

TECHNICAL

Direct Taxation

TAX CASE UPDATE

Whether payment of an Equivalent Cash Consideration in lieu of shares offered under an Employee Share Option Scheme comes within section 25(1A) and section 32(1A) of the Act.

Ketua Pengarah Hasil Dalam Negeri & Lembaga Hasil Dalam Negeri Malaysia v Maxis Communication Berhad (2012) [CA] (Civil Appeal No: W-01-665-2010)

Facts:

There was in place a binding Maxis Employee Share Option Scheme (ESOS). Pursuant to the conditional takeover offer by Binariang GSM Sdn Bhd to acquire all voting shares in Maxis for a determined cash consideration, Maxis could no longer honour its obligations under the ESOS. Hence the following parallel offers were made to Maxis employees who are holders of outstanding options under the Maxis ESOS:

- (i) In respect of vested/exercisable options, the Maxis employees must exercise their options before the takeover in order to be entitled to accept the offer by Binariang; and
- (ii) In respect of unvested options, the Maxis employees will be paid in lieu thereof, an Equivalent Cash Consideration (ECC), the acceptance of which would relieve Maxis of its contractual obligations under the ESOS to offer shares to participating employees.

In view of the conditional takeover offer, Maxis had requested confirmation from the IRB on the taxation of the ECC received by Maxis employees with unvested options before they could proceed with filing of the Return of Remuneration by an Employer and with reporting the taxable income arising from the Offer in the respective employees' annual income statement (Form EA).

If the unvested share option is considered as the right to acquire shares in Maxis, the amount to be included in the employees' gross income from employment shall be calculated based on [S.32\(1A\)](#) for the year in which the right is exercised, assigned, released or acquired as enunciated in [S.25\(1A\)](#). Otherwise, the payment received will be considered as a gross income under [S.13\(1\)](#) and [S.25\(1\)](#) applies. The payment must be reflected in the employees' income statement for the year in which the payments were received.

The DGIR ruled (among other points made in the ruling) that:

- (i) Under the relevant ESOS Byelaw, the option only vested from the date of the first anniversary that the employee is offered the option and not from the date of grant. Consequently, an employee does not have any rights in an unvested option before the date of the first anniversary, and the requirement that there be a "right to acquire shares in a company..." in [S.25\(1A\)](#) of the Act is not fulfilled.
- (ii) The alternative consideration paid to employees is no longer in the form of shares which need to be valued, but is a receipt of cash arising from employment;
- (iii) Employees are not offered fresh share options in consequence of the takeover, but are paid a sum of money as ECC, the value and timing of which is based on the ESOS. Further, unlike offers under the ESOS, they do not have to pay anything to receive the said payment.

Maxis is of the view that the ECC payment was made to relieve it from its contractual obligations under the ESOS and therefore was not a salary or cash remuneration under [S13\(1\)\(a\)](#) of the Act, but was a share-based payment that falls under [S.25\(1A\)](#) and S.32(1A) of the Act.

Consequently, Maxis filed an appeal by way of judicial review to the High Court which ruled in favour of Maxis and set aside the order of the Director General of Inland Revenue (DGIR) on the following grounds:

- [S.25\(1A\)](#) does not impose any vesting element before its applicability. The fact that the options will only be vested based on the vesting schedule is immaterial.
- The grant of option gives rise to a right to acquire shares at the point of the grant. [Public Ruling No.4/2004 – Employee Share Option Scheme Benefit](#) defines “option” as right offered in respect of a number of shares at a specific price to be exercised at a future date. When the offer takes place is dependent on the date the employer offers their employee the right to purchase a number of shares in the company which is at the point of grant.
- [S.25\(1A\)](#) clearly provides that the gross income in respect of any right to acquire shares in a company is taxed in the year where the right is exercised, assigned, released or acquired. In the instant case, the acceptance of respective employees to surrender all outstanding unvested options for cancellation in consideration of the ECC payments by Maxis gives rise to the “release” event which is the taxing point of a right to acquire shares under [S.25\(1A\)](#).
- [S.32\(1A\)](#) provides the method of ascertaining the gross income from an employment in respect of any right to acquire shares in a company.

