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**TECHNICAL**

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**Direct Taxation****TAX CASE UPDATE****Cash payments to employees in lieu of shares under ESOS**

**[Maxis Communication Berhad v Director General of Inland Revenue and Inland Revenue Board of Malaysia](#) (FC) 2014 [Civil Appeal No. 01(f)-42-09/2013(W)]**

Date of Judgment: 20 November 2014

**Facts & Findings:**

This is an appeal against the decision of the Court of Appeal (reported in our [e-CTIM 160/2013](#)) on the taxation of payments [referred to as Equivalent Cash Consideration (ECC)] made to the employees of the appellant, Maxis Communication Bhd. (Maxis) in lieu of shares offered under an ESOS.

In the appeal to the High Court, the Court ruled, in favour of Maxis, that the ECC was taxable under [S13\(1\)\(a\)](#) of the Act but its value was to be assessed under sections [25\(1A\)](#) and [32\(1A\)](#) of the Act.

Subsequently, the Order of the High Court was set aside by the Court of Appeal, which decided *inter alia*, that employees with unvested shares had no right to specific shares yet while their shares remain unvested, and the ECC was dealing with these unvested shares. Hence, it concluded, the application of sections [25\(1A\)](#) and [32\(1A\)](#) of the Act did not arise.

**Questions of law**

Leave was granted for appeal to the Federal Court on the following questions of law (quoted verbatim from the judgment):

- 1) *Where an employee's participation in an ESOS results in tax liability arising under [S13\(1\)\(a\)](#) of the Income Tax Act 1967 ("the Act") with the taxable value being determined under sections [25\(1A\)](#) and [32\(1A\)](#) of the Act -*
  - i. *Does the RM1.00 paid by the employee to the employer constitute valid and sufficient consideration so as to create a binding contract between the employer and employee?*
  - ii. *If the employer subsequently cannot honour the employee's exercise of that option (due to circumstances beyond that employer's control e.g. the employer is the subject of a takeover and thereafter becomes a private limited company), can the employee maintain that his contractual right to acquire shares under the ESOS has been breached?*
  - iii. *Where an employee is eligible to participate in ESOS but his option is at that point in time unvested (i.e. it will be exercisable only after a particular date), does that employee have a valid and enforceable contractual right under the ESOS?*
- 2) *From the point of view of taxation value under section [13\(1\)\(a\)](#) read with [25\(1A\)](#) and [32\(1A\)](#) of the Act, does an employee who holds vested option in the ESOS differ from an employee who holds unvested options in the ESOS?*
- 3) *Whether a payment (i.e. ECC payment) received by an employee (who holds unvested*

*options) from his employer (in return for the employee giving up his contractual rights in the unvested options) is liable to be taxed:*

- i. under section 13(1)(a) of the Act to the exclusion of sections 25(1A) and 32(1A) of the Act for the receipt of such payment?; or*
- ii. under section 13(1)(a) of the Act with the value of the tax being determined under sections 25(1A) and 32(1A) of the Act?*

**Decision:**

Appeal dismissed. The following is a summary of the grounds of judgment:

- 1) The Court was of the view that the ECC constituted a perquisite under [S13\(1\)\(a\)](#) of the Act. The basis of assessment for this type of income is provided in [S25\(1\)](#) of the Act. The word “perquisite” is not defined in the Act, but reference was made to Black’s Law Dictionary which gives the meaning as “*a privilege or benefit given in addition to one’s salary or regular wages.*” In the present case, the employees of Maxis were offered shares at a price which is lower than market value of the shares.
- 2) In the case of ESOS, the benefit arising from the ESOS to Maxis employees was considered as a perquisite under the Act, which was taxed in accordance with the basis of assessment provided under S25(1A) of the Act, while the value to be taxed was determined under [S32\(1A\)](#).
- 3) “Shares” is defined in [S2](#) of the Act as “share: in relation to a company, includes stock other than debenture stock.” Upon a plain reading of [S25\(1A\)](#) of the Act, the elements that must be in existence are:
  - a. A right to acquire shares exists;
  - b. The shares must be owned by the employee under his name;
  - c. If the right to acquire the shares exists, the date when that right is exercised or released.
- 4) In the present case, Maxis was subjected to a takeover by another company before the option to purchase the shares was exercised (on the vested date). As such, there were no shares to be offered to the employee. It was noted that the option was only vested on the employees, “*one third of the shares on each of the first three anniversaries of the date of grant*” (i.e. the employee must exercise the right on or after the anniversary date). Hence the date of grant was not the date the employee acquired the right over the shares.
- 5) In the Court’s judgment, the payment of ECC was not based on ESOS. For the employee to be entitled for shares under ESOS, they must purchase the shares. In a letter by Maxis’ tax consultant, it was confirmed that “*Maxis was delisted from the Main Board on 13 July 2007 and hence no listed share price can be attached to the shares...*” Based on this admission, the Court is in agreement with Revenue’s contention that the cash payment was not an ESOS.
- 6) There is no ambiguity in interpreting the words of [S25\(1A\)](#) and [S32\(1A\)](#) of the Act, which in their ordinary meaning, mean that they are applicable to employment income (perquisite) in respect of any right to acquire shares and provides the mechanism to compute the value of the perquisite. The words used and the intention of Parliament are clearly shown, that these provisions apply to shares and not to cash payments or the ECC. Even if there is ambiguity, the purposive approach to interpretation must be adopted (reference made to [LHDN v Alam Maritim Sdn Bhd \(2014\) 1 MLRA1](#)).
- 7) Reference was also made to the Explanatory Statement in the Finance Bill 2005 which provided the explanation for the introduction of [S25\(1A\)](#) and [S32\(1A\)](#) of the Act. “*It clearly shows that the intention of introducing the provisions is to clarify the tax treatment on income*

*from employment on any right to acquire shares in a company...(It) is also made clear that (these provisions) do not apply to benefit or perquisite received by an employee by way of cash payment."*

8) In concluding, the Court gave the following answers to the questions quoted above:

Q1 – RM1 paid by the employee merely indicated the employee's acceptance of the offer but did not give him the right to acquire shares. His eligibility to purchase shares arose only on the anniversary date and not before that date. He could not maintain the offer to purchase shares by reason of the takeover because Maxis had been delisted.

Q2 – The answer is in the affirmative.

Q3 – An employee who had an unvested option in ESOS had no right to acquire the shares before the anniversary date. Thus the cash benefit received was not taxed under [25\(1A\)](#) and [32\(1A\)](#) of the Act, but under [S25\(1\)](#).

Members may read the full [Grounds of Judgment](#) from the Official website of the Office of Chief Registrar, Federal Court of Malaysia.

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