor and T agreed that the back end approach applies in assessing 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 of assessment 2007/08 is to be calculated as:

$A x (638/730) x (65/91)

Phantom share plans

Under an incentive scheme involving phantom or hypothetical shares, 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 a bonus is paid by the employer, it will be taxed with his other income in the year of payment (DIPN 38 (revised), para 68).

Tax Administrative Matters Relating To Persons Departing Permanently From Hong Kong With Share Awards Not Yet Vested

If share awards have been granted but are not yet vested in the employee, and where the back end approach applies, the IRD will facilitate early finalization of the taxpayer's salaries tax liability before his permanent departure. A person may elect to be assessed on either:

- the deemed value on a day within seven 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
- the deemed value on the date of his departure if his election is made within three months from the

date of permanent departure from Hong Kong (DIPN 38 (revised), para 74).

Once an election is made it cannot be withdrawn, and an election is only accepted if it applies to all unvested shares chargeable to salaries tax, according to DIPN 38 (revised). Once an election is accepted by the IRD and an assessment made according to DIPN 38 (revised),

- a subsequent request to revise the assessment will not be entertained unless the assessment is objected to within the statutory time allowed for objection, and
- the IRD will not seek to increase the assessment for the sole reason that the value upon vesting has increased (DIPN 38 (revised), para 74).

Conclusion

Depending on the terms of the share award schemes, the IRD will use either the upfront or back end approach to assess the taxpayers concerned. The share award of a taxpayer with a non-Hong Kong employment may have to be apportioned.

This topic is relevant to Paper 5. Students studying for this paper should know when a share award benefit will be taxed, calculate the taxable amount and explain the related tax treatment.