The IRB appealed to the Court of Appeal on the High Court decision.

Issue:

Whether the ECC payment

- a) is ordinary cash remuneration falling under [S.13\(1\)\(a\)](#) of the Act, or
- b) is to release the employee of his right to acquire shares, and is gross income to which [S.25\(1A\)](#) and [S.32\(1A\)](#) of the Act applies.

Decision:

The appeal was allowed. The Court of Appeal was of the view that [S.32\(1A\)](#) means that the exercise, assignment, release or acquisition of the right to the shares relates to shares an employee is determined to be entitled to since in order for vesting to occur, the number of shares awarded/offered must be determined. The ECC exercise did not appear to be part of any such exercise. There was no vesting of any rights to shares. Hence, it was not made under the ESOS per se, but a collateral and separate exercise to relieve Maxis of its obligations under ESOS while the shares were not yet offered and therefore, remain unvested. The application of [S.25\(1A\)](#) and [S.32\(1A\)](#) therefore does not arise.

Consequently, there was no reason for judicial intervention by the High Court and the ruling of the DGIR dated 10/10/2008 was affirmed.

Members may view the [judgment](#) of Court of Appeal at the Official Website of the Office of the Chief Registrar of Federal Court of Malaysia.

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**IN THE COURT OF APPEAL, MALAYSIA
AT PUTRAJAYA**

[APPELLATE JURISDICTION]

CIVIL APPEAL NO: W-01-665-2010

Between

- 1. KETUA PENGARAH HASIL DALAM NEGERI**
- 2. LEMBAGA HASIL DALAM NEGERI MALAYSIA - APPELLANTS**

And

MAXIS COMMUNICATION BERHAD - RESPONDENT

**[Dalam Mahkamah Tinggi Malaya Di Kuala Lumpur
Dalam Wilayah Persekutuan, Malaysia
(Bahagian Rayuan dan Kuasa-Kuasa Khas)
Permohonan bagi Semakan Kehakiman No. R3-25-335-2008**

Between

Maxis Communication Berhad - Applicant

Dan

- 1. Ketua Pengarah Hasil Dalam Negeri**
- 2. Lembaga Hasil Dalam Negeri Malaysia - Respondents**

CORAM:

**Syed Ahmad Helmy Syed Ahmad, JCA
Abdul Wahab Patail, JCA
Abdul Aziz Abd Rahim, JCA**

Date of Judgment: 14th August 2012

JUDGMENT OF THE COURT

[1] Having heard the submissions of the parties, this Court allowed the appeal with costs fixed at RM15,000.00. The order of the High Court was set aside and the ruling of the Director-General of Inland Revenue dated 10/10/2008 was affirmed.

[2] The appeal was against the order of the High Court which allowed the Respondent's application for judicial review filed under Order 53 rule 2 of the Rules of the High Court 1980 and setting aside the ruling by the Director-General that:

- i. Pursuant to Clause 7.1.1 of ESOS Scheme Byelaws, the options only vested from the date of the first anniversary that the employee is offered the option and not from the date of grant;
- ii. Consequently, an employee does not have any rights in an unvested option before the date of the first anniversary and the requirement that there be a "...right to acquire shares in a company..." in s 25(1 A) of the Act is not fulfilled;

- iii. From a legal standpoint, before the amendment to ss 25(1) and 32(1) of the Act, these un-amended provisions did not apply to IS because the ECC offered to the employees were not offered in their original form i.e. as shares and the price has been ascertained without reference to the material market value. It is further not subject to market risks as ordinary ESOS schemes are;
- iv. When Maxis employs Clause 10.1 of the ESOS Scheme Byelaws, Maxis substitutes the cancellation of the ESOS Scheme with an alternative consideration. In this instance, Maxis' employees are paid an alternative consideration in return for the cancellation of the ESOS Scheme. The alternative consideration is no longer in the form of shares which need to be valued, and to the contrary, it is the receipt of cash arising from employment; and
- v. Maxis' employees are not offered fresh share options as a consequence of the takeover and instead are paid a sum of money the value and timing of which is based

on the ESOS Scheme. Further, Maxis' employees do not have to pay anything to receive the said payment and this is different from the ordinary ESOS where an employee has to make payment to enforce the offer of shares given to him.

- [3] A brief description of the background is necessary in understanding the issue before the Court.

Background

- [4] There was in place a binding Maxis Employee Share Option Scheme (ESOS Scheme) offered by Maxis and accepted by its employees. When Binariang GSM Sdn Bhd takeover offer succeeded, Maxis could no longer honour its obligations under the ESOS Scheme. Maxis proposed and the employees accepted in lieu thereof an Equivalent Cash Consideration ("ECC"), the acceptance of which would relieve Maxis of its contractual obligations under the ESOS Scheme to offer shares to participating employees.

[5] The issue is whether:

- a) the ECC payment is ordinary cash remuneration to which section 13(1)(a) of the Income Tax Act 1967 (Revised 1971) applied, or
- b) the ECC payment to release the employee of his right to acquire shares and is gross income to which section 25(1A) and section 32(1A) of the Act applies.

[6] The argument for the Respondent is that the ECC payment was to relieve Maxis from having to honour its contractual obligation under the ESOS Scheme and was therefore not a salary or ordinary cash remuneration under s 13(1)(a) of the Act, but was, instead, a share based payment to which the special provisions on the right to acquire shares under ss 25(1A) and 32(1A) of the Act applies.

The Law

[7] Gross income of an employee in respect of gains or profits from an employment is defined in section 13 of the Act to include any wages, salary, remuneration, leave pay, fee. Commission,

bonus, gratuity, perquisite or allowance (whether in money or otherwise) in respect of having or exercising the employment.

[8] Section 25 concerns the basis period to which the gross income is related. Subsection (1A) provides that the gross income from an employment in respect of any right to acquire shares in a company of the kind to which paragraph 13(1)(a) applies, shall where the right is exercised, assigned, released or acquired in the relevant period be treated as gross income of the relevant person for that relevant period.

[9] Section 32(1A) sets out the special provisions for determination of the amount to be included in his gross income and the relevant period. It was provided that the amount shall be the market value of the shares

- a) on the date of; or
- b) on the date specified for; or
- c) the first day of the period specified for
the exercise, assignment, release or acquisition of the right
to the shares.

[10] Paragraph (b) of subsection (1A) what is meant by the term market value of the shares.

[11] In our view, section 32(1A) means that the exercise, assignment, release or acquisition of the right to the shares relates to shares an employee is determined to be entitled to since in order for vesting to occur the number of shares awarded or offered must be determined. The ECC exercise does not appear to be part of any such an exercise. Under the ECC, Maxis was in fact to be relieved of the contractual obligation to make such award or offer. There was no vesting of any shares the rights to which may be exercised, assigned, released or acquired. It was not, therefore, made under the ESOS Scheme *per se* but was a collateral and separate exercise to relieve Maxis of the ESOS Scheme obligation while the shares were not yet awarded or offered and was therefore unvested. Following **Palm Oil Research and Development Board Malaysia & Anor v Premium Vegetables Oils Sdn Bhd [2004] 2 CLJ 265 CA** as to interpretation of a taxing statute, and looking fairly at the language used, it is true there was a binding contractual obligation giving the employees a right to acquire shares under the terms of the Scheme, but the actual entitlements remained

to be determined, e.g. the passage of time the employee remained in employment. There was no right to specific shares yet. They remained unvested. The ECC was dealing with these unvested shares. We conclude that the application of Sections 25(1A) and 32(1A) does not arise.

[12] It is evident that the High Court has misconstrued the law and the Director-General of Inland Revenue had not. There was no reason for judicial intervention by the High Court.

[13] For the foregoing reasons, we made the decision first above set out.

sgd.

**(DATUK ABDUL WAHAB BIN PATAIL)
JUDGE
Court of Appeal, Malaysia
Putrajaya**

Dated: 20th February 2013

